[South Carolina Law Review](https://scholarcommons.sc.edu/sclr)

Volume 39 | Issue 3 Article 7

Spring 1988

The D & O Insurance Crisis: Darkness at the End of the Tunnel

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THE D&O INSURANCE CRISIS: DARKNESS AT THE END OF THE TUNNEL

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I. THE D&O CRISIS

In 1984 a director of a Delaware corporation occupied a prestigious position, well-protected from personal liability arising from actions one might take as a director. He was shielded

initially by the business judgment rule, by which courts gave deference to the policy and business management decisions of businessmen.[1] He probably was indemnified by his corporation for the expense of defending and paying settlements or judgments in actions brought against him in his capacity as a director.[2] In addition, the corporation protected him from liability not covered by indemnification by purchasing director and officer ("D&O") liability insurance.[3] This insurance was comprehensive and relatively cheap. In 1984 the typical D&O policy for a medium-sized corporation ($100-250 million in corporate assets) cost $19,339,[4] provided $16.6 million of coverage,[5] and carried a total deductible of $44,626.[6]

Since 1984, that has changed. While most states have enacted statutes allowing corporations to eliminate a director's personal liability to the corporation or its shareholders for monetary damages resulting from the director's gross negligence,[7] and several states have expanded their corporate indemnification statutes,[8] a corporate directorship has become nonetheless

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1. *See generally* D. BLOCK, N. BARTON, & S. RADIN, THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS AND OFFICERS (1987) [hereinafter BLOCK].

2. *See infra* text accompanying notes 76-118.

3. In 1984 more than 90% of companies with assets in excess of $100 million had D&O insurance. THE WYATT COMPANY, DIRECTORS AND OFFICERS AND FIDUCIARY LIABILITY SURVEY 49 (1987) [hereinafter WYATT SURVEY]. (References to the *Wyatt Survey* throughout this note refer to the portion of the survey related to U.S. corporations.)

4. The premium cost of $19,339 to a $150-250 million company in 1984 is based on an average policy limit of $16.6 million, WYATT SURVEY, *supra* note 3, at 57, and a premium cost on a $10 million policy of $11,650. *Id.* at 97. ($11,650 x 1.66 = $19,339).

These figures and others that follow are cited primarily for comparison purposes, and occasionally, when gaps in the *Wyatt Survey* are apparent, a rational, but unscientific, extrapolation is necessary to derive the appropriate figure. Also, the numbers used are averages and cannot account for the specific insurance risks—or lack thereof—that any particular company might have. In addition, although the *Wyatt Survey* is the best resource currently available for evaluating D&O insurance, it is, nonetheless, only a survey, and as such reflects merely the responses of participating companies.

5. WYATT SURVEY, *supra* note 3, at 57.

6. The deductible in a D&O policy typically is divided between the personal coverage side of the policy and the corporate reimbursement side. *See infra* text accompanying notes 129-34. In the case of a medium sized corporation the aggregate personal deductible (*i.e.*, the maximum personal deductible for claims against all directors or officers) was approximately $11,304. WYATT SURVEY, *supra* note 3, at 81. The corporate reimbursement deductible was $33,322. *Id.* at 82.

7. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986); Hanks, *Director Liability: 35 States Act To Limit Liability of Directors*, INSIGHTS, Jan. 1988, at 20.

8. *See, e.g.*, DEL. CODE ANN. tit. 8, § 145(b) (Supp. 1986) (expanding indemnification statute to comport with the *Aronson* gross negligence standard); MO. ANN. STAT. §

"The Job Nobody Wants"[9] because D&O insurance has become more difficult to acquire,[10] and its cost has skyrocketed. The $19,339 policy mentioned above would now cost $243,011.[11] Instead of a $44,626 deductible, it would now carry a total deductible of $295,195.[12] Despite these gargantuan increases in premiums and deductibles, the policy would likely exclude coverage of liability arising from pending or prior litigation, environmental damage, failure to maintain insurance, and the payment of bribes or kickbacks; and, although less likely, the policy might also contain exclusions relating to such critical matters as mergers, tender offers, and securities transactions.[13] This is a staggering change to occur in three years.[14]

This Note begins with a brief description of the events contributing to this rapid transformation and then evaluates the current status of and relationship between the three primary

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351.355(2) (Vernon Supp. 1988) (allowing indemnification of settlements paid in shareholder derivative suits); N.Y. BUS. CORP. LAW § 721 (McKinney Supp. 1988) (making statutory indemnification not exclusive of indemnification that might be provided for directors and officers in certificate of incorporation or bylaws).

9. Baum, *The Job Nobody Wants*, BUS. WEEK, Sept. 8, 1986, at 56; *see also Business Struggles to Adapt as Insurance Crisis Spreads*, WALL ST. J., Jan. 21, 1986, at 31, col. 5.

10. The *Wyatt Survey* reports that 51.5% of the responding companies in its 1987 survey experienced difficulty securing coverage. WYATT SURVEY, *supra*, note 3, at 161. There are indications, however, that the "availability crisis," not to be confused with the "cost of premium crisis," has abated somewhat. *See id*; Slater, *Companies Beginning To See Signs That the Insurance Crisis Is Easing*, WALL ST. J., Aug. 26, 1986, at 27, col. 4; *cf.* Hilder, *Risky Business: Liability Insurance Is Difficult To Find Now for Directors, Officers*, WALL ST. J., July 10, 1985, at 1, col. 6.

11. This figure is based on the 1987 average policy limit of $12.5 million, WYATT SURVEY, *supra* note 3, at 57, that would cost $125,386 (The cost of a $10 million policy is $100,309. *Id.* at 97. So by multiplying $100,309 by 1.25 one should get at least an approximation of what a $12.5 million primary policy would cost), plus an excess premium of $117,625. This excess premium must be added to compensate for the drop in the primary coverage to $12.5 million. The 1984 average policy limit was $16.6 million, so the $4.1 million difference ($16.6 - $12.5 = $4.1) must be paid at the "excess premium" rate, which in 1987 was $28,689 per million. *Id.* at 103. ($28,689 x $4.1 = $117,625). By comparison, the 1984 excess premium cost was $948 per million. *Id.*

12. The average of the personal aggregate deductibles for these medium sized companies in 1987 was $30,568, WYATT SURVEY, *supra* note 3, at 81, and the corporate reimbursement deductible was $264,627. *Id.* at 82. ($30,568 + $264,627 = $295,195).

13. *Id.* at 68, 69. All of the exclusions listed here are in addition to the "standard" D&O exclusions. *See infra* notes 149-52 and accompanying text.

14. The figures discussed in the text for medium sized companies (*i.e.*, 100 to 250 million in assets) are exhibited below for smaller (*i.e.*, $25 million in assets) and larger (*i.e.*, $2 billion in assets) companies.

sources of director protection—limited liability statutes, indemnification statutes, and D&O insurance. Following this discussion is an attempt to rationalize the apparent anomaly discussed above, to determine why rates continue to be inflated, and to speculate about the prospects for D&O rates in the future.

II. BACKGROUND

In 1968 Professor Joseph W. Bishop, Jr. stated that "[t]he search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncompli-

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Smaller Corporations	1984	1987
Coverage	$6.1 million	$6.1 million
Premium	$8,877	$60,318
Deductible	$30,066	$130,375
Larger Corporations	1984	1987
Coverage	$48.6 million	$48.6 million
Premium	$94,996	$2,296,824
Deductible	$127,092	$1,527,780

These figures, subject to the limitations of the *Wyatt Survey* set forth in *supra* note 4, were derived as follows:

A. Smaller Corporations
1. Policy Limit (coverage)
   a. 1984: $6.1 million, WYATT SURVEY, *supra* note 3, at 56.
   b. 1987: For comparison purposes the same policy limit ($6.1 million) is being used here for the 1987 figures. The average policy limit, however, had in fact dropped to $5.0 million.
2. Premium
   a. 1984: A $5 million policy cost $7,276, *id.* at 97, so a $6.1 million policy cost approximately $8,877 (1.22 x $7,276 = $8,877).
   b. 1987: The 1987 policy limit shrank to an average of $5 million. *Id.* at 57. Primary coverage for $5 million was $30,530. *Id.* at 97. Excess coverage for the additional $1.1 million of coverage (6.1 - 5.0 = 1.1) at a rate of $27,080 per million, *id.* at 103, was $29,788. So the total premium was $60,318 ($30,530 + $29,788 = $60,318).
3. Deductible
   a. 1984
      i. Aggregate personal deductible: $10,084, *id.* at 81.
      ii. Corporate reimbursement deductible: $19,982, *id.* at 82.
      iii. Total: $30,066
   b. 1987
      i. Aggregate personal deductible: $19,417, *id.* at 81.
      ii. Corporate reimbursement deductible: $110,958, *id.* at 82.
      iii. Total: $130,375

cated by self-dealing is a search for a very small number of needles in a very large haystack."[15] He found "little precedent for liability even for the kind of Merovingian supineness for which directors were held liable in the old bank cases."[16] By 1988, however, several enormous needles have effectively eradicated the haystack of prior case law, and a plethora of litigation, spawned by the frenetic merger and acquisition activity of the late seventies and early eighties, has altered the corporate landscape.

The most notable, and noted,[17] case in which directors and officers have been found liable for a breach of the duty of care is *Smith v. Van Gorkom*.[18] The case is subject to extraordinarily

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B. Larger Corporations
1. Policy Limit
a. 1984: $48.6 million, *id.* at 57.
b. 1987: For comparison purposes the same policy limit ($48.6 million) is being used here for the 1987 figures. The average policy limit, however, had in fact dropped to $41.3 million.
2. Premium
a. 1984: A $25 million policy cost $48,866, *id.* at 98, so a $48.6 million policy cost $94,996 (1.944 x $48,866). Obviously, this is a very rough method of estimation, and is useful only for comparison purposes.
b. 1987: The 1987 policy limit shrank to an average of $41.3 million. *Id.* at 57. Primary coverage for $41.3 million was roughly $2,130,837 (based on $1,289,853 for $25 million of coverage, *id.* at 98). Excess coverage for the additional $7.3 million (48.6 - 41.3 = 7.3) at a rate of $22,738 per million, *id.* at 103, was $165,987. So the total premium was $2,296,824 (2,130,837 + 165,987 = 2,296,824).
3. Deductible
a. 1984
i. Aggregate personal deductible: $16,513, *id.* at 81.
ii. Corporate reimbursement deductible: $110,579, *id.* at 82.
iii. Total: $127,092.
b. 1987
i. Aggregate personal deductible: $47,974, *id.* at 81.
ii. Corporate reimbursement deductible: $1,479,806, *id.* at 82.
iii. Total: $1,527,780.

15. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968).
16. *Id.* at 1101.
17. *See, e.g.*, Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985); Kirk, *The Trans Union Case: Is It Business as Usual?*, 24 AM. BUS. L.J. 467 (1986-87). A collection of articles related to the *Van Gorkom* decision can be found at 10 DEL. J. CORP. L. 405-568 (1985).
18. 488 A.2d 858 (1985).

divergent characterizations, depending upon which facts one chooses to emphasize. The following is a very brief synopsis of the facts of the case[19] and a discussion of the opposing viewpoints regarding the propriety of the court's decision.

In *Van Gorkom* the court found nine directors and officers of the Trans Union Corporation personally liable for approving the sale of the corporation at less than its intrinsic value.[20] The notion to sell the corporation apparently originated with the company's chairman, Jerome Van Gorkom, who was a sizable shareholder of Trans Union and who was approaching sixty-five years of age and mandatory retirement. After consulting briefly with Trans Union's chief financial officer about the feasibility of a leveraged buyout of Trans Union in the range of $50-$60 per share, Van Gorkom met privately with corporate takeover specialist Jay Pritzker to discuss the outright sale[21] of the company. With virtually no negotiation or bargaining, Pritzker agreed to buy the company at Van Gorkom's suggested price of $55 per share. Van Gorkom agreed to allow Pritzker to purchase one million shares of treasury stock at $38 per share and acceded to Pritzker's demand that the deal be consummated over the course of the upcoming weekend.

Van Gorkom called a special meeting of the Trans Union board to consider the proposed sale. Nine of the ten directors, including five "outside"[22] directors, were present at the meeting and approved the sale of the company at $55 per share, based upon a twenty minute oral presentation by Van Gorkom, a supporting statement by the company's president, and a discussion among the board members lasting less than two hours.

Judge McNeilly, in dissent, characterized the Trans Union board of directors as a highly qualified and informed group of

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19. For a complete discussion of the facts upon which this synopsis is based, see *id.* at 864-70.

20. The Delaware Supreme Court found the directors and officers liable for gross negligence. *Id.* at 873-74. The question whether the amount received in the sale of Trans Union was less than its intrinsic value was remanded to the court of chancery. *Id.* at 893. Following the supreme court decision the case was settled with the approval of the court of chancery for $23,500,000. R. HAMILTON, CORPORATIONS, 679 (3d ed. 1986).

21. The actual transaction was a merger, but the effect of the deal, for present purposes, was as if the company were sold.

22. For a relevant discussion of outside directors, see Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25 (1987).

"professional business men." Collectively, the five "inside" directors had worked for the company for 116 years and had served for a total of 68 years as directors. Similarly, the five "outside" directors represented 78 years of experience as chief executive officers and 53 years of service as Trans Union directors. According to Judge McNeilly, "[t]hese men knew Trans Union like the backs of their hands and were more than well qualified to make on the spot informed business judgments concerning the affairs of Trans Union, including a 100% sale of the corporation."[23] In addition to the approval of the transaction by the board of directors, the plan was overwhelmingly accepted by the Trans Union shareholders four and a half months later. During the interim the board was able to receive bids from other parties but could not actively solicit bids.

The effectiveness of the above procedure in acquiring a fair price for the company is subject to debate. Van Gorkom and the board of directors failed to make a probing study of the $55 price. The Company's chief financial officer, in fact, opined that the price was too low.[24] Neither Van Gorkom nor any member of the board of directors actually read the Pritzker agreement before approving it. The company was severely limited by this agreement and subsequent amendments thereto in its ability to solicit higher bids, and Van Gorkom apparently even rebuffed a legitimate attempt by Kohlberg, Kravis, Roberts & Co. to top the Pritzker bid.[25] The only other serious attempt to exceed the $55 bid was made by General Electric Credit Corporation and was thwarted by the nature of the agreement with Pritzker.[26] The shareholders were less informed than the directors with respect to the appropriateness of the $55 price,[27] so their approval provided little empirical support for the price paid. Also, the court focused on the board's diligence prior to their approval of the bid, so the shareholders' approval, coming months after the board's action, was of limited consequence.

Much of the commentary generated by the case has been

23. 488 A.2d at 5, 895 (McNeilly, J., dissenting).
24. *Id.* at 867, n.6.
25. *Id.* at 882-85.
26. *Id.* at 870, 885.
27. The Delaware Supreme Court held that the directors failed to disclose to the shareholders all material information such as a reasonable stockholder would consider important in deciding whether to approve the Pritzker bid. *Id.* at 893.

negative. One prominent commentator described the decision as "surely one of the worst decisions in the history of corporate law."[28] The critics have assailed the Delaware court for imposing staggering personal liability on the Trans Union directors in a case involving no fraud or self dealing and in which the court refused to evaluate the fairness of the price received for the company.[29] The court focused its attention solely on the decision making process of the board, effectively ignoring the $55 per share price received for the company, a price that represented a 48% premium over the market price of the stock at the time.[30]

Other commentators, however, characterize the case as an unremarkable application of existing Delaware law.[31] They contend that the court was compelled to reach its ultimate result, based upon the egregious factual context of the case.

Whether the members of the board of directors of Trans Union under the circumstances of this case were guilty of gross negligence is a question that could be discussed at great length. For the purpose of this Note, however, one need only recognize that the court, rightly or wrongly, imposed liability for monetary damages on individual defendants for their decision to sell a company with which they were intimately familiar for a price that substantially exceeded the market price of the company's stock. The directors' ultimate liability of $23.5 million understandably sent shockwaves through both the insurance industry and the executive suite.[32]

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28. Fischel, *supra* note 17, at 1455.

29. For reviews critical of the decision, see *id.*; Baldo, *Delaware Rocks the boat*, FORBES, Apr. 8, 1985, at 126; Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1 (1985).

30. 488 A.2d at 869 n.9. The trial court stated:

> [T]he merger price offered to the stockholders of Trans Union represented a premium of 62% over the average of the high and low prices at which Trans Union stock had traded in 1980, a premium of 48% over the last closing price, and a premium of 39% over the highest price at which the stock of Trans Union had traded any time during the prior six years.

Id.

31. Schwartz & Wiles, *Trans Union: Neither "New" Law Nor "Bad" Law*, 10 DEL. J. CORP. L. 429, 430 (1985); *see also* Prickett, *An Explanation of Trans Union to "Henny Penny" and Her Friends*, 10 DEL. J. CORP. L. 451 (1985) (written by attorney for the plaintiffs in *Smith v. Van Gorkom*).

32. *Van Gorkom* was not the only case of its kind. *See, e.g.*, Fox v. The Chase Manhattan Corp., No. 8192-85, slip op. (Del. Ch. Jan. 9, 1986) (court approved settlement of $32.5 million); National Union Fire Ins. Co. v. Seafirst Corp., No. C85-396R (W.D. Wash.

Even before the Delaware Supreme Court issued the *Van Gorkom* opinion, several D&O insurers had withdrawn from the market.[33] Following *Van Gorkom*, the remaining carriers lowered their policy limits, raised premiums and deductibles, and expanded exclusionary clauses. The crisis engendered by these changes threatened to drive talented people from the boardroom, and fear of this result led a majority of the states to pass legislation attempting to mitigate the impact of *Van Gorkom*.[34] The resulting "limited liability statutes" are the first of the three essential sources of director protection evaluated in this Note.

III. Limited Liability Statutes

From at least as early as 1967, Delaware has favored officers and directors over shareholders in the struggle for corporate control.[35] The state derives substantial revenues from this bias.[36] It was therefore predictable, but also ironic, that the state which started the liability furor by handing down the *Van Gorkom* decision was the first to enact legislation seeking to reduce its effect. Following a year of intensive study and debate,[37] the Delaware legislature passed a limited liability statute[38] in June 1986, and it has become the prototype that other states have emulated. The Delaware statute is the best example of the statutes existing in most other states. The following sections describe the

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Dec. 19, 1985) ($110 million settlement), *cited in* Galante, *The D&O Crisis: Corporate Boardroom Woes Grow*, Nat'l L.J., Aug. 4, 1986, at 29, col.3.

33. *See* Wyatt Survey, *supra* note 3, at 106.

34. Although there is no express indication that the limited liability statutes are the direct product of the *Van Gorkom* decision, such presumption readily obtains. *See, e.g.*, Hanks, *supra* note 7, at 20; Hanks, *Update on State Legislative Responses to the Director Liability Crisis*, 21 Sec. & Com. Reg. 23 (Feb. 10, 1988).

35. *See generally* Seligman, *A Brief History of Delaware's General Corporation Law of 1899*, 1 Del. J. Corp. Law 249 (1976). The chief critic of the apparent bias in Delaware law has been Professor William Cary. *See, e.g.*, Cary, *Federalism and Corporate Law, Reflections Upon Delaware*, 83 Yale L.J. 663 (1974). *But see* Arsht, *Reply to Professor Cary*, 31 Bus. Law. 1113 (1976).

36. Cary, *supra* note 35, at 663; Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. Econ. & Org. 225, 240 (1985).

37. *See* Balotti & Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 Del. J. Corp. L. 5, 9 (1987); Note, *Delaware's Limit on Director Liability: How the Market for Incorporation Shapes Corporate Law*, 10 Harv. J.L. & Pub. Pol'y 665, 685-86 (1987).

38. Del. Code Ann. tit. 8, § 102(b)(7) (Supp. 1986).

Delaware law and then discuss the differences found in the liability statutes of other states.

A. *The Delaware Limited Liability Statute*

The Delaware statute is an enabling act requiring a decision by corporate shareholders before its safeguards apply to the corporation's directors. The statute provides:

> (b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:
>
> . . . .
>
> (7) 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 § 174 of this title;[39] 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 paragraph to a director shall also be deemed to refer to a member of the governing body of a corporation which is not authorized to issue capital stock.[40]

Several opinions exist regarding the underlying purpose of and justification for the Delaware statute.[41] Some criticize the law as continuing Delaware's effort to profit from a corporate

39. Section 174 relates to the liability of directors for unlawful payment of dividends or for unlawful stock purchases or redemptions. It also applies to the exoneration of a director who dissents from or is absent at the time of such unlawful act, contribution among directors, and directorial entitlement to subrogation to the rights of the corporation against those receiving the benefit of the above dividend, purchase, or redemption if such person had knowledge of the illegality. DEL. CODE ANN. tit. 8, § 174 (1983).

40. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986).

41. For a discussion of the various schools of thought on the justification for section 102(b)(7), see Note, *supra* note 37, at 670-81.

code that is notoriously favorable to management.[42] The effectiveness of this policy, to the extent it exists, is indicated by the twenty-eight percent rise in the number of new incorporations in Delaware[43] and the $1.4 million increase in proceeds from incorporation fees received in the six months following enactment of the amendment.[44]

Others respond, however, that, even if the Delaware corporate code benefits the state financially, and even though it is forged by a "tight little club"[45] of pro-management constituencies in Delaware, nonetheless the freedom given to directors of Delaware corporations by statutes such as section 102(b)(7) benefits the shareholders and is reflected in the price of the company's stock.[46] The purpose of the statute, they assert, is to protect the entrepreneurial spirit in the corporate boardroom. The Council of the Corporation Law Section of the Delaware State Bar Association, which proposed the legislation, agrees with the latter view above that the statute addresses the need for unfettered decision making at the top.[47]

The statute apparently would change the result in *Van Gorkom*, which was a shareholder derivative suit for monetary damages alleging a breach of the directors' duty of care, but not

42. *See, e.g.*, Cary, *supra* note 35.

43. Franklin, *D&O Dilemma: N.Y., Other States Grapple With Liability Issue*, N.Y.L.J., Jan. 29, 1987, at 5, col. 3.

44. *Id.* at 6, col. 2.

45. Cary, *supra* note 35, at 692.

46. *See* Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U.L. Rev. 913, 916-20 (1982).

47. The synopsis delivered by the Council with the proposed legislation described its purpose as follows:

> Section 102(b)(7) and the amendments to Section 145 represent a legislative response to recent changes in the market for directors' liability insurance. Such insurance has become a relatively standard condition of employment for directors. Recent changes in that market, including the unavailability of the traditional policies (and, in many cases, the unavailability of any type of policy from the traditional insurance carriers) have threatened the quality and stability of the governance of Delaware corporations because directors have become unwilling, in many instances, to serve without the protection which such insurance provides and, in other instances, may be deterred by the unavailability of insurance from making entrepreneurial decisions. The amendments are intended to allow Delaware corporations to provide substitute protection in various forms, to their directors and to limit director liability under certain circumstances.

Synopsis, S.533, 133d Gen. Assembly § 2 (1986).

alleging bad faith or self dealing. But as one trio of commentators has described the statute, it "is not, and was not intended to be, a panacea for directors."[48] It is, in fact, narrowly focused.

First, as mentioned above, the application of the statute is optional. Even in the *Van Gorkom* context the statute would be ineffectual if the shareholders did not vote to include in it the certificate of incorporation. Furthermore, this shareholder action need not fully eliminate directorial liability. The shareholders may choose merely to limit such liability to a specific amount of money. Second, the statute is prospective only. The shareholder vote must precede the relevant directorial conduct. Third, because the limitation of liability is determined only by corporate shareholders and not the legislature, the statute's protection extends only to suits brought by or in behalf of the corporation. Third party actions are unaffected. Fourth, director misconduct constituting breach of the duty of loyalty, acts or omissions not in good faith, intentional misconduct, knowing violation of law, or improper personal benefit, is expressly excluded from the protection of the statute. Fifth, the statute relates only to actions for monetary damages. It does not extend to actions for injunctive relief or rescission, nor does it cover attorneys' fees and other costs of litigation. Sixth, the statute protects only directors. It is of no use to corporate officers. This factor substantially limits the statute's protection of inside directors, who frequently implement policy as officers and determine policy as directors. Their actions as officers are not shielded by the statute. Accordingly, the limited liability statute affords less protection to directors of the typical closely held corporation, in which the principals frequently serve as both directors and officers, than it does to directors of publicly held corporations.

The statute, therefore, by its own language, is significantly restricted. Perhaps more critical than these readily apparent limitations, however, will be the judicial determination of the scope of section 102(b)(7). The statutory language refers to the "fiduciary duty" of corporate directors. This duty includes both the duty of loyalty, which precludes a director from realizing an

48. Veasey, Finkelstein & Bigler, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399, 403 (1987) [hereinafter Veasey].

undue personal benefit at the corporation's expense,[49] and the duty of care in the performance of directorial duties.[50] Section 102(b)(7) expressly excludes limitation of liability in cases in which a director breaches the duty of loyalty. Therefore, the "fiduciary duty" mentioned in the statute means only the duty of care. The statute is also inapplicable if the director's acts or omissions are intentional, in knowing violation of the law, or not in good faith. On the lower end of the spectrum, the common law protects directors from liability in cases of mere negligence.[51] Therefore, the focus of section 102(b)(7) is narrowed to the amorphous realm of culpability that lies between negligence and intentional wrongdoing, and which is typically characterized as "gross negligence" or "recklessness."

There is general agreement that the statute was written to protect directors from liability for gross negligence.[52] The statute was a direct response to the *Van Gorkom* opinion.[53] The court in *Van Gorkom* affirmed earlier decisions establishing gross negligence as the standard of care for directors, holding that the defendant-directors in that case had breached the standard. Therefore, one can reasonably interpret the statutory phrase "breach of fiduciary duty" to refer to cases of gross negligence.

It is less certain that acts deemed "reckless" are afforded the same protection. Most courts view reckless conduct as more offensive than gross negligence.[54] Obviously intentional wrongdoing, illegality, and acts of bad faith are also more egregious than gross negligence. The Delaware legislature, however, did not include recklessness with illegal conduct, intentional wrongdoing, and acts or omissions not in good faith when specifying express exclusions from the statute. Practitioners, commentators, and board members, therefore, are left to speculate about

49. *See generally* Committee on Corporate Laws, Section of Corporation, Banking & Business Law, American Bar Association, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1599 (1978).

50. *See generally id.* at 1600; *see also* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); BLOCK, *supra* note 1, at 23.

51. 473 A.2d at 812 (clarifying the standard of care required of a director under the rubric "gross negligence").

52. *See, e.g.*, Veasey, *supra* note 48, at 402.

53. *See supra* note 27.

54. W. PROSSER, D. DOBBS, R. KEETON, & D. OWEN, PROSSER AND KEETON ON THE LAW OF TORTS § 34 (5th ed. 1984).

whether recklessness is bound up in the phrase "breach of fiduciary duty."[55]

J. Brad Wiggins of the Securities and Exchange Commission contends that the apparently intentional omission of recklessness[56] from the statutory exclusions should allow a corporation to limit a director's liability for reckless inattention to the duty of care.[57] Other commentators indicate, however, that such an allowance depends upon the characterization of a given act by the court. The authors of one recent article remarked:

> To the extent recklessness involves conscious disregard of a known risk, it could be argued that such an approach is one not taken in good faith and thus would not be a liability subject to limitation under the new statute. On the other hand, to the extent recklessness only involves sustained inattention to duty, it could be labeled "grossly negligent" and thus any resulting liability would be subject to limitation.[58]

In addition to these questions regarding the judicial application of the duty of care standard, there is some question whether courts might begin to evaluate cases with a new, broader application of the duty of loyalty. One prominent attorney and commentator has predicted that because of the Delaware statute "many more cases will be brought under the duty of loyalty theory,"[59] and some have asserted that the Delaware courts are already using the term "duty of care" less freely in order to avoid the effect of the statute.[60] While these types of predictions and interpretations are subject to challenge, they, nonetheless, expose another potential limitation to the Delaware statute and,

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55. The problem is perhaps exacerbated by the failure of the Delaware Code to articulate a standard of care for directors. *Cf*, REV. MODEL BUSINESS CORP. ACT § 8.30 (1984) (providing that a director shall discharge his duties "(1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in the best interests of the corporation").

56. *Cf.* IND. CODE ANN. § 23-1-35-1(e)(2) (Burns Supp. 1987) (express requirement of director's willful misconduct or recklessness).

57. Wiggins, *Delaware's D&O Liability Law: A "Windfall" for Directors*, LEGAL TIMES, Aug. 18, 1986, at 11. Note the misnomer, however, in the above title. The Delaware law, applicable only to directors, is not, in reality, a "D&O" law.

58. Veasey, *supra* note 48, at 403.

59. Franklin, *supra* note 43, at 6, col. 3 (quoting Joseph Hinsey); *see also* Hanks, *supra* note 7, at 25 n.6.

60. Veasey, Finkelstein & Bigler, *Responses to the D&O Insurance Crisis*, 19 REV. SEC. & COM. REG. 263 (1986).

therefore, contribute to the continued high cost of D&O insurance.

B. Variations on the Delaware Model

As of January 1988 thirty-five states had adopted a limited liability statute.[61] Most states' enactments parallel the Delaware statute, allowing shareholders to decide whether to limit directorial liability.[62] In some states, however, the statutory protections exceed those allowed in Delaware.

One method of enhancing a director's protection is to loosen the standard of liability by requiring a plaintiff to submit proof of more than a director's simple negligence. Colorado, Florida, Indiana, Ohio, and Wisconsin have adopted statutes changing the standard of liability, and, not surprisingly, the Model Act of the National Association of Corporate Directors has a similar provision.[63] These statutes all require some degree of willfulness or recklessness. Indiana's statute, for example, requires a showing of willful misconduct or recklessness,[64] and the Ohio law predicates liability upon proof of "deliberate intent to cause injury" or "reckless disregard for the best interests of the corporation."[65]

Another method of protecting directors is to expand the criteria directors may properly consider in reaching their decisions. Previously the only legitimate criterion to be considered was the financial interest of the shareholders.[66] Some recently enacted liability statutes, however, allow directors to consider the interests of the corporation's employees, suppliers, creditors, and customers. Others allow directors to base their decisions on the

61. Hanks, *supra* note 7, at 20.

62. The states with what have been referred to as "Charter Opt-In" statutes are as follows: Arizona, Arkansas, California, Colorado, Delaware, Georgia, Iowa, Kansas, Massachusetts, Michigan, Minnesota, Montana, Nevada, New Jersey, New Mexico, New York, North Carolina, Oklahoma, Oregon, Pennsylvania, South Dakota, Texas, Utah, Washington, and Wyoming.

63. MODEL STATUTE STANDARD OF CONDUCT (National Ass'n of Corp. Directors 1973), *reprinted in* DIRECTOR'S MONTHLY, May 1987, at 2.

64. IND. CODE ANN. § 23-1-35-1(e)(2) (Burns Supp. 1987). This statute, unlike most limited liability statutes, applies to third party suits as well as derivative suits and relates to equitable relief as well as damages.

65. OHIO REV. CODE ANN. § 1701.59(D) (Anderson Supp. 1987).

66. *See, e.g.*, Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919).

state of the national economy, societal considerations, and the long-term interests of the corporation.[67] Perhaps the most significant variation of the Delaware statute is a Virginia law that limits the amount of money damages recoverable from a director or officer in shareholder derivative suits.[68] The Virginia statute limits liability for a single transaction, occurrence, or course of conduct to the greater of $100,000 or the cash compensation received by the director or officer in the twelve months preceding the alleged improper act or omission.[69] Unlike the Delaware statute, the Virginia law applies without shareholder action (shareholders can reduce the liability cap, but cannot increase it), and the only statutory exclusions are for willful misconduct or knowing violation of criminal or securities laws. Whether the Virginia law can withstand constitutional scrutiny is debatable,[70] but it is clearly the strongest legislative effort to date for the protection of directors and indicates widespread concern about the D&O liability crisis.

The South Carolina legislature recently passed a statute allowing some corporations to limit the liability of their directors for breaches of "fiduciary duty," but unlike the Delaware statute, the South Carolina act prohibits companies from eliminating or limiting a director's liability for acts of gross negligence.[71] The *raison d'etre* of limited liability statutes has been to shield

67. The Pennsylvania statute, for example, states: "In discharging [their] duties . . . directors may, in considering the best interests of the corporation, consider the effects of any action upon employees, upon suppliers and customers of the corporation and upon communities in which officers or other establishments of the corporation are located, and all other pertinent factors." 42 PA. CONS. STAT. ANN. § 8363(b) (Purdon Supp. 1987).

Ohio specifically adds that directors may consider "[t]he economy of the state and nation" and "[t]he long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation." OHIO REV. CODE ANN. § 1701.59(E) (Anderson Supp. 1987).

68. VA. CODE ANN. § 13.1-692.1(A)(1) (Supp. 1987); *see also* King, *Director Protection Under Virginia Law*, 20 REV. SEC. & COM. REG. 129 (Aug. 1987).

69. The articles of incorporation or the bylaws (with shareholder approval) can contain a provision limiting the liability to zero if desired. VA. CODE ANN. § 13.1692.1(A)(1) (Supp. 1987).

70. *See* King, *supra* note 68, at 133 n.40 (citing Boyd v. Bulala, 647 F. Supp. 781 (W.D. Va. 1986), which held Virginia's cap on medical malpractice damages unconstitutional).

71. This provision is part of the new South Carolina Business Corporation Act, 1988 S.C. Acts 444, which will become effective on January 1, 1989. It will be codified as S.C. CODE ANN. § 33-2-402(e).

directorial acts of gross negligence. It is therefore difficult to discern the intent of the South Carolina legislature.

The South Carolina act, like its Delaware counterpart, uses the term "fiduciary duty," but the act then whittles away at the term until it is virtually meaningless. As the discussion above indicates, the term "fiduciary duty" means both the duty of loyalty and the duty of care.[72] The South Carolina statute prohibits corporations from limiting directors' liability for duty of loyalty violations. The common law protects directors from duty of care violations entailing negligence.[73] The South Carolina statute excludes duty of care violations that constitute intentional misconduct, acts or omissions not in good faith, or knowing violations of the law. This conforms with the Delaware pattern. The South Carolina legislation, however, adds an exclusion for acts of gross negligence. As a result, the only category of culpability neither excluded by the statute nor protected by the common law is recklessness. It seems extremely unlikely that the statute was drafted to protect directorial recklessness. As mentioned previously, most courts consider recklessness to be more reprehensible than gross negligence.[74] If not intended to address recklessness, however, the statute is apparently meaningless.[75]

IV. INDEMNIFICATION OF OFFICERS AND DIRECTORS

State statutes that allow, and in some circumstances require, a corporation to indemnify[76] a director or officer for costs

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72. *See supra* text accompanying notes 49-50.

73. *See supra* note 51.

74. *See supra*, note 54.

75. The statute is also subject to constitutional challenge as being violative of the equal protection clause of the fourteenth amendment. It allows only those corporations having securities registered with the Securities and Exchange Commission under § 12 of the Securities Exchange Act of 1934, corporations with gross assets in excess of $25 million, and corporations having more than 500 shareholders of any class of stock to "limit" director liability. Thus, the directors of many smaller corporations are excluded from the statute.

76. To "indemnify" is, *inter alia*, "to give security for the reimbursement of a person in case of an anticipated loss falling upon him." BLACK'S LAW DICTIONARY 692 (5th ed. 1979). An "indemnity" is defined as follows:

> A collateral contract or assurance, by which one person engages to secure another against an anticipated loss or to prevent him from being damnified by the legal consequences of an act or forbearance on the part of one of the parties or of some third person. [The] [t]erm pertains to liability for loss shifted

he incurs defending his corporate actions provide the second source of protection for corporate officers and directors. The following is a brief overview of the history of indemnification followed by a description of the Delaware statute, which is once again indicative of the type of statutes existing elsewhere.[77]

A. *Historical Overview*

The appropriateness of indemnification has been a subject of controversy and confusion since the early days of the twentieth century. It continues to arouse debate.[78] On the one hand, there is longstanding support for the notion that a corporate director or officer who is made to answer in court for good faith actions taken in his capacity as director or officer should receive financial support from the corporation to help defend the action. As early as 1906, for example, the court in *Figge v. Bergenthal*[79] stated that "if no case is made against defendants it is not improper or unjust that the corporation should pay for the defense of the action."[80]

This opinion was far from universal, however, and later judicial decisions required that, before an officer or director could be indemnified, the court must have concluded that the director's defense of the action provided a "benefit" to the corporation.[81] The zenith (or nadir, depending on one's perspective) of judicial efforts to deny indemnification was the 1933 case of *New York Dock Co. v. McCollom*.[82] In *McCollom*, the New York Supreme Court held that, because a derivative suit is brought on behalf of the corporation, it is impossible for a corporation to benefit from the defense of such suit. The court determined that corporations were not empowered to pay the legal costs of direc-

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from one person held legally responsible to another person.

Id.

77. *See* Veasey, *supra* note 48, at 404 n.14. *See generally* Pease, *Indemnification Under Section 145 of the Delaware General Corporation Law*, 3 DEL. J. CORP. L. 167 (1978).

78. *See, e.g.*, Pillai & Tractenberg, *Corporate Indemnification of Directors and Officers: Time for a Reappraisal*, 15 U. MICH. J.L. REF. 101 (1981).

79. 130 Wis. 594, 625, 109 N.W. 581, 592 (1906).

80. *Id.* at 625, 109 N.W.2d at 592 (1906).

81. *See, e.g.*, Griesse v. Lang, 37 Ohio App. 553, 175 N.E. 222 (1931); *see also* J. BISHOP, THE LAW OF CORPORATE OFFICERS AND DIRECTORS ¶ 5.03 (rev. ed. 1981).

82. 173 Misc. 106, 16 N.Y.S.2d 844 (Sup. Ct. 1939).

tors in derivative suits, even if the directors prevailed on the merits.[83]

Two years later, however, the New Jersey Court of Chancery brought the common law full circle by deciding that directors who were successful on the merits in shareholder derivative suits not only could be indemnified by the corporation but were "entitled" to indemnification.[84] The common law of indemnification had become, as Professor Bishop described it, "a welter of confusion, sadly deficient in that element of certainty so dear to the hearts of the corporate bar."[85] To remedy this situation, New York in 1941 passed the first indemnification statute.[86] Soon, all other states followed suit.[87]

The purpose of indemnification statutes, like the purpose of the liability statutes discussed above, is "to induce capable and responsible businessmen to accept positions in corporate management."[88] One commentator describes the statutes as efforts to "seek the middle ground between encouraging fiduciaries to violate their trust, and discouraging them from serving at all."[89] The drafters of the 1984 Revised Model Business Corporation Act (RMBCA) struck a similar chord when stating the goal of the RMBCA indemnification provisions:

> Indemnification provides financial protection by the corporation for its directors, officers, and employees against expenses and liabilities incurred by them in connection with proceedings based on an alleged breach of some duty in their service to or on behalf of the corporation. Today, when both the amount and the cost of litigation have skyrocketed, it would be difficult or impossible to persuade responsible persons to serve as directors if they were compelled to bear personally the cost of vindicating the propriety of their conduct in every instance in which it might be challenged. While reasonable people may differ as to what constitutes a meritorious case, almost all would agree

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83. *Id.* at 111-12, 16 N.Y.S.2d at 850.

84. Solimine v. Hollander, 129 N.J. Eq. 264, 19 A.2d 344 (N.J. Ch. 1941).

85. J. BISHOP, *supra* note 81, ¶ 6.01.

86. *Id.*, ¶ 6.02.

87. *See* BLOCK, *supra* note 1, at 383; W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS, § 19.04 (3d ed. 1978).

88. Merritt-Chapman & Scott Corp. v. Wolfson, 264 A.2d 358, 360 (Del. Super. Ct. 1970).

89. Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993, 1994 (1978).

that corporate directors should have some protection against personal risk and that the rule of *New York Dock Co. v. McCollum* [*sic*] . . . should as a matter of policy be overruled by statute.[90]

B. The Delaware Statute

The Delaware indemnification statute is probably the best example of the statutes currently existing in the various states.[91] It was the prototype for the 1967 version of the Model Business Corporation Act,[92] and at least twenty-five states have similar statutes.[93] The Model Act was revised in 1969, 1980, and again in 1984, but the original Delaware model, with slight variations, remains the statute most widely used.[94]

The first part of the Delaware statute, section 145(a),[95] is permissive only. Like the early indemnification statutes that sought to reverse the *McCollom* decision, section 145(a) grants corporations the authority to indemnify any person who is sued because of his status as a director, officer, employee, or agent, or because of his service at the request of the corporation as a director, officer, employee, or agent of another corporation. But the statute requires that the corporation take affirmative steps before such protection becomes effective.[96] Section 145(a) applies only to third-party actions instead of actions brought by or on behalf of the corporation. Accordingly, it allows payment of attorneys' fees, expenses, judgments, and settlements. The section covers both defendants and plaintiffs[97] in civil actions and defendants in criminal prosecutions. For a civil litigant to recover under section 145(a) he must have acted in good faith and in a manner he reasonably believed to be in or not opposed to

90. REV. MODEL BUSINESS CORP. ACT, Introductory Comment to Subchapter E of Chapter 8 (1984).

91. *See generally* Arsht, *Indemnification Under Section 145 of the Delaware General Corporation Law*, 3 DEL. J. CORP. L. 176 (1978).

92. J. BISHOP, *supra* note 81, ¶ 6.02 at 6-6; W. KNEPPER, *supra* note 87, § 19.07.

93. Veasey, *supra* note 48, at 404 n.14.

94. *Id.*; W. KNEPPER, *supra* note 87, § 19.07 (Supp. 1985).

95. DEL. CODE ANN. tit. 8, § 145(a) (1983).

96. *See infra* notes 109-10 and accompanying text for discussion of the steps a corporation must take to provide indemnification.

97. *Cf.* REV. MODEL BUSINESS CORP. ACT, §§ 8.51(a) & 8.50(6) (limiting coverage to defendants or respondents).

the best interests of the corporation. For a criminal defendant to be indemnified he must meet these same standards, and he must also have had no reasonable cause to believe that his conduct was unlawful.

Section 145(b),[98] like section 145(a), is merely an enabling statute, requiring corporate action to implement its provisions. But unlike the former section, it relates only to actions brought by or on behalf of the corporation; it does not apply to third-party lawsuits. As a result, the section is more narrow than section 145(a), permitting payment of only attorneys' fees and expenses. Corporate payment of settlements or judgments is not permitted. The reason for this limitation is grounded in the tautological character of a derivative suit and the inequity to shareholders that would result if a corporation were made to fund what is essentially its own judgment. The plaintiff in a derivative suit litigates on behalf of the corporation. If he is successful, the corporation receives the amount of the judgment, and section 145(b) simply recognizes the anomaly that would result if the corporation also paid some or all of that amount to the directors and officers.[99] Several states have enacted legislation that overlooks this anomaly and allows the payment of judgments and settlements in derivative suits,[100] but Delaware has yet to adopt such a policy.

The third section of the Delaware indemnification statute, unlike section 145(a) and (b), is not merely permissive, but establishes mandatory corporate indemnification for directors, officers, employees, and agents in certain situations. Section 145(c) provides that:

98. DEL. CODE ANN. tit. 8, § 145(b) (Supp. 1986).

99. The current reality of the D&O insurance crisis makes this reasoning less persuasive, even though it is at least superficially reasonable. The ultimate source of protection for a defendant-director who is forced to pay a settlement or judgment in a shareholder derivative suit is the personal reimbursement side of the corporation's D&O insurance policy. *See* chart, *infra* Part VI. The corporation does not pay these insurance claims directly, but it does pay the premiums for the policies, and premiums can no longer be considered de minimus corporate expenditures. The average premium for example, paid by a large corporation (over $2 billion in assets) in 1987 for a $25 million D&O policy was $1,783,296. WYATT SURVEY, *supra* note 3, at 96. Clearly, the corporation is paying substantial sums that are related to derivative suit settlements and judgments regardless of the inapplicability of the indemnification statute. Therefore, the argument that a corporation should not fund a derivative suit settlement or judgment by means of indemnification is not so forceful as perhaps it once was.

100. *See, e.g.*, LA. REV. STAT. ANN. § 12:83 (West Supp. 1987).

> To the extent that a director, officer, employee or agent of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) and (b) of this section, or in defense of any claim, issue or matter therein, he shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by him in connection therewith.[101]

This section differs from the RMBCA inasmuch as it requires corporate indemnification "to the extent" the litigant is "successful."[102] The RMBCA requires that the defendant be "wholly successful,"[103] which means that the entire proceeding must be "disposed of on a basis which involves a finding of nonliability."[104] Therefore, under the Delaware statute, a criminal defendant who successfully defends several counts against him, but who is convicted on one count, could require partial indemnification.[105] Under the RMBCA he would be entitled to no indemnification.

Section 145(c) requires indemnification if the defendant is "successful on the merits or otherwise." If a case goes to trial and the defendant is exonerated on the merits of the case, he is certainly entitled to repayment of expenses. Under section 145(c), however, he also has a right to indemnification if his defense is technical, such as a statute of limitations defense.[106] If a case is settled and dismissed with prejudice and the defendant is neither required to make payment nor to assume any liability, then indemnification is appropriate;[107] but if the dismissal is without prejudice, the litigant is not vindicated and the mandatory indemnification of section 145(c) is inapplicable.[108]

Before the corporation can pay litigation expenses under the indemnification statute, an ad hoc determination must be

101. DEL. CODE ANN. tit. 8, § 145(c) (1983).

102. For a discussion of cases dealing with the question of what constitutes "success," see J. BISHOP, *supra* note 81, ¶ 6.02[1], at 6-9.

103. REV. MODEL BUSINESS CORP. ACT § 8.52 (1984).

104. *Id.*, § 8.52 official comment.

105. Merritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138 (Del. Super. Ct. 1974).

106. *See* E. FOLK, THE DELAWARE GENERAL CORPORATION LAW § 145, at 99-100 (1972); Veasey, *supra* note 48, at 406; *cf.* CAL. CORP. CODE § 317(d) (West Supp. 1988)(requiring success "on the merits").

107. Wisener v. Air Express Int'l Corp., 583 F.2d 579 (2d Cir. 1978).

108. Galdi v. Berg, 359 F. Supp. 698 (D. Del. 1973).

made pursuant to section 145(d) that the individual is entitled to indemnification. Section 145(d) requires that:

> Such determination shall be made (1) by the board of directors by a majority vote of a quorum consisting of directors who were not parties to such action, suit or proceeding, or (2) if such a quorum is not obtainable, or, even if obtainable a quorum of disinterested directors so directs, by independent legal counsel in a written opinion, or (3) by the stockholders.[109]

Whoever evaluates the case must determine whether "indemnification of the director, officer, employee or agent is proper in the circumstances because he has met the applicable standard of conduct set forth in subsections (a) and (b) [of section 145]."[110] Of course if the litigant seeks indemnification under the mandatory provisions of section 145(c), the determination would relate to the extent of his success "on the merits or otherwise."

Section 145(e) of the Delaware statute allows the corporation to advance attorneys' fees and other legal costs to officers and directors sued for their corporate activities, but employees and agents are not entitled to such advance payments under the statute. To receive these funds, the officer or director must make "an undertaking . . . to repay such amount if it shall ultimately be determined that he is not entitled to be indemnified by the corporation."[111] Because the underlying policy of the indemnification statute is to encourage talented people to serve as corporate officers and directors, section 145(e) is lenient, requiring neither security for the director's "undertaking" to repay the money, nor an indication of financial ability to make reimbursement.[112]

The final indemnification section of the Delaware statute, section 145(f), allows corporate indemnification beyond the scope of the statute by means of a contract, bylaw, or resolution. Section 145(f) provides:

> The indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to

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109. DEL. CODE ANN. tit. 8, § 145(d) (1983).
110. *Id.*
111. DEL. CODE ANN. tit. 8, § 145(e) (Supp. 1986).
112. *See* Veasey, *supra* note 48, at 411.

which those seeking indemnification or advancement of expenses may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office.[113]

The scope of this nonexclusive provision is uncertain; no cases have addressed the issue.[114] One commentator states that "[n]obody knew what the clause meant in the old statutes, and if anyone knows what it means in the new ones, he has not published the information."[115] The limited case law in jurisdictions other than Delaware indicates a judicial inclination to interpret nonexclusive clauses restrictively,[116] and to be guided by public policy considerations.[117] It is unlikely, therefore, that a director who has breached his fiduciary duty to the corporation could be indemnified under section 145(f).[118]

V. D&O INSURANCE

The third, and in many instances, the most important source of protection for officers and directors of large, publicly held companies[119] is D&O insurance.[120] First marketed by

113. DEL. CODE ANN. tit. 8, § 145(f) (Supp. 1986).

114. Veasey, *supra* note 48, at 413.

115. J. BISHOP, *supra* note 81, ¶ 6.03[1].

116. Block, Barton & Radin, *Indemnification and Insurance of Corporate Officials*, 13 SEC. REG. L.J. 239, 248 (1985).

117. *See* Arsht & Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75, 80 (1967); Sebring, *Recent Legislative Changes in the Law of Indemnification of Directors, Officers and Others*, 23 BUS. LAW. 95, 105 (1967).

118. Veasey, *supra* note 48, at 414.

119. The prevalence of D&O insurance is greater in large corporations and in publicly held corporations than in small or privately held corporations. For example, 96.8% of all New York Stock Exchange listed companies have D&O insurance and 87.8% of corporations with assets of $100 million to $1 billion have the insurance; but only 42.4% of closely held companies and 34.7% of companies with $10 to $25 million in assets maintain D&O coverage. WYATT SURVEY, *supra* note 3, at 51, 52.

The reasons companies cite for not carrying the insurance are as follows:

	1984	1987
See No Need For It	58%	26%
Advice of Counsel	13%	9%
Cost Too High	12%	39%
Coverage Too Limited	5%	14%
Unable To Obtain Coverage	5%	18%
Other	14%	13%

Lloyd's of London in the mid-1950s,[121] the insurance, at least theoretically, fills the interstices between indemnification statutes, common-law protections, and limited liability statutes. The relationship between these sources of protection is addressed in Part VI below. This Part provides an overview of the primary characteristics of a D&O policy.[122]

A. *Policy Structure*

Because of the early prominence of Lloyd's of London,[123] its forms of policies still dominate the D&O market.[124] The most widely accepted policy, with a name only an insurer could love—ALS(D4)-ALS(D5)[125]—was issued first by Lloyd's in 1974. After substantial criticism was leveled at the form for its "tortuous and opaque language and ambiguities,"[126] it was revised in 1976. The new form, "Lyando No.1,"[127] was less ambiguous, but because it resolved most ambiguities against the insurers, it was not met with substantial enthusiasm by corporate America, and

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Id. at 55.

120. Most states expressly authorize the purchase of D&O insurance by statute. The Delaware statute, § 145(g) of the Delaware Corporate Code, states:

> A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the corporation would have the power to indemnify him against such liability under this section.

DEL. CODE ANN. tit. 8, § 145(g) (1983).

121. Comment, *Void Ab Initio: Application Fraud as Grounds for Avoiding Directors' and Officers' Liability Insurance Coverage*, 74 CALIF. L. REV. 929 n.1 (1986).

122. For a comprehensive treatment of the characteristics of D&O insurance, see Miller, *An Analysis of Key Policy Provisions of Directors' and Officers' Liability Insurance Policies*, in STRATEGIES FOR RESPONDING TO THE D&O INSURANCE CRISIS 58 (Law & Bus. 1986); *see also* Mallen & Evans, *Surviving the Directors' and Officers' Liability crisis: Insurance and the Alternatives*, 12 DEL. J. CORP. L. 439 (1987).

123. Currently Lloyd's underwrites only 5-6% of the U.S. D&O insurance. WYATT SURVEY, *supra* note 3, at 107.

124. J. BISHOP, *supra* note 81, ¶ 8.02.

125. A complete discussion of this policy and a copy of its full text can be found in Johnston, *supra* note 89.

126. J. BISHOP, *supra* note 81, ¶ 8.02.

127. For a thorough evaluation of the Lyando No.1 policy, see Hinsey, *The New Lloyd's Policy Form for Directors and Officers Liability Insurance—An Analysis*, 33 BUS. LAW 1961 (1978).

the previous Lloyd's policy remains the most representative form in use. No perfect example of a D&O policy exists because many variations occur on a company-by-company basis.[128] The following, however, is an attempt to give the general framework within which most policies are written.

D&O policies are usually in two parts. The first part, the "personal coverage" section, provides direct insurance to the directors and officers of the company. The insuring clause of this portion of the Lyando No.1 policy is as follows:

> In consideration of the payment of the premium . . . Underwriters agree—
> (A) to pay to or on behalf of the DIRECTORS and OFFICERS of the COMPANY LOSS arising from any claim or claims made against the DIRECTORS and OFFICERS, jointly or severally, during the Policy Period . . . by reason of any WRONGFUL ACT done or attempted or allegedly done or attempted by the DIRECTORS and OFFICERS during or at any time prior to the Policy Period.[129]

Because of the prevalence of corporate indemnification, relatively few directors and officers incur defense costs personally,[130] and the majority of claims are made under the second part of the policy, the "corporate reimbursement" section.[131] In the insuring clause of this portion of the Lyando No.1 policy, the underwriter agrees:

> to pay to or on behalf of the COMPANY LOSS arising from any claim or claims made against the DIRECTORS and OFFICERS, jointly or severally, during the Policy Period by reason of any WRONGFUL ACT done or attempted or allegedly done or attempted by the DIRECTORS and OFFICERS during or at any time prior to the Policy Period, but only when the

128. Miller, *supra* note 122, at 59.

129. Hinsey, *supra* note 127, at 1981.

130. The level of corporate reimbursement of directors' and officers' defense costs is not entirely certain. Recent increases in deductibles for personal coverage are quite low vis-a-vis those increases reported for the corporate reimbursement portion of D&O policies. WYATT SURVEY, *supra* note 3, at 75 (indicating a substantially greater incidence of corporate reimbursement claims filed than personal coverage claims filed). It is, nonetheless, estimated that in one of every four D&O lawsuits the individual officer or director bears some portion of the defense costs personally. *Id.* at 18.

131. Miller, *supra* note 122, at 61; WYATT SURVEY, *supra* note 3, at 18, exhibit 11.

COMPANY shall be required or permitted to indemnify the DIRECTORS and OFFICERS for such LOSS pursuant to statutory or common law or pursuant to duly effective charter or by-law provisions.[132]

Neither portion of a D&O policy insures the corporation itself for its direct liability to a plaintiff or the expenses of defending a lawsuit. This factor creates problems when a plaintiff wins a judgment against both the corporation and its directors or officers in a single action. Assuming the defendants are jointly and severally liable, they can theoretically pay the judgment by whatever method of apportionment they choose. Therefore, if the judgment is within the limits of the D&O policy, the directors could pay the entire judgment and be reimbursed by the company, which in turn could demand payment under the corporate reimbursement section of the D&O policy. If, however, the corporation paid the judgment directly, it would have no claim for the insurance money. In such circumstances, the ability of the corporate entity to shift its liability to the insurer by means of collusion with its directors and officers is clear, and courts have been receptive to the argument that judgments should be allocated to the various defendants in such cases.[133] The burden of proving that portions of the judgment are not covered by the D&O policy, however, lies with the insurer.[134]

B. Definitions

Defining the highlighted terms within the two insuring clauses above is critical in determining the scope of a D&O insurance policy. The terms "directors" and "officers" typically include previous, current, and future directors and those officers appointed by action of the stockholders or the board of directors, including directors and officers of both the parent company and its subsidiaries.[135] The definition of these terms will be expanded or narrowed in many policies, with a concomitant ad-

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132. Hinsey, *supra* note 127, at 1981-82.

133. *See* Pepsico, Inc. v. Continental Casualty Co., 640 F. Supp. 656, 662 (S.D.N.Y. 1986)(joint tortfeasors may demand contribution from each other in securities fraud case).

134. *Id.*

135. *See, e.g.*, Hinsey, *supra* note 127, at 1982; Miller, *supra* note 122, at 64.

justment of the premium, to fit the particular situation.[136]

The definition of the term "loss" is also critical to the scope of the policy. Under the Lyando No.1 policy, a loss means "any amount a DIRECTOR or OFFICER is obligated to pay in respect of his legal liability . . . for a WRONGFUL ACT."[137] Loss entails costs, charges, expenses, damages, judgments, and settlements related to the investigation of or defense of claims before judicial, legislative, or administrative bodies.[138] The definition of loss does not, however, include fines or penalties resulting from a criminal proceeding.[139] Interestingly, these fines and penalties, which D&O insurance will not reimburse, are subject to corporate indemnification, assuming the executive acted in good faith and in a manner he reasonably believed to be both not opposed to the best interests of the corporation and not criminal. Therefore, although insurance generally covers a broader range of activity than indemnification, in some instances the indemnification statute protects the director or officer and insurance does not.[140]

Also excluded from the definition of "loss" is any matter that is "uninsurable" as a matter of law.[141] The term "uninsurable" is not defined in a typical D&O policy and has been the source of some dispute.[142] Whereas some courts have held that intentional wrongdoing and even criminal activity is insurable,[143] others have found the contrary.[144] Professor Bishop states that "[t]he prevailing rule seems to be that insurance against at least

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136. Miller, *supra* note 122, at 65.

137. Hinsey, *supra* note 127, at 1982-83. The term "wrongful act" is defined as follows: "[A]ny actual or alleged breach of duty, neglect or error or accountability of the DIRECTORS or OFFICERS as DIRECTORS or OFFICERS or any actual or alleged misstatement, misleading statement or other act or omission by the DIRECTORS or OFFICERS in their respective capacities as DIRECTORS or OFFICERS." *Id.* at 1983; *see also* Miller, *supra* note 122, at 72.

138. Hinsey, *supra* note 127, at 1982-83. Notice that this definition should include SEC and IRS proceedings, grand jury probes, and legislative hearings. Miller, *supra* note 122, at 69.

139. Hinsey, *supra* note 127, at 1983-84.

140. *See*, chart, *infra* Part VI, box 44.

141. Hinsey, *supra* note 127, at 1983-84.

142. *See generally* J. BISHOP, *supra* note 81, ¶ 8.03[1].

143. Colson v. Lloyd's of London, 435 S.W.2d 42 (Mo. App. 1968); Wolff v. General Casualty Co., 68 N.M. 292, 361 P.2d 330 (1961).

144. Portaro v. American Guar. & Liab. Ins. Co., 210 F. Supp. 411 (N.D. Ohio), *aff'd*; 310 F.2d 897 (6th Cir. 1962).

compensatory damages is permissible even when the insured's wrongdoing was deliberate. The validity of insurance against punitive damages is more doubtful."[145]

C. *Limitations on Liability*

Reimbursement under a D&O insurance policy typically has been limited by "co-insurance" and "deductible" provisions. Co-insurance clauses require that the insured provide five percent of the total costs related to a claim, while deductibles are negotiated amounts that the insured must pay before insurance becomes available. The trend of insurers has been to drop the relatively insignificant co-insurance provisions and boost deductibles enormously.[146] Approximately seventy percent of D&O policies no longer have co-insurance provisions,[147] but the increase in the typical deductible has more than compensated for the loss. Between 1984 and 1987, the average deductible on the corporate reimbursement side of a D&O policy increased an astounding 1,326% from $51,646 to $736,290.[148]

D. *Exclusions*

D&O policies can now also include a daunting array of exclusions which deny insurance coverage in particular circumstances. The exclusions are split between the corporate reimbursement side and the personal coverage side.[149]

The corporate reimbursement section typically excludes claims actually paid by any other insurance policy, claims covered (whether actually paid or not) by prior insurance policies, claims based on bodily or personal injury, and claims based on violations of the Employer Retirement Income Security Act of 1974. Most policies[150] also include a specific exclusion of claims

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145. J. BISHOP, *supra* note 81, ¶ 8.03[1](emphasis in original). *Compare* Greenwood Cemetery, Inc. v. Travelers Indem. Co., 238 Ga. 313, 316, 232 S.E.2d 910, 913 (1977) (permitting insurance for punitive damages) *with* Ford Motor Co. v. Home Ins. Co., 116 Cal. App. 3d 374, 379, 172 Cal. Rptr. 59, 65 (1981) (denying, for public policy reasons, insurance against liability for punitive damages).

146. WYATT SURVEY, *supra* note 3, at 79.

147. *Id.*

148. *Id.* at 75.

149. Miller, *supra* note 122, at 79.

150. Approximately 80% of D&O policies currently carry a pollution exclusion. WY-

arising from environmental pollution, even though pollution claims would likely be covered by bodily injury or property damage policies and would be filed against the corporation itself instead of its officers and directors.[151] Insurers are simply taking additional precautions to avoid the potentially enormous liability of pollution claims.

On the personal coverage side of the policy, reimbursement is excluded if the directors and officers are indemnified by the corporation, or if the claim against them is for libel or slander, personal gain, unauthorized remuneration, short swing profits in violation of section 16(b) of the Securities Exchange Act of 1934, or dishonesty.[152]

In addition to the these commonplace exclusions, insurers are beginning to insert exclusions that *in toto* would effectively render the policies worthless. For example, some policies now exclude claims arising from merger and acquisition activities, responses to tender offers, and violations of securities regulations in addition to the standard 16(b) exclusion. These exclusions are not typical, being reported respectively by only thirteen, fifteen, and twenty-five percent of companies with D&O policies.[153] These exclusions, however, and others like them[154] represent a

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ATT SURVEY, *supra* note 3, at 68.

151. For further discussion of liability related to pollution, see Comment, *Corporate Officer Liability for Hazardous Waste Disposal: What Are The Consequences?*, 38 MERCER L. REV. 677 (1987).

152. For a broader discussion of these exclusions see Miller, *supra* note 122, at 79.

153. WYATT SURVEY, *supra* note 3, at 68.

154. The Wyatt Company reports that the following exclusions currently exist in the percentage of policies indicated:

Exclusion	Percentage of companies reporting policies with the exclusion
1. Pending or prior litigation	70%
2. Going private	2%
3. Public Offerings	5%
4. Securities transactions	19%
5. Failure to maintain insurance	49%
6. Joint ventures	12%
7. Partnerships	12%
8. Illegal payments or commissions	51%
9. Actions by regulatory agencies	18%
10. Litigation between insureds	28%

growing and menacing phenomenon in the D&O market.

E. Cancellation

In addition to high premiums, high deductibles, numerous exclusions, and shrinking coverage facing corporate executives, the possibility of losing the insurance altogether also exists. Illustrative of the problem is the following chain of events reported in the *National Law Journal* in August 1986:

> The directors of Unocal Corp. thought it was bad enough when they learned last year that corporate raider T. Boone Pickens, Jr. might attempt a hostile takeover.
>
> Then they learned the really bad news. The day after Mr. Pickens revealed his purchase of 7.9 percent of Unocal's common stock, the company was notified that its directors' and officers' liability insurance was being canceled.[155]

Unfortunately, this scenario is not surprising. D&O insurance is written on a "claims-made" basis, requiring that notice of a claim be given to the insurer during the policy period and must relate to "wrongful acts" occurring during or prior to the policy period.[156] If events transpire making it likely that directors and officers will be sued, therefore, it is in the insurer's interest to cancel the policy. Currently, 57% of all D&O policies can be canceled with thirty days' notice, and 86.6% with sixty days' notice.[157]

Under earlier interpretations of the business judgment rule, a corporate takeover attempt such as Pickens's pursuit of Unocal mentioned above, might not have caused great concern among insurers. Today, however, a director walks a treacherous path in resisting, rejecting, or even approving a takeover offer. In *Van Gorkom*, for example, the directors of Trans Union Corporation, who ultimately became liable for approving the sale of the company at $55 per share, were advised by James Brennan, an attorney retained by Van Gorkom to review the proposed merger, that if they did not accept the Pritzker offer, they might

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WYATT SURVEY, *supra* note 3, at 68-69.

155. Galante *supra* note 32, at 1, col.4.

156. *See* Miller, *supra* note 122, at 75.

157. WYATT SURVEY, *supra* note 3, at 70.

be sued for their failure to act.[158] This sort of directorial "Catch-22" and the specter of canceled insurance has made life at the top considerably less enticing.

VI. The Interrelationship Between Limited Liability Statutes, Indemnification Statutes, and D&O Insurance

To appreciate the protection—or lack thereof—currently afforded a corporate officer or director, it is useful to analyze the coordination between the three forms of protection discussed above. The chart below attempts to display the salient features of these relationships graphically, with explanations of each segment of the chart following. Undoubtedly, the subtleties of director and officer protection cannot all be relegated to a single chart. This chart, therefore, is only a guide and is drawn with the following assumptions in mind:

1. That the hypothetical company is incorporated in Delaware.

2. That the company has indemnified and limited the liability of its directors and officers to the full extent allowed by law.

3. That the company maintains a typical D&O insurance policy, and that no specific exclusion applies to any of the circumstances discussed.

158. 488 A.2d at 868.

	Does the Limited Liability Statute Protect the Defendant?	Is Indemnification Allowed by State Statute?	Does D&O Insurance Cover the Defendant?	Ultimate Source of Protection*
I. Civil Actions:				
A. Actions Not Brought by or in Behalf of the Corporation:				
1. Fees & Expenses	1 No	2 Yes	3 Yes	4 D&O(CR)
2. Settlements & Judgments	5 No	6 Yes	7 Yes	8 D&O(CR)
B. Actions Brought by or in Behalf of the Corporation (Usually Shareholder Derivative Suits)				
1. Fees & Expenses	9 No	10 Yes	11 Yes	12 D&O(CR)
2. Settlements	13 Yes/No	14 No	15 Yes	16 LL or D&O (P)
3. Judgments Based on Breach of Duty of Care				
a. Defendant Was Negligent	17 Yes	18 No	19 No	20 CL, LL
b. Defendant Was Grossly Negligent	21 Yes	22 No	23 Yes	24 LL
c. Defendant Was Reckless	25 Uncertain	26 No	27 Yes	28 D&O (P)
d. Defendant's Acts Were Intentionally Wrong, Illegal, or Not in Good Faith	29 No	30 No	31 Possibly	32 D&O (P)
4. Judgments Based on Breach of Duty of Loyalty	33 No	34 No	35 Yes/No	36 D&O (P)
II. Criminal Actions				
A. Fees & Expenses	37 No	38 Yes	39 Yes	40 D&O(C.R.)
B. Fines & Penalties	41 No	42 Yes	43 No	44 I
III. Miscellaneous				
A. Amounts Less than D&O Deductible	45 No	46 Yes	47 No	48 I
B. Advancement of Expenses Prior to Final Adjudication or Settlement	49 No	50 Yes	51 Uncertain	52 I, or D&O(C.R.)
C. Protection for More than Directors (i.e., Officers, Employees, Agents)	53 No	54 Yes	55 Yes	56 I, or D&O(C.R.)
D. Corporation is Unable or Unwilling to Indemnify the Defendant	57 Depends	58 Yes	59 Yes	60 D&O (P)
E. Insurer Refuses to Pay	61 No	62 Yes	63 No	64 I, or D&O(C.R.)
F. Violation of Certain Securities Laws	65 Yes/No	66 No	67 Yes	68 D&O(P) or D&O(C.R.)

*Sources of Protection: LL = Limited Liability Statute
I = Corporate Indemnification
D&O (P) = D&O Insurance, Personal Coverage Section
D&O (C.R.) = D&O Insurance, Corporate Reimbursement Section
CL = Common Law

The following outline corresponds with the outline at the left margin of the chart above and is intended to serve as something of a roadmap. All code sections refer to the *Delaware Corporate Code.*

I. *Civil Actions*

A. *Actions Not Brought by or in Behalf of the Corporation.*

The division of the "Civil Actions" category into third party suits (Subsection A) and derivative suits (Subsection B) is primarily to indicate the limitations many state indemnification statutes place on the reimbursement of settlements and judgments in derivative suits (see boxes 14, 18, 22, 26, 30 and 34) as opposed to third party suits (box 6).

1. *Fees & Expenses*

a. Box 1

Section 102(b)(7) only refers to a director's liability to the corporation or its shareholders, so a director would not be protected by the limited liability statute from fees and expenses in third party suits.

b. Box 2

Section 145(a) relates to third party actions and permits indemnification for expenses. Section 145(c) requires indemnification of expenses if the defendant is successful on the merits or otherwise.

c. Box 3

For purposes of D&O insurance there is no distinction between third party actions and derivative suits. These fees and expenses (to the extent they exceed the D&O deductible) would be covered by insurance.

d. Box 4

Although indemnification is available, the corporation would be reimbursed under the "corporate reimbursement" side of the D&O policy, so insurance is the ultimate source of protection.

2. *Settlements & Judgments*

a. Box 5

Same as Box 1, above.

b. Box 6

Section 145(a) permits indemnification and section 145(c) requires indemnification if the defendant is successful. The defendant must 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.

c. Box 7

This is similar to box 3, above; D&O insurance would cover these settlements or judgments.

d. Box 8

Like the situation discussed at box 4, above, D&O insurance (the corporate reimbursement side) is the ultimate source of protection even though indemnification is available

B. *Actions Brought by or in Behalf of the Corporation (Usually Shareholder Derivative Suits)*

1. *Fees & Expenses*

a. Box 9

Section 102(b)(7) relates only to monetary damages assessed against a director. It does not cover the fees and expenses that he incurs defending the action. Of course, to the extent monetary damages assessed against the director include the fees and expenses of the plaintiff, the statute does provide protection.

b. Box 10

Section 145(b), relating to suits brought by or in the right of the corporation, permits indemnification for fees and expenses, and section 145(c) requires indemnification if the defendant is successful.

c. Box 11

The typical D&O policy expressly covers general costs, costs of investigation, and amounts incurred in the defense of legal actions.

d. Box 12

Having indemnified the defendant, the corporation would be reimbursed under its D&O policy.

2. *Settlements*

a. Box 13

Section 102(b)(7) protects a director from his negligent or grossly negligent acts, with respect to actions by or in behalf of the corporation. For the plaintiff to recover there must be an intentional act, a violation of the law, a breach of the duty of loyalty, or (perhaps) directorial recklessness.

The payment of a settlement is, to some degree, an admission of one of these bases of liability, and by the very payment of the settlement, it is clear that the statute did not protect the defendant. The statute would, however, help a merely negligent or grossly negligent director-defendant avoid payment of a settlement. This "settlement" category was placed on the chart to point out the distinction between fees-expenses and settlements in derivative suits with respect to indemnification statutes rather than to make such distinction with respect to liability statutes.

b. Box 14

In actions brought by or in behalf of the corporation, sections 145(b) and (c) allow indemnification for only fees and expenses, so indemnification is not available to pay settlements or judgments in these cases. Some states, however, have begun to eliminate this limitation on indemnification.

c. Box 15

One of the primary purposes of D&O insurance is to protect directors and officers in shareholder derivative suits in which corporate indemnification is unavailable.

d. Box 16

As indicated with regard to box 13, the limited liability statute would in some cases be the source of protection. Otherwise, it would be provided by D&O insurance. Because indemnification is not available, the insurance payment would be based on the personal side of the D&O policy.

3. *Judgments Based on Breach of the Duty of Care*

a. *Defendant Was Negligent*

i. Box 17

Aronson v. Lewis[159] established that a director did not breach his duty of care if he was merely negligent.[160] So a defendant does not need the limited liability statute to protect him in cases in which he is negligent. The common-law rule already protects him. Because the statute covers the same cases, however, the proper response in Box 17 is "Yes."

ii. Box 18

Same as box 14, above.

iii. Box 19

D&O insurance would cover the defendant but the common law, as discussed at box 17, above, should prevent liability.

iv. Box 20

The sources of protection for a director against liability for his acts of negligence are both the common-law standard articulated in *Aronson* and the limited liability statute.

b. *Defendant Was Grossly Negligent*

i. Box 21

The limited liability statute was drafted specifically to address this situation, allowing a corporation to eliminate or limit directorial liability for monetary damages in derivative suits based on the director's gross negligence.

ii. Box 22

Same as box 14, above.

iiii. Box 23

D&O insurance would cover the defendant, but the limited liability statute, by denying the plaintiff's judgment, should make such coverage unnecessary.

iv. Box 24

The director is protected by the limited liability statute when a director's gross negligence is at issue.

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159. 473 A.2d 805, 812 (Del. 1984).

160. *Id.* at 812. By specifically establishing gross negligence as the standard of care for directors, *Aronson* clarified the standard that had been described variously in previous cases. *See id.* at 812 n.6.

c. *Defendant Was Reckless*

i. Box 25

Recklessness is a level of culpability between gross negligence and intentional wrongdoing, and the effect of the statute is uncertain.

ii. Box 26

Same as box 14, above.

iii. Box 27

D&O insurance extends to directorial recklessness.

iv. Box 28

D&0 insurance is the source of coverage, and because corporate indemnification is not permissible, reimbursement would be based on the personal side of the D&O policy.

d. *Defendant's Acts Were Intentionally Wrong, Illegal, or Not in Good Faith*

i. Box 29

Section 102(b)(7) expressly excludes this type of directorial malfeasance.

ii. Box 30

Same as box 14, above.

iii. Box 31

There are too many variables here to give a definitive answer. D&O policies define covered "losses" to exclude liability that is "uninsurable" as a matter of public policy, but the scope of the term "uninsurable" is anything but precise. Fines and penalties in criminal actions are expressly excluded from coverage in D&O policies, but expenses in criminal actions can be insured. Whether intentional acts or those acts not in good faith can be insured are issues that have been decided differently in different jurisdictions.

Notice that the enabling provision for D&O insurance, section 145(g), allows the purchase of insurance "whether or not the corporation would have the power to indemnify . . . ." This provision, however, does not allow one to disregard the public policy considerations discussed above.

iv. Box 32

If the director can be protected in this instance, D&O insurance will be the source of protection. See note at box 31, above.

4. *Judgments Based on Breach of Duty of Loyalty*

a. Box 33

Section 102(b)(7) expressly denies protection for breach of the duty of loyalty.

b. Box 34

Same as box 14, above.

c. Box 35

D&O insurance covers a director's breach of duty. Many of the acts of a director that constitute duty of loyalty violations (actions resulting in personal gain), however, are specifically excluded from coverage in most D&O policies. Theoretically D&O insurance can protect a director in this instance, but in practice it seldom does.

d. Box 36

See note at box 35, above. To the extent coverage exists the source of reimbursement would be the personal side of the D&O policy because of the unavailability of corporate indemnification.

II. *Criminal Actions*

A. *Fees & Expenses*

1. Box 37

Section 102(b)(7) relates to civil, not criminal, actions.

2. Box 38

Section 145(a) allows corporate indemnification of a director who is a criminal defendant if the director acted in good faith, in a manner he reasonably believed to be in or not opposed to the best interest of the corporation and if he did not have reasonable cause to believe that his actions were criminal

3. Box 39

Although there is some difference of opinion among cases, some courts have upheld the validity of policies covering liability for criminal misconduct. One prominent commentator states that "any cost that is lawfully indemnifiable is also 'insurable.'[161] Under section 145(a), a corporation may indemnify a criminal defendant who acted in good faith, in a manner he reasonably believed to be in, or not opposed to, the best interests of the corporation, and without reasonable cause to believe his actions were criminal. In such cases, therefore, D&O insurance should be available.

4. Box 40

   Assuming insurability (see box 39, above), the corporate reimbursement side of the D&O policy would be the ultimate source of protection because it would reimburse for the corporation indemnifying the director.

B. *Fines & Penalties*

1. Box 41

   Section 102(b)(7) relates to civil, not criminal actions.

2. Box 42

   Same as box 38.

3. Box 43

   D&O policies expressly exclude from the definition of a covered loss fines and penalties in criminal actions.

4. Box 44

   Section 145(a) (corporate indemnification) is the only source of protection from payment of criminal fines and penalties.

III. *Miscellaneous*

A. *Amounts Less Than D&O Retentions*

1. Boxes 45-48

161. J. BISHOP, *supra* note 81, ¶ 8.03[1].

To the extent of D&O deductibles, the cost of litigating or of paying settlements or judgments is covered by corporate indemnification alone.[162]

B. *Advancement of Expenses Prior to Final Adjudication or Settlement*

1. Box 49

Section 102(b)(7) does not relate to expenses.

2. Box 50

Section 145(e) allows advancement of expenses from the corporation to a director or officer, but not to employees or agents.

3. Box 51

Courts are split on the question whether D&O policies — none of which expressly undertake to pay expenses in advance — contain an inherent obligation of the insurer to defend the insured.[163]

4. Box 52

Depending on the applicable judicial rule (see box 51, above), the source of this interim protection is either corporate indemnification or D&O insurance. The insurance would ultimately cover these costs, so this category only refers to the short term out-of-pocket expenses

C. *Protection for More Than Directors*

1. Box 53

Section 102(b)(7) expressly covers only directors.

2. Box 54

162. The Wyatt Company reports that the average deductible in 1987 was $37,766 on the personal coverage side of the policy. This is the aggregate maximum deductible for personal coverage claims against all of the directors and officers covered. The average deductible for a single director or officer was $7,292. The average deductible in 1987 was $736,290 on the corporate reimbursement side. WYATT SURVEY, *supra* note 3, at 75.

163. *See* Mallen & Evans, *supra* note 122, at 449; Oettle & Howard, *D&O Insurance: Judicially Transforming a "Duty to Pay" Policy into a "Duty To Defend" Policy*, 22 TORT & INS. L.J. 337 (1987); Comment, *Practical Aspects of Directors' and Officers' Liability Insurance—Allocating and Advancing Legal Fees and the Duty to Defend*, 32 UCLA L. REV. 690 (1985).

Section 145(a) and section 145(c) respectively provide permissive and mandatory indemnification for directors, officers, employees and agents, but section 145(e) precludes advancement of expenses to employees and agents.

3. Box 55

As indicated by the name, D&O policies generally relate to directors and officers only. Section 145(g) allows a corporation to extend coverage to other employees or agents, but the premium would rise accordingly.

4. Box 56

The ultimate source of protection is typically:

a. Directors: D&O insurance

b. Officers: D&O insurance

c. Employees: *Post hoc* indemnification

d. Agents: *Post hoc* indemnification

D. *Corporation Is Unable or Unwilling to Indemnify the Defendant*

1. Boxes 57-60

If a corporation is unable because of bankruptcy, for example, or unwilling because of corporate takeover, with hostility between the new and old management, for example, to indemnify its directors, and assuming the directors' culpability exceeds gross negligence, thereby rendering the limited liability statute useless, the director would nonetheless be protected by D&O insurance.

E. *Insurer Refuses to Pay*

1. Box 61-64

Along with the rise in D&O judgments and settlements that have imposed large liabilities on executives has come an equivalent increase in the number of insurers denying coverage under their policies.[164] Many of these attempts have been unsuccessful, but others have succeeded. Even if a court eventually forces the insurer to pay a claim, the insured's interim protection will have been corporate indemnification. If the court upholds the insurer's positon, both the interim and the ultimate source of protection will be indemnification.

F. *Violation of Certain Securities Laws*

1. Box 65

   If a director breaches his fiduciary duty by the grossly negligent violation of the securities laws, the limited liability statute bars civil liability.

2. Box 66

   In order to promote the *in terrorem* effect of the securities laws, many courts deny indemnification of liabilities incurred under some securities laws.[165]

3. Box 67

   All D&O policies expressly exclude coverage for violations of section 16(b) of the Securities Exchange Act of 1934 (short swing profits). The Wyatt Company, reporting what it calls a "serious erosion of coverage," also indicates that twenty-five percent of D&O policies exclude SEC violations in addition to 16(b) violations, and nineteen percent exclude securities transactions.[166]

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164. One factor cited with some frequency by insurers as a reason for nonpayment of claims is alleged misrepresentations by insureds in filing applications for insurance. Directors and officers are typically asked whether they have knowledge of any acts or omissions that might give rise to a claim under the policy, and deceptive responses to such questions have resulted in the voiding of some policies. *See* Comment, *supra* note 121, at 930.

165. For a discussion of this topic, *see* W. KNEPPER, *supra* note 87, ¶ 19.06; Block & Barton, *Contribution and Indemnification Under the Federal Securities Laws*, 11 SEC. REG. L.J. 351 (1984).

166. WYATT SURVEY, *supra* note 3, at 68.

The "yes" response on the chart is to indicate that even in jurisdictions not allowing indemnification for securities laws violations, a corporation can negotiate D&O insurance coverage for such acts. The extent of protection under a prototype policy, however, is not entirely clear.[167]

4. Box 68

Depending on whether corporate indemnification is allowed in the jurisdiction for the particular statutory violation in question, the ultimate source of protection will either be the personal coverage side of the D&O policy (if no indemnification) or the corporate reimbursement side (if corporation indemnifies defendant).

VII. The Prospect for Insurance Rates to Come

The *Van Gorkom* opinion[168] was the catalyst in the decision of many states to adopt limited liability statutes. Those statutes, barring an unanticipated treatment by the judiciary, will likely prevent a ruling like *Van Gorkom* in those jurisdictions. The broader D&O insurance crisis, however, stems from a variety of sources, and is not so easily reversed. This section cites six factors, which either helped create this insurance crisis or which will tend to perpetuate the current high cost of insurance, indicating that substantial rate reductions in the future are unlikely.[169]

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167. *See* J. Bishop, *supra* note 81, ¶ 8.03[2][b].

168. *See supra* text accompanying notes 17-34.

169. The reasons cited here for the high level of D&O premiums necessarily entail a degree of speculation or extrapolation. One writer depicts the "information crisis" regarding D&O insurance as follows:

> The insurance industry does not have a centralized body of experience data from which to make underwriting decisions—which risks to undertake to cover and at what price. For example, the Insurance Services Office (ISO), the principal statistical and advisory organization for commercial lines of insurance, does not provide any advisory services with respect to directors and officers liability insurance, which is considered a "specialty line." If the ISO were providing services for this coverage, they would provide advisory information, rules, forms, and classifications. The lack of such information increases the importance of highly specialized underwriting expertise and reduces the number of companies that feel qualified to provide this coverage.

A. *The Insurance Industry*

Van Gorkom and other cases resulting in huge judgments or settlements against directors and officers came at a time when the insurance industry was least prepared to absorb them. Six years of price wars relating to all lines of insurance had left insurers particularly vulnerable to large claims.[170] The insurance companies, eager to invest the money they received in premiums at the high money market rates of the early 1980s, cut prices in order to attract whatever premiums they could.[171] Earning twenty percent or more on their investments, the companies remained blissfully indifferent to a growing gap between premiums received and claims incurred. When interest rates fell and claim frequency rose the insurers sought to recover in premiums what they were previously earning through their investments. The result was an explosion in the cost of insurance to the consumer. As indicated at the outset, from 1984 to 1987 the cost of an average D&O policy jumped from $19,339 to $243,011.[172]

Whereas the vulnerability of the insurance industry contributed to this price explosion, there is no indication that D&O insurers are currently losing money. In fact D&O insurers as a group may have never been unprofitable. It is difficult to reach a definitive conclusion on this issue because much of the information relating to the insurance industry is not available to the public.[173] Acquiring accurate information regarding D&O insurance is even more difficult because of its relatively minor place in the insurance market.[174] It is intriguing, however, to consider the claims of several commentators, who contend, without discussing D&O insurance specifically, that the insurance companies have made handsome profits through the worst of the insur-

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Jones, *D&O Insurance Info Breakthrough: 1987 Wyatt Company Survey Released*, DIRECTOR'S MONTHLY, Sept. 1987, at 7.

170. Hilder, *supra* note 10, at 1, col.6; Note, *The Illinois Legislature's Attempt to Resolve the Insurance Crisis: Too Much Tort Reform and Too Little Insurance Regulation*, 21 J. MARSHALL L. REV. 159, 162 (1987).

171. The authors of one article refer to this practice as "cash flow underwriting." Mallen & Evans, *supra* note 122, at 442; *see also The Manufactured Crisis*, CONSUMER REPORTS 544 (Aug. 1986); Note, *supra* note 170, at 162.

172. *See supra* notes 4-14 and accompanying text.

173. Note, *supra* note 170, at 159 n.3.

174. *See supra* note 169.

ance "crisis."[175] Their conclusions are supported by studies of governmental agencies[176] and perhaps more convincingly by the performance of insurance company stocks in the stock market.[177] The reentry of at least one major insurer, Home Insurance Company,[178] into the market in 1986 and the first-time entry of two major commercial carriers, Aetna Life & Casualty Group and Commercial Credit Group,[179] are further indications of profitability.

Evidence also indicates that primary insurance rates have begun to stabilize,[180] and excess premiums have actually dropped in 1986.[181] Both factors indicate that the losses of insurers, if in fact they ever existed, are coming under control. Therefore, the overextended position of the insurance industry in the mid-1980s, while contributing to the crisis initially, should not be a continuing problem.

B. *The Corporate Environment*

At the same time that insurance companies were engaged in their rate war, corporate activities were becoming more likely to result in litigation challenging directorial judgment. A proliferation of corporate mergers and acquisitions beginning in the late 1970s created circumstances in which directors were called upon to make quick decisions of tremendous scope, decisions similar to the one that confronted the Trans Union directors in *Van Gorkom*.[182] Also, from July 1984 to October 1987, the great bull

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175. *See, e.g.*, Schroeter & Rutzick, *"Tort Reform"-Being an Insurance Company Means Never Having To Say You're Sorry*, 22 GONZAGA L. REV. 31, 36-39 (1986); *The Manufactured Crisis*, CONSUMER REPORTS 544 (Aug. 1986).

176. *See, e.g.*, Schroeter & Rutzick, *supra* note 175, at 37.

177. *See* Note, *supra* note 170, at 163 n.37.

178. WYATT SURVEY, *supra* note 3, at 106.

179. *Id.* at 162.

180. *Id.*

181. *Id.* at 92.

182. This statement presumes that the directors in *Van Gorkom* were indeed faced with the necessity of making a quick decision. One can certainly argue that the sense of emergency surrounding the weekend board meeting in *Van Gorkom* was manufactured by Jay Pritzker, and to a lesser extent Jerome Van Gorkom, to discourage an escalation of the price. If the time pressure in this case had not been so artificial perhaps the result would have been different. On the other hand, the directors were told by counsel that their failure to accept the Pritzker bid—a bid with a very short time limit—could result in personal liability for the directors. 488 A.2d at 868. Even if the time constraints were

market on Wall Street inflated stock prices, and this situation, according to at least one securities litigator, caused prices to drop more drastically when news of directorial malfeasance was released.[183] Like the overextension of insurance companies, however, the corporate environment might be less of a problem in the near future. Merger and acquisition activity, while still healthy, is not as prevalent as in the early eighties, and the euphoric stock market environment has been dramatically altered by the "crash" of October 1987.

C. *Diversity of D&O Claims*

The diverse nature of D&O claims has contributed to the crisis initially and will probably continue to have an effect. The Wyatt Company predicts that one out of every five Fortune 500 companies experienced a D&O claim in 1987 and that the average total claim cost for D&O claims brought in 1986 will be $2,567,000 when final figures are tabulated.[184] The most common claims reported are predictable. They are, in order: misleading representations (21%), breach of employment contract (14.2%), breach of duty to minority stockholders (13.9%), and civil rights violations (13.9%).[185] More startling is that eighty-three types of claims in addition to the four listed above were reported in the Wyatt Company's 1987 survey.[186] With such diversity of claims, it is no wonder that exclusions are proliferating and prices remain high. The insurers cannot safely predict the source of future claims.

D. *The Nature of Limited Liability Statutes*

Another reason for the continuing high cost of insurance is the limited impact of the various limited liability statutes. First, roughly thirty percent of the states have not passed legislation limiting director liability. Second, of the statutes that have been passed most are narrowly focused, covering only monetary dam-

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artificial, therefore, the directors were still under pressure.

183. Galante, *supra* note 32, at 29, col.2.

184. WYATT SURVEY, *supra* note 3, at 11. The term "total claim cost" means the sum of direct damages and legal defense costs. *Id.*

185. *Id.* at 31.

186. *Id.* at 17, 31.

ages assessed against a director in a shareholder derivative suit.[187] The Wyatt Survey indicates that over sixty percent of D&O claims stem from sources other than shareholder derivative suits;[188] and average defense costs—payable regardless of the defendant's ability to avoid monetary damages—amount to $281,684 per claim.[189] So the existing statutes leave some significant loopholes and protect directors in only a narrow set of circumstances. Last, even if a case falls within the ambit of the statute as written, it is not entirely clear that a court will apply the statute.[190] Many duty of care cases also include duty of loyalty questions,[191] and several commentators fear continuing liability under the rubric duty of loyalty for what are essentially duty of care violations.[192] So limited liability statutes, while reducing the likelihood of director liability under certain circumstances, are not the entire solution to high insurance rates.

E. The Nature of D&O Insurance Policies

Three aspects of D&O policies themselves, or in one instance the judicial interpretation of such policies, also affect rates in ways not immediately apparent. First, the operation of the corporate reimbursement side of the policy has an effect. The chart in Part VI above reveals that, except in relatively minor or temporary ways, D&O insurance underwrites corporate indemnification. When a corporation indemnifies its directors and officers, the ultimate source of funds is usually the corporate reimbursement portion of the company's D&O insurance, not the corporate coffers.

Second, despite provisions to the contrary in most policies, courts have interpreted D&O insurance to entail a duty to pay the defense costs of directors and officers in addition to the payment of insured losses.[193] This judicial posture causes insurers to

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187. *See supra* text accompanying notes 48-61.

188. WYATT SURVEY, *supra* note 3, at 28.

189. *Id.* at 25.

190. *See supra* notes 59-60 and accompanying text.

191. *See, e.g.*, MacAndrews & Forbes Holdings v. Revlon, 506 A.2d 173 (Del. 1986); AC Acquis. Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986).

192. *See supra* note 59.

193. *See* Okada v. MGIC Indem. Corp., 795 F.2d 1450, 1452 (9th Cir. 1986) (holding that a D&O insurer was obligated to pay the costs of insureds' defense at the time when the costs were incurred despite contractual language stating only that "[t]he Insurer may

advance funds earlier than would otherwise be necessary, encourages defendants to contest claims that they might otherwise settle, and can result in the payment by the insurer of costs not actually insured. The insurer can benefit from this judicial policy when its early involvement in the lawsuit helps to reduce the cost of the ultimate claim, but in at least one case, the court both required the insurer to advance funds for the directors' defense and precluded the insurer from participating in the lawsuit.[194] The insurer's opportunity to reduce the total cost of the claim was therefore eliminated. From the insurer's standpoint, financial responsibility for a lawsuit without control of its defense clearly increases the prospects for higher costs.[195]

A third aspect of D&O policies that helps account for continuing high premiums is the limited application of exclusions. At first blush, one might read a list of D&O policy exclusions and wonder whether any activities of directors and officers are actually insured after the exclusions are applied. The list of potential exclusions is long and continues to grow. In practice, however, relatively few of these exemptions can be found in any given policy. The introduction of exclusions relating to mergers and acquisitions, for example, is a disturbing new phenomenon, but such exclusions are currently included in only thirteen percent of D&O policies.[196] Similarly, exclusions relating to tender offers are found in only fifteen percent of the policies.[197] This is not to imply that exclusions are not seriously eroding the coverage previously offered. They are. D&O policies are negotiable, however, and the number and type of exclusions varies substantially from policy to policy. Many of the potential exclusions will not be present in a given policy, and the fewer the applicable exclusions, the higher the D&O premium.

at its option . . . advance on behalf of the Directors or Officers . . . expenses which they have incurred"); Pepsico, Inc. v. Continental Casualty Co., 640 F. Supp. 656 (S.D.N.Y. 1986); *see also* authorities cited *supra* note 163.

194. Okada v. MGIC Indem. Corp., 608 F. Supp. 383 (D. Haw. 1985), *aff'd in relevant part*, 795 F.2d 1450 (9th Cir. 1986).

195. Not all courts have ruled against the insurer in "duty to defend" cases. *See, e.g.*, Bank of Commerce & Trust Co. v. National Union Fire Ins. Co., 651 F. Supp. 474 (N.D. Okla. 1986) (allegations required adjudication in order to determine whether claims were insured).

196. WYATT SURVEY, *supra* note 3, at 68; *see also supra* note 154.

197. WYATT SURVEY, *supra* note 3, at 68.

F. Public Policy

Finally, although many steps have been taken to protect corporate executives, public policy requires managers of corporations to be responsible for their corporate actions. Like many other corporate battles, the current D&O crisis is a struggle between conflicting policies.[198] On one hand, corporate directors and officers need freedom to exercise their entrepreneurial skill. Without adequate autonomy, corporate executives cannot take the measured risks that spur the growth of great businesses. On the other hand, these executives manage what is frequently a vast fortune in trust for corporate shareholders; some restraint on their latitude is only appropriate.[199] Accordingly, the limited liability statutes discussed above must be narrowly focused, and the indemnification of directors and officers must be limited. States cannot hold directors completely harmless without radically altering the nature of corporations, or the nature of society itself. A balance must be struck between director autonomy and shareholder protection, and D&O premiums simply reflect the current status of the conflict between these two policies.

VIII. ALTERNATIVES

The D&O crisis has caused many companies to seek new means of protecting their directors. Commentators have identified five alternative methods of addressing the D&O problem.[200] Two of these, the broadening of indemnification statutes and the enactment of limited liability statutes, have been discussed at length in this Note. Their capacity for relieving the crisis is sub-

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198. One author states:

> [P]ower corrupts. It can be turned to the personal use of the wielder of power in ways that hurt the other persons having claims on the organization. The problem, then, is how to keep managers accountable to their other-directed duties while nonetheless allowing them great discretionary power over appropriate matters. This is the major problem dealt with by corporate law.

R. CLARK, CORPORATE LAW § 1.5, at 33-34 (1986).

199. Similar balancing of interests is required with regard to the actions of public officials, and the immunity of such officials is apparently on the wane. *See* Butz v. Economou, 438 U.S. 478 (1978). For a comparison between the liability and immunity of government officials and corporate officials, see Pillai & Tractenberg, *supra* note 78, at 126-28.

200. *See* Block, Barton, & Garfield, *Advising Directors on the D&O Insurance Crisis*, 14 SEC. REG. L.J. 130 (1986).

ject to challenge, as indicated in section VII above.

The third alternative is for a company to establish a wholly owned or "captive" insurance company to provide insurance for the parent company's directors and officers. While perhaps more attractive than having no insurance or paying the high cost of the current open market D&O policies, captive insurance raises a host of problems, many of which have not been addressed by the courts. Of primary concern is whether a captive insurance company adequately spreads the risk of loss, and therefore whether it is insurance at all, or merely a form of indemnification.[201] If a court determines that the captive insurer merely indemnifies the present corporation, then the propriety of the insurance would presumably be tested under the indemnification statute, which is more narrow than most insurance policies.[202] Another problem with captive insurance is that policy premiums might not be deductible for federal income tax purposes, whereas standard D&O premiums are deductible.[203] Therefore, the wisdom of creating a captive insurance subsidiary is doubtful.

A better alternative is the formation of a self-insurance pool among a group of companies. This sort of pooling spreads the risk of loss, thus avoiding the "indemnification" problem of captive insurers. Also, whatever premiums are paid qualify for deductibility under section 162 of the Internal Revenue Code, making a pooling arrangement clearly preferable to a captive insurance scheme.

One problem with insurance pooling, however, is access. The most noted insurance pool, for example, was formed by thirty-three prominent corporations, including IBM, Ford Motor Company, General Electric, and U.S. Steel.[204] Obviously, this is an exclusive club. Other pools exist, however,[205] and to the extent a company can gain access to or create a new pool, this alternative could alleviate the corporation's D&O insurance problem. The

201. Veasey, Finkelstein, & Bigler, *supra* note 60, at 266.

202. Indemnification statutes, for example, do not allow indemnification in shareholder derivative suits, except for fees and expenses. *See* chart *supra* part VI.

203. Block, Barton, & Garfield, *supra* note 200, at 144; Rev. Rul. 77-316, 1977-2 C.B. 53.

204. Block, Barton, & Garfield, *supra* note 200, at 145-46.

205. *See* Tilton, *Director and Officer Liability Insurance: What To Look for in 1988*, DIRECTOR'S MONTHLY, Oct. 1987, at 1, 2.

ability of the managers of insurance pools to predict accurately the cushion of protection needed, given the vagaries of the current D&O marketplace, and to provide adequate protection at rates lower than those of the standard D&O carriers is, however, open to question.[206]

The fifth method of addressing the insurance crisis is through loss prevention.[207] Corporations should develop programs to identify practices and situations likely to result in claims against directors and officers. Executives should be educated about their legal responsibilities, and companies should implement programs to avoid D&O claims or mitigate the resulting losses when they are inevitable. As the authors of a recent article stated, however, " '[l]oss prevention' is not a science, it is barely an art."[208] The effectiveness of loss prevention in the executive suite is not as easily quantified as it is in the factory. Nonetheless, the stakes are high for companies unable to acquire or afford the desired level of insurance coverage, and loss prevention programs could be a major line of defense for some companies.

IX. CONCLUSION

The D&O insurance crisis emanates from a variety of causes and, accordingly, is unlikely to subside without substantial changes in the corporate environment. Triggered by such varied phenomena as the insurance premium wars of the early eighties, increased merger and acquisition activity among corporations, and a spate of lawsuits successfully challenging directorial discretion, the crisis, like a cancer, defies simple treatment. In many states limited liability statutes address a prominent segment of director and officer liability, but these statutes are narrowly focused and will not have a significant impact on D&O insurance rates. The other source of director protection, corporate indemnification, is rarely the ultimate source of protection since it tends to provide only interim assistance to the director until an insurance claim can be filed. While this indemnification

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206. Block, Barton, & Garfield, *supra* note 200, at 146.

207. For a thorough discussion of loss prevention, see Mallen & Evans, *supra* note 122, at 468.

208. *Id.* at 468.

is important to directors and officers, it does little to ease the burden on D&O insurance. Limited liability and indemnification statutes have perhaps enhanced the availability of D&O insurance, and the current stabilization of insurance rates could reflect the impact of these statutes. The statutes, however, have not effected, and will not effect, substantial reductions in D&O premiums. They are drafted too narrowly and leave too many questions unanswered.

Public policy as it relates to corporations requires that corporate officials bear the responsibility for their actions. Until directors and officers become error free, or judges scrutinize executive decisions with less exaction, or state legislatures immunize directors and officers from liability, D&O insurance will continue to be the primary source of director protection, and D&O premiums will continue to be high, reflecting the current societal balance between shareholder rights and directorial prerogative.

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