Winter 1987

Statutory and Non-Statutory Responses to the Director and Officer Liability Crisis

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Recommended Citation
Available at: https://www.repository.law.indiana.edu/ilj/vol63/iss1/6
INTRODUCTION

Directors and officers constitute an integral part of corporate governance. Although compensation for a director is not excessively high,1 both directors and officers may be the subjects of lawsuits in which plaintiffs seek high stakes for alleged breaches of corporate duties. To mitigate this financial disincentive to corporate service, corporations rely on two methods, indemnification and insurance, to insulate directors and officers from the financial impact that results from personal liability incurred while acting in a corporate capacity.2 Today, however, a crisis has arisen, and director and officer liability insurance may be inadequate or even unavailable. Recognizing the potential dangers of this situation, many states and commentators have proposed measures to protect directors and officers.

States are an appropriate body to propose protective measures because corporations are creatures of state law. States regulate the conduct of directors and officers and impose liability on those who fail to meet these standards. At the same time, state statutes determine the circumstances under which a corporation may indemnify its directors and officers for expenses incurred in litigation.3 In accordance with state law guidelines, corporate bylaws may include indemnification clauses in which the corporation declares that it will or might reimburse a director or officer for expenses associated with defending a lawsuit. State laws also authorize corporations to purchase director and officer (D&O) insurance policies. These policies serve a dual function. The company reimbursement portion of these policies eases the financial burden on the corporation when it indemnifies, while the director and officer reimbursement portion protects directors and officers by providing for direct reimbursement when a corporation fails to indemnify.4 Together, indemnification and insurance reassure a director or officer that

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1. The average board member of an industrial corporation was paid $24,624 for corporate services in 1985. The average board member of a financial organization was paid only $21,290 in 1985. Barker, "Director Compensation: Board Fees and Benefits 1986," 10 DIRECTORS AND BOARDS, Spring 1986, at 37.

2. In addition to the protection secured by insurance and indemnification, directors and officers are protected by the judicial application of the business judgment rule. Note, "Indemnification of Corporate Directors: A Disincentive to Corporate Accountability in Indiana," 17 VAL. U.L. REV. 229, 230 (1983).


4. Id. at 132-33.
if her conduct falls within a designated standard of conduct deemed to be
insurable or indemnifiable, her personal assets will not be jeopardized by
personal liability incurred in her corporate capacity.

Insurance, however, may no longer be an available source of protection
because insurance policies are becoming ever-increasingly more difficult\(^6\) and
more expensive to obtain.\(^6\) As insurance protection declines, directors and
officers are more vulnerable to the economic hardships which personal li-
ability imposes because they are being sued more often and are being held
liable for increasingly higher judgments.\(^7\) As a result, some directors are
resigning from their corporate posts.\(^8\) Furthermore, corporations now claim
it is more difficult to recruit for those positions.\(^9\)

This combination of shrinking insurance coverage and increasing liability
exposure has resulted in a D&O insurance crisis. The cause of the crisis is
disputed.\(^10\) But whatever the cause of the crisis, its effects are threatening
incumbent directors and officers as well as the traditional system of corporate
governance. Those who have responded to the crisis have proposed both
protective and corrective proposals. The protective measures are aimed at
mitigating the financial impact of personal liability, while the corrective
measures are aimed at restoring stability to the insurance market.

This Note examines both the statutory and the non-statutory responses to
the crisis. The purpose of this Note is to determine which of these proposals
will be desirable in terms of policy interests and which will be successful in

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7. The 1985 Wyatt Directors and Officers Liability Insurance Survey, quoted in Block, supra note 3, at 146-47 [hereinafter Wyatt].
8. Cruthcher’s Chairman and 3 Directors Quit; Lack of Insurance Cited, Wall St. J., Feb. 12, 1986, at 21, col. 2; Lewin, supra note 5, at D1, col. 3.

It is the theory of this Note that regardless of the cause of the crisis, the analysis of the proposals is the same. The ideal response to the crisis should not drastically alter traditional standards of care, nor should it remove the deterrence imposed by the threat of liability.
providing protection. Section I examines the problems that might arise if
the D&O insurance crisis were left unchecked. Section II highlights the policy
considerations involved in determining the amount of protection which should
be restored to directors and officers. Although corporate welfare suggests a
need to restore protection, overprotection is counterproductive. Finally, this
Note examines each proposal to determine whether it is effective and whether
it provides a balanced solution to the D&O insurance crisis.

This Note argues that the statutory responses which eliminate directors' liabil-
ity for certain conduct are effective in providing protection, but they
are not balanced approaches. These statutes err on the side of overprotection.
The more balanced responses propose to expand indemnity rights or to
establish captive insurance subsidiaries. Proposals focusing on expanded
indemnity and captive insurance will enable a corporation to protect its
directors while not altering the standards to which they are held.

I. THE D&O INSURANCE CRISIS TODAY

The symptoms of the D&O insurance crisis are widespread and well doc-
umented. According to the 1985 Wyatt Directors and Officers Liability
Insurance Survey:

18.5 percent of the companies it surveyed for its 1984 Directors and
Officers Liability Survey had experienced claims against their directors,
up from 7.1 percent ten years earlier. [This is] an increase of 182 percent.
At the same time, the average cost of defending these claims had risen
dramatically from $181,500 per claim ten years ago to $461,000 today.
[Moreover,] the percentage of claims paying over $1 million rose from
4.8 to 8.3 percent, and the average settlement award [rose] from $385,000
to $583,000.12

As the number of claims continues to rise and the judgment value of these
claims increases, the degree of protection offered by insurance is simulta-
eaneously diminishing. At the same time that insurers are adding policy ex-
clusions, the costs of the D&O policies have skyrocketed.13 Some insurers
have raised premiums to levels that are fifteen or twenty times higher than
their prior levels,14 and those insured are subject to higher deductibles.15
Even corporations willing to pay a higher price for less coverage may have
a problem; such corporations may not be able to obtain insurance because

11. See supra notes 5-9.
12. Block, supra note 3, at 146-47 (quoting 1985 Wyatt Directors and Officers Liability
Insurance Survey).
13. At the same time that prices “have risen astronomically,” many “new exclusions have
been developed that seriously restrict coverage.” Foley, supra note 6, at 16.
14. Olson, supra note 6, at 25, col. 1.
15. Id.
many insurers no longer offer D&O coverage. Prohibitive costs and general unavailability, therefore, may preclude many from obtaining D&O insurance. As a result, the crisis is stripping directors and officers of one of the protective measures upon which they traditionally have relied.

As indicated by the Wyatt Survey, the crisis is compounded because the disarray of the D&O insurance market is coupled with an increasingly litigious environment. Directors and officers face a greater possibility of being sued and held liable for significant adverse judgments. In addition, directors and officers are being held to higher standards of care. Smith v. Van Gorkom exemplifies the high liability risks to which directors and officers may be exposed. In Smith, the Delaware Supreme Court held that the directors breached their duty of care in approving a cash-out merger proposal. Although the directors acted in good faith, they were subject to high personal liability. The insurance company was required to contribute $10 million, the policy limit, and the directors were responsible for the remainder of the $23.5 million settlement.

The directors in Smith, however, were fortunate in comparison to others. While some corporations are having difficulty finding D&O insurance, other corporations with D&O coverage are finding that their policies may offer little security. In some instances, D&O policies are “[vulnerable] to early . . . cancellation by a nervous insurer . . . .” For example, the news of a possible hostile takeover of Unocal Corporation prompted Unocal’s insurer to cancel the corporation’s D&O policy. Without the protection of D&O insurance, the personal assets of Unocal’s directors and officers were exposed to potential liability.

The ultimate effect of the D&O insurance crisis is that some directors are resigning from their positions. "Being a director is not worth risking all

16. Id.
17. "The uncertainties of indemnification and insurance of corporate officials are likely to be exacerbated in today's litigious society, where high-stakes lawsuits asserting claims against corporate officials are increasingly common." Block, Indemnification and Insurance of Corporate Officials, 13 Sec. Reg. L.J. 239, 251-52 (1985).
18. Courts are holding directors to higher standards of conduct and are more likely to impose substantial penalties on directors for failing to meet these standards. Foley, supra note 6, at 17. For an example of the standards to which directors are being held, see Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).
19. Id. at 858.
20. Id. Finding no "fraud, bad faith, or self dealing" and applying the business judgment rule, the court presumed that the directors acted in good faith. Id. at 873.
21. Block, supra note 3, at 136. The company's acquirer, however, relieved the defendants of the potentially crushing burden of liability by contributing the majority of the remaining settlement value. Id. at 136 n.28.
22. See Olson, supra note 6, at 25, col. 1; supra text accompanying note 6.
23. Id.
24. Galante, supra note 6, at 1, col. 3.
25. "Just in the last six months, the Control Data Corporation, the Continental Steel
your holdings,' said Joseph Barr, one of three Control Data Corp. directors who resigned last December after the company lost its insurance.\textsuperscript{26} If left unchecked, some observers speculate that the crisis could lead to "an exodus of talented individuals from corporate service . . . ."\textsuperscript{27}

II. POLICY CONSIDERATIONS AND THE LIMITS THEY IMPOSE ON D&O PROTECTION

Recognizing the actual and potential danger of the crisis and the important role directors and officers play in corporate governance, the need for restoring protection is apparent. Providing protection to directors and officers advances several policy considerations. First, the availability of protection will reduce the current problem of director and officer resignations by removing the financial risks of personal liability. When no protection is available, a director is more likely to resign because she has no insulation from financial liability. The possibility of being subject to the high costs of defending lawsuits and to adverse judgments will outweigh the benefits of a directorship.\textsuperscript{28} Second, the availability of protection will serve as a catalyst to desired corporate behavior by encouraging good faith risk-taking. Although risk-taking invites lawsuits, it may be necessary for corporate success and profitability.\textsuperscript{29} If indemnification and insurance are readily available, a director or officer will feel freer to take good faith risks. In the event she is sued for such activity, she is likely to be reimbursed. Alternatively, if no protection is available a director may avoid \textit{all} risk in an effort to decrease the possibility of being sued.\textsuperscript{30} Such over-cautiousness is undesirable.

These policy considerations, however, are not without limit. In deciding the extent to which a director should be insulated from personal liability, state laws must strike a delicate balance between competing policy interests. On one side are the policy interests discussed above; a corporation must be

\begin{quote}
Corporation, the Lear Petroleum Corporation, South Texas Drilling and Exploration Inc. and Sykes Dataronics have all lost directors when their insurance ended." Lewin, \textit{supra} note 5, at D1, col. 3.
27. Block, \textit{supra} note 3, at 132.
28. 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. \textit{MODEL BUSINESS CORP. ACT ANN.} § 8.44E introductory comment, at 1081 (1980).
\end{quote}
able to provide enough protection so that it is able to attract and retain directors. Furthermore, the protection must be sound enough to encourage directors and officers to take good faith risks. These concerns must be balanced against the possibility that if protection is too liberally bestowed, such measures will defeat an underlying goal of laws imposing liability on aberrant behavior. This would mean that "faithless" directors would not be punished. Directors or officers should be required to bear the financial burden for inappropriate conduct because retaining the threat of personal liability will act as a deterrent to such conduct.

Ideally, the balance of these competing policy considerations should "seek the middle ground between encouraging fiduciaries to violate their trust, and discouraging them from serving at all." The D&O insurance crisis, however, has caused the balance to shift, and the result is under-protection. This lack of protection is chilling directors' willingness to serve in corporate posts.

### III. STATUTORY RESPONSES TO THE CRISIS

#### A. Delaware's Approach

The threat posed by the D&O insurance crisis has elicited responses from varied sources advocating different resolutions to the crisis. In the forefront are the statutory responses from state legislatures which aim to create an environment more favorable to directors and officers. Delaware, traditionally a leader in developing corporate law, enacted a statute designed to reinstate the financial protection which D&O insurance once offered. Many states

32. Note, supra note 2, at 231. According to the Model Business Corporation Act: A director, officer, or employee who acted wrongfully or in bad faith should not expect to receive indemnification for legal or other expenses and should be required to satisfy not only any judgment entered against him but also expenses incurred in connection with the proceeding from his personal assets. Any other rule would tend to encourage socially undesirable conduct. Model Business Corp. Act Ann. § 8.44E, at 1082.
35. According to the synopsis of the bill: Section 102(b)(7) ... represent[s] 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 ... . 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. S. 533, 133 Del. Laws 1387 (1986).
have followed Delaware's lead and enacted similar statutes. These statutory responses, however, fall short of being a balanced approach to the crisis. These statutes are overprotective, and they diminish the deterrence normally imposed by the threat of liability.

Delaware, in Title 8, section 102(b)(7) of the Delaware Code, allows a corporation to include in its original certificate of incorporation, or to amend its charter to include "'[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 . . . .'") Section 102(b)(7) exempts certain conduct from its protective ambit including breaches of duty of loyalty, acts or omissions not in good faith, intentional misconduct, knowing violations of law, and acts for which a director gains improper personal benefit.

Under Delaware's new law, shareholders are given the option of deciding whether to include the provision in their corporation's charter. An existing corporation may include the provision only if its shareholders vote for its inclusion. If the shareholders of a corporation do adopt this provision, they are not completely without a remedy because the amendment does not preclude shareholders from seeking equitable relief in the form of injunctions or recision. In addition, the statute does not extend its coverage to officers. The narrow application of the law reinforces its purpose of allowing corporations to attract and retain directors. "It was not felt [by the drafters] that the increased perception of risk of personal liability coupled with the unavailability of D&O insurance were sufficient to cause officers, who depend upon a corporation for their livelihood, to resign or refuse to serve."

Delaware corporations that adopt amended section 102(b)(7) will succeed in creating an environment more favorable to directors. The liability-limiting
measure allows directors to serve in a relatively risk-free environment despite an insurance market that offers inadequate coverage. Proponents of the Delaware law point out that the proposal to eliminate liability for negligence is not a completely novel idea; it is analogous to trust law standards in which a trustee can bargain for a contract which excludes him from negligence liability. An additional benefit of the law is that, in the long run, the law may make corporations more insurable. With a regime of limited liability, insurers will be able to base premiums on more reliable and possibly lower figures. Insurers' exposure to liability claims will decrease as the circumstances under which directors can be held liable decrease. The Delaware law, therefore, has both corrective and protective aspects; it is corrective because it helps to stabilize premiums, and it is protective because it shields directors from liability.

While achieving these advantages, the Delaware law takes corporations into uncharted territory. The law strips shareholders of their traditional right to seek monetary damages from directors who breach their duty of care. The question, however, is whether the cost of this solution is greater than the benefits. An analysis of how the need to restore director protection compares with the need to maintain the deterrence imposed by the threat of personal liability will answer this question.

On the director protection side, the Delaware legislature was generous. By allowing the elimination of liability, Delaware corporations can place their directors in a position superior to that held when D&O insurance was the primary means of protection. Insurance provides a director with insulation from the financial burden of personal liability, but "[i]nsurance has never totally protected directors against the risk of monetary liability." Even with D&O policies, directors may be required to contribute up to the amount of the policy deductible, which may be a substantial amount. Directors similarly are better off because the law eliminates liability for previously uninsurable conduct. Recklessness, for example, is generally not insurable. By eliminating liability for recklessness, directors will no longer be required to bear the risk of liability for this conduct.

Although directors will be better off under Delaware's new law, removing potential liability will frustrate the two goals—compensation and deterrence—which liability normally advances. As a consequence of Delaware's

45. Id.
46. Note, supra note 2, at 231.
liability-eliminating statute, shareholders will not be compensated for pecuniary losses suffered by the corporation allegedly due to a breach of duty of care. In addition, the statute diminishes the efficacy of the deterrence which liability imposes. Normally, the possibility of liability deters directors from breaching their corporate duties because directors want to avoid the consequences of personal liability. Under the new Delaware law, the possibility of personal liability for certain conduct is eliminated. This lifting of the specter of liability decreases deterrence.

In addition, the Delaware provision abolishes the non-pecuniary risks associated with potential liability. Non-pecuniary risks of liability are a product of two factors. First, liability may tarnish one’s professional reputation. Second, liability may cause the director to lose time due to discovery or trial proceedings. The time factor “can be crippling to [directors’] other responsibilities.” When the threat of liability is eliminated, a director is no longer subject to these non-pecuniary risks. This point emphasizes that under the Delaware law, directors occupy a position superior to that held when D&O insurance was available. Insurance could never insulate a director from damage to reputation or loss of time. The elimination of deterrence under the new Delaware law may result in more frequent occurrences of negligent and bad faith acts.

The liability-eliminating statute will effect laws imposing liability on aberrant director activity by stripping them of their efficacy. A director needs only to avoid the conduct enumerated in section 102(b)(7) to be exonerated by a court. The effect of the law, therefore, will be to lower the standards by which directors will conduct themselves. To illustrate, consider the situation of Delaware directors who are liable for bad faith but not for negligence.

Directors whose only potential liability is for bad faith need only make sure that they appear to have honestly believed their conduct was in shareholders’ best interests. But potential liability for negligence encourages directors to monitor the quality of their beliefs because their good faith may be checked for its objective reasonableness.

The shareholders of corporations adopting the new Delaware provision are vulnerable to conduct guided by these lower standards. The statute, therefore, creates the paradoxical situation of increasing the possibility for less scrupulous conduct while diminishing the opportunity for adequate re-

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47. Lamalie, Tapping the Pipeline of Future Directors, 10 DIRECTORS AND BOARDS, Spring 1986, at 22.
49. See supra text accompanying note 38.
medial action. Equitable remedies cannot recover pecuniary losses; the losses that arise will remain with the corporation and the shareholders.

The burdens which the Delaware law imposes on the corporation and the shareholders demonstrate that it is not the "balanced solution" which its drafters meant it to be. Section 102(b)(7) does indeed provide protection to directors. It removes, however, the deterrence of liability laws and simultaneously pays little heed to "the rights and remedies of the legitimately injured . . ." The Delaware legislature, therefore, offers shareholders a bleak choice; in order to help a corporation weather the D&O insurance crisis, shareholders must opt for a provision that tips the scales towards overprotection. Directors are granted a "windfall," and shareholders must relinquish their right to sue for monetary damages.

B. Indiana's Approach

Indiana has responded to the crisis by narrowing the standard of conduct for which a director may be held liable. Under the Indiana law, a director is not personally liable unless she breaches her duties and "the breach or failure to perform constitutes willful misconduct or recklessness." The effect of section 23-1-35-1 of the Indiana Code is to alter the traditional duty of care. For example, a director may no longer be held liable for gross negligence because a court must find the director guilty of a higher standard of culpability. Like Delaware, Indiana has enacted a statute that is not a balanced response to the crisis.

In many ways, the Indiana and Delaware laws are similar. Like Delaware's amended section 102(b)(7), Indiana's section 23-1-35-1 is a protective measure because it may serve to increase the insurability of Indiana corporations. Liability is restricted to more narrow circumstances, and ultimately, insurers may decrease premiums to reflect the more restricted potential for liability. The Indiana statute also creates an environment more favorable to directors because the statute attempts to limit the situations in which a director can be held liable. A director previously could be held liable for failing to act in good faith and "with the care an ordinarily prudent person in a like position would exercise." Under the new law, a director of an Indiana

51. A Delaware attorney is skeptical of the effects of a liability-limiting provision. "If you limit liability, do you make it impossible for shareholders or people injured by actions of directors to get meaningful redress?" Victor, supra note 42, at 5, col. 1.
52. One of the drafters of the Delaware statute urges other states to follow Delaware's model. He describes it as a "balanced solution" to the D&O insurance crisis. Sparks, supra note 40, at 10, col. 1.
53. Foley, supra note 6, at 18.
56. Id. § 23-1-35-1(e)(2).
57. Id. § 23-1-35-1.
corporation may be held liable only if, in addition to falling below the traditional standard, the director's conduct constitutes willful misconduct or recklessness. The Indiana provision, therefore, attempts to instill both corrective and protective measures.

The new Indiana law resembles Delaware's new law in another way. Although it provides a strong measure of director protection, it sacrifices competing policy interests. Indiana's statute narrows the standards for director liability, and this undercuts the deterrence of liability laws. "The potential for negligence liability is a significant and necessary deterrent to both negligence and bad faith."58 In Indiana, however, a court that is sympathetic to plaintiffs may be able to circumvent the new law by more readily finding that questionable director conduct constitutes recklessness.

C. Proposals for Expanded Indemnification Statutes

Other state legislatures have responded to the D&O insurance crisis by amending their statutes to expand director and officer indemnification rights. Both Missouri59 and New York60 now provide for more liberal indemnification. The expanded indemnification statutes provide protection while maintaining some of the deterrence that the liability-eliminating statutes abolish. These statutes, therefore, represent a better balance between providing protection and maintaining a check on aberrant behavior.

Missouri, in section 351.355 of the Missouri Code, no longer restricts indemnification to conduct which is in good faith and reasonably believed to be in the best interests of the corporation. The new law allows a corporation to include in its original articles of incorporation, or to amend its bylaws to include a provision allowing indemnity for any conduct so long as the conduct does not constitute "knowingly fraudulent, deliberately dishonest or willful misconduct."61

The New York legislation similarly provides more extensive indemnification to those whose conduct does not exceed certain levels of culpability. Section 721 of the New York Code states that the statutory provisions for indemnification are not a corporation's exclusive rights. A corporation may also indemnify a director or officer for any conduct so long as the director or officer indemnified is not finally adjudged to have acted in bad faith or with active and deliberate dishonesty, or in a way through which she gained advantages to which she was not entitled.62

60. N.Y. BUS. CORP. LAW § 721 (McKinney 1986).
By responding to the crisis with indemnity provisions, the New York and Missouri statutes advance policy interests that their Indiana and Delaware counterparts diminish. Shareholders of New York or Missouri corporations retain all rights to sue directors and officers for any breach of corporate duties. The rights and remedies of shareholders, therefore, remain intact. Because the shareholder's right to sue is retained in both the New York and Missouri statutes, these laws preserve a higher degree of deterrence than either the Indiana or Delaware laws. It is true that both New York and Missouri allow a corporation to protect its directors and officers from the financial burdens of personal liability. The desire to avoid pecuniary loss, however, is not the only aspect of potential liability which deters aberrant behavior. Deterrence also stems from the possibility of damage to professional reputation that also may result from personal liability. Regardless of the breadth of the New York and Missouri indemnity provisions, neither statute can insulate a director or officer from the loss which accompanies a tarnished reputation.

While it is true that these statutes serve the traditional functions of maintaining shareholder remedies and preserving deterrence, these responses to the crisis do not provide as much protection to directors and officers as the liability limiting approaches of Indiana and Delaware. First, the New York and Missouri indemnity statutes are not corrective measures; expanded indemnification laws will not help to make corporations more insurable. These laws instead "shift some of the risk of being uninsured . . . to the corporation." A corporation runs the risk that the insurer will not reimburse the corporation for payments made according to expanded indemnity provisions. Expanded indemnification rights increase the number of situations in which an insurer may be subject to claims by the insured. To compensate for this increased risk, the insurer may raise premiums to a prohibitive level or alternatively may cancel a D&O policy. Risk, in those cases, would fall on the corporation or its directors rather than on an independent third party, like an insurer.

A second weakness of the expanded indemnification statutes is that they are limited in the extent of financial protection that they can provide. Indemnification is "only as good as the assets of the [director's or officer's] corporation." This means that indemnification provisions offer no help to a director or officer when the corporation is financially unable to provide the requested amount of indemnification. This problem could arise if a

63. See supra text accompanying note 47.
64. Block, supra note 3, at 147.
65. Id. at 147-48.
67. Olson, supra note 6, at 33, col. 1.
corporation declares bankruptcy because priority claims might limit the amount which a corporation could pay as indemnity. In these circumstances, the directors and officers will expose their personal assets to liability.\(^6\)

To mitigate the weaknesses of indemnity statutes and to maximize their efficiency, corporations adopting expanded indemnity rights should use mandatory language in their articles or bylaws.\(^6\) The corporation's indemnity provisions, for instance, should read that the corporation "shall indemnify" rather than the corporation "may indemnify."\(^7\) The latter is an example of permissive indemnification and only provides the corporation with an option to indemnify.\(^8\) The former is a mandatory indemnification provision that gives a director or officer a right to indemnification.\(^9\) Assuming a corporation is solvent, its directors or officers will have greater security when the corporation employs mandatory language because her claim for reimbursement is based on a right rather than a corporate option to indemnify.

\[D. \text{ Statutes Aimed at the Insurance Industry}\]

Another statutory response to the D&O insurance crisis is directed at the insurance industry itself. West Virginia recently enacted a reform that places new limits on insurers' conduct.\(^3\) One example of the new restrictions is that the statute mandates that an insurer must give extended advance notice of its intent to cancel a D&O policy.\(^4\) This effort to ease the insurance crisis backfired, however, when insurers reacted adversely. "Financial institutions throughout West Virginia recently received notice that their D&O policies would be cancelled summarily on May 31 in reaction to [the] state-enacted insurance reform bill [which became effective June 1, 1987]."\(7\)

In an attempt to dissipate the negative reactions to the bill, the legislature convened in a special session. During that session, the legislature softened the requirements imposed by the previous bill.\(^6\) The reactions of both the insurers and the West Virginia legislature demonstrate an important fact: insurers will not be passive when states enact statutes directly affecting insurance. Insurers, moreover, possess sufficient political clout to see that legislatures respond to their outcries against restrictive legislation.\(7\)

\(^{68.}\) Id.
\(^{69.}\) Block, supra note 3, at 139.
\(^{70.}\) Id.
\(^{71.}\) Oesterle, supra note 30, at 518-19.
\(^{72.}\) Id. at 519. Protection is greater if it takes the form of a binding commitment that provides security against the costs of legal proceedings. \(\text{Id.}\)
\(^{74.}\) See id. An insurer may cancel a policy only if the insured is notified 30 days prior to cancellation. \(\text{Id.}\)
\(^{75.}\) Giesen, supra note 66, at 12.
\(^{77.}\) For a comprehensive listing of insurance reforms and pending reforms, see \text{Illinois Department of Insurance, Summary of State Actions on Availability (April 1986).}\)
makes it difficult—if not impossible—for legislatures to respond to the crisis with direct reforms on the insurance market.

IV. NON-STATUTORY RESPONSES

A. Captive Insurance Subsidiaries

In addition to the above-mentioned statutory responses, several non-statutory approaches have been suggested which may help corporations cope with the D&O insurance crisis. One such alternative is for a corporation to form a captive insurance subsidiary. This method allows corporations to form their own source of D&O insurance in order to counteract the consequences of the general unavailability and inadequacy of commercial insurance. A corporation desiring captive insurance will act as the parent of the captive insurance subsidiary, providing a capitalization plan for the subsidiary. After capitalization, captive insurance companies generally "[are] professionally managed, and [they charge] premiums to the parent for the issuance of policies modeled on those in the commercial market." By forming captive insurance companies, corporations create substitutes for the protection offered by commercial insurers.

The captive insurance alternative, however, may pose several problems to corporations which will prevent them from enjoying the full range of benefits supplied by a commercial insurer. For instance, corporations forming captive insurance subsidiaries will face the same difficulty that commercial insurers face in "gaug[ing] their potential losses accurately" in the "current litigious environment." These corporations, therefore, will bear the risks of loss that would be transferred to a third party if the corporation were commercially insured. In addition, because of the close connection between a parent corporation and a captive subsidiary, "[c]ourts may disregard the separate corporate status of the entities." Courts may view the arrangement as merely a scheme to skirt indemnity laws and, consequently, may not allow captive insurers to make insurance payments to the insured parent corporation.

Another problem frequently encountered by corporations establishing captive insurance companies involves tax disadvantages. The Internal Revenue Service (IRS) refuses to allow deductions for premiums paid to captive insurance subsidiaries even though premiums paid to commercial insurers

78. See supra text accompanying notes 5-9.
79. Olson, supra note 6, at 34, col. 1.
80. Block, supra note 3, at 146.
81. Id. at 145.
are deductible. According to the IRS, premiums are not deductible when "there is no economic shifting or distributing of risks of loss." Under this theory, premiums paid to insurance subsidiaries are not deductible because the parent and subsidiary "represent one economic family with the result that those who bear the ultimate economic burden of loss are the same persons who suffer the loss."

As a result of the IRS' position, the IRS repeatedly has prevailed over taxpayer corporations claiming deductions for premiums paid to captive insurance subsidiaries. In *Beech Aircraft Corp. v. United States,* for example, the plaintiff corporation formed an insurance subsidiary to provide the corporation with products liability insurance. The court held that the premiums were not deductible because the taxpayer corporation, Beech, failed to prove a true risk transfer. According to the court, "[the subsidiary] had a capitalization of not more than $150,000.00. [The subsidiary, however,] purported to cover a loss of several million dollars excess coverage. [In reality,] only Beech could have responded to such a loss had such occurred."

In an exception to the IRS' success in these cases, the taxpayer in *Crawford Fitting Co. v. United States* prevailed. In that case the IRS characterized the premium payments as reserves held by the subsidiary to cover the parent's contingent losses. The court, however, found evidence of a "distribution of risk" and allowed the taxpayer to deduct the premiums. Through captive insurance, therefore, the corporation was successful in obtaining substitute protection. More importantly, the corporation achieved the same tax advantages as if it had been insured by a commercial insurer because its premiums were tax deductible.

The foundations of the holding in *Crawford Fitting* provide some guidance for corporations planning to set up a captive insurance subsidiary. To increase the likelihood that a court will find the premiums to be deductible, a corporation should: (1) maintain separate and independent identities between the parent and captive insurance company; (2) establish premiums that are "actuarially based, and proportionate to the risks they [cover];" (3) sell shares of the captive to third parties so that the "taxpayer is not a shareholder..."
of the captive;” and (4) insure “various nonaffiliated persons or entities facing risks similar but independent of those faced by [the parent].”

A well organized captive subsidiary, therefore, may provide an effective means of protecting directors and officers. This approach does not sacrifice any competing policy interests because it mimics the traditional system of insurance. This alternative, unfortunately, may not be feasible for small corporations or for corporations that are experiencing financial trouble. Such corporations may be unable to generate sufficient assets to initially capitalize a subsidiary.

B. Advisory Boards

A second protective measure which a corporation may use during the D&O insurance crisis is to substitute its traditional board with an advisory board. Under this plan, a corporation devises a new board system in an attempt to eliminate potential liability for board members. Advisory boards are composed of “former directors who serve without compensation and have no binding vote on company policy.” Under this system, the chief executive officer bears the responsibility of final decisionmaking and, theoretically, directors will not be legally accountable for corporate decisions.

In practice, however, advisory boards may be ineffective in protecting directors and officers from liability. Courts and plaintiffs' lawyers may disregard the advisory board's special status and impose liability on those who have guided corporate decisions allegedly leading to corporate losses. “[A]lmost everyone connected with a corporation is likely to be sued whenever an investor believes he or she has suffered a loss.”

In addition, placing board members in an advisory status undermines public policy considerations in several ways. First, if members of the advisory board are led to believe that they are not legally accountable for their actions, the incentive to exercise careful business judgment decreases. Second, this tactic places the chief executive officer in a precarious position. The advisory board plan provides the chief executive officer with no protection from liability, and yet it forces him into a position in which he is the “only accountable person.” The effect of advisory boards could be that the chief executive officer is “more conservative and [less likely to take risks], and

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91. Id. See also Olson, supra note 6, at 25, col. 1.
92. Galante, supra note 6, at 30, col. 1.
94. Galante, supra note 6, at 30, col. 1.
95. Louden, supra note 93, at 20.
96. Id.
thus [he] is harmful to the growth, profitability, and continuance of the enterprise."

C. The Damage Limitation Approach

A third approach is suggested by the American Law Institute (A.L.I.).98 The A.L.I. recommendation retains director and officer liability, but it limits damages for breaches of duty of care if certain standards are met.99 Under this proposal, damages for violations would be "limited to an amount that is not disproportionate to the compensation received by the director or officer for serving the corporation during the year of the violation."100 This limitation on damages would be allowed only if the director or officer's conduct did not: (1) "involve a knowing and culpable violation of law;" or (2) enable her to receive an "improper" benefit; or (3) "show a conscious disregard for the duty of the director or officer to the corporation under circumstances in which [she] was aware that her conduct created an unjustified risk of serious injury to the corporation;" or (4) amount to an "abdication of the defendant's duty to the corporation."101

The A.L.I. suggests two possible ways of implementing its plan. The plan could be effected by legislative enactment of an enabling statute or by shareholder adoption of a provision in the certificate of incorporation.102 Virginia is the one state that has enacted a statute adhering to the damage limitation proposal.103

By limiting liability damages instead of eliminating liability, the damage limitation proposal maintains some policy interests which liability eliminating statutes do not.104 Provisions eliminating liability for certain conduct may detract from the credibility of the duty of care standards because directors and officers are not legally accountable for their conduct.105 The damage limitation approach, however, maintains the deterrence inherent in potential

97. Id.
99. See id. § 7.17(a).
100. Id.
101. Id.
102. Id. § 7.17(b).
104. Section 7.17 of the A.L.I. PRINCIPLES OF CORP. GOVERNANCE limits damages instead of eliminating personal liability. This is an intermediate position which falls between the two "poles" of "full liability" and "elimination of all liability." A.L.I. PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.17 comment c, at 30 (Tent. Draft No. 7, 1987). The premise of the A.L.I. approach is that "there should be a minimum boundary in order that the risk of liability not be so low that the duty of care ... 'fail of its essential purpose.'" Id. at 31.
105. See id. at 31.
liability. In addition, this approach allows shareholders to retain their cause of action for violations of duty of care.

A consideration underlying the damage limitation proposal is fairness to the directors. "[T]he potential liability in cases where the ceiling could apply would otherwise be excessive in relation to the nature of the defendant’s culpability and the economic benefits expected from serving the corporation."

A second consideration underlying the proposal revolves around shareholders’ interests. When directors and officers are exposed to potentially staggering liability, they may become “excessively risk-averse.” Excessive conservatism may enable a director or officer to avoid being held liable for her conduct, but it is not necessarily in the best interests of the corporation.

Theoretically, damage limitation protects directors and officers while maintaining some degree of deterrence. To be effective, however, several practical barriers must be overcome. To date, only one legislature has enacted such a provision. For corporations incorporated under any other law, only corporate amendments or possibly judicial decisions may be used to implement the provision. Neither of these methods, however, provides certain enforcement. If a corporation adopts an amendment, for instance, it is possible that a court will overlook the damage limitation provision and impose a higher liability because this approach lacks precedential value. “Indeed, no American decision has been discovered which addresses a charter provision limiting liability for due care violations.” Implementation by judicial decision is similarly a tenuous basis of protection. It offers no reassurance of financial protection because it depends on each court’s receptiveness to this proposal. Therefore, until legislatures indicate their approval of this approach, the damage limitation proposal will not be a reliable form of protection.

A second problem of this approach involves determining the amount to which damages should be limited. An idea inherent to the A.L.I. provision is that the damages limitation will be higher for officers than for directors because officers are paid more. The A.L.I. suggests limiting damages to one year’s salary, but this may not be the ideal ceiling. The traditionally

106. Id.
107. Id. at 30. “No evidence suggests that senior executives have been chilled in their willingness to accept corporate employment or are fleeing the board. Still, concern over liability may make corporate officers excessively risk-averse.” A.L.I. PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.17 comment g, at 241 (Tent. Draft No. 6, 1986).
108. Id.
low director salaries\textsuperscript{112} may create ceilings on damages that are so low that shareholders will have no incentive to sue. Damage awards would not cover shareholder losses unless that shareholder could also sue officers with higher salaries and, consequently, higher damage limitations. On the other hand, expanding the proposed limit of one-year’s salary would provide little extra protection to directors and officers. In short, finding an equilibrium raises difficult policy questions, and the result may be a sacrifice of either shareholder rights or director protection.

The Virginia legislature decided upon a damage ceiling that limits a director’s or officer’s liability to either: (1) an amount specified in the articles of incorporation or bylaws, or (2) the greater of $100,000 or the amount which the director or officer was compensated in the twelve months preceding the alleged wrong.\textsuperscript{113} The policy considerations discussed above can be used to analyze this statute. If a Virginia corporation opts to set the limits through its articles or bylaws, the corporation faces the difficulty of finding an equilibrium. If the corporation selects the second alternative, the question arises whether such a ceiling provides shareholders with adequate remedies.

**CONCLUSION**

If the effects of the D&O insurance crisis do not dissipate, the crisis could disrupt corporate governance and diminish corporate profitability. Without some form of cushion between the directors’ or officers’ personal assets and the full impact of personal liability, directors will be unwilling to continue in their posts, and both directors and officers will be excessively risk-averse. Recognition of this problem, fortunately, has led to various proposals to reinstate protection to directors and officers. Some of these proposals, however, are less than ideal solutions from the viewpoint of efficiency and competing interests.

In examining the desirability of the statutes which have been enacted, it should be clear that the effects of state laws will remain *unless* the legislature repeals or amends the law. While it is not uncommon for legislatures to repeal or amend laws, this point emphasizes that statutory measures should be examined for potentially long-term effects. Specifically, statutory responses which sacrifice the long-term interests of corporate welfare are undesirable.

Scrutinizing the new Delaware and Indiana laws under these guidelines, it is clear that these statutes do not provide a balanced approach to the D&O insurance crisis. When directors are no longer legally accountable for

\textsuperscript{112} See Barker, *supra* note 1, at 37 (suggesting that if the limitations are so low that even successful litigation could not possibly recover the alleged loss, litigation would lose its meaning as a vehicle to recover corporate losses).

their decisions, the laws imposing duty of care standards on them become merely recommended standards. Directors of Delaware and Indiana corporations have the option of complying with these laws, but their actions will no longer be shaped by the threat of liability which is normally imposed upon conduct falling below prescribed standards.

The best statutory approach offered to date is represented by the statutes of New York and West Virginia. Under the expanded indemnity laws which they have adopted, duty of care standards are still viable forces because directors and officers are legally accountable for their conduct. Expanded indemnity rights, moreover, reinstate an outward sign of financial protection. Corporations adopting these proposals profess financial support to their directors and officers who are called upon to defend lawsuits. This solution will encourage directors to serve in their corporate posts and will diminish the problem of excessive conservatism.

Corporations can easily maximize the efficiency of expanded indemnity statutes by amending bylaws which employ mandatory indemnification provisions. A corporation creating mandatory indemnification provides its director or officer with a right to indemnity. Mandatory indemnification can be achieved if corporate bylaws read that the corporation “shall indemnify” directors and officers for conduct which satisfies the standard deemed to be indemnifiable. The same result can be achieved by writing an employment contract for a director or officer which provides that the corporation will indemnify her if certain standards of conduct are met.

The above methods of indemnification maximization can be used by any corporation, provided it is within the bounds of conduct deemed indemnifiable by its governing state. Another non-statutory proposal is that a corporation may form a captive insurance company. Such insurance companies provide a substitute for the protection which was once readily available from commercial insurers. By utilizing either indemnification maximization or captive insurance subsidiaries, a corporation can protect its directors and officers and weather the D&O insurance crisis.

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