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PROTECTING THE CORPORATE EXECUTIVE: DIRECTOR AND OFFICER LIABILITY INSURANCE REEVALUATED

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I. INTRODUCTION

The increasing maze of easily violated governmental regulation in the areas of both securities and anti-trust laws, together with the proliferation of third-party and stockholders' derivative suits, has made it necessary for every professional business management group to seek some means to afford itself sufficient protection against the spiraling exposure to liability [1] In an effort to attract and retain competent executives despite this increasing exposure, many publicly held corporations are choosing to protect management from the so-called "honest mistake" or "shakedown" stockholders' suits through the purchase of directors' and officers' liability insurance. Although Lloyds of London has issued this type of insurance for over twenty-five years, only within the last five to seven years has corporate management seriously considered this form of protection.[2] To demonstrate the present magnitude of reli-

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1. Rather descriptively noting the extent of exposure, one author wrote:

> The directors and decision-making officers of such a corporation sit at the controls of a gigantic engine of economic power. Misuse of those controls can bring the engine into collision with whatever stands in its way—customers, competitors, employees, the public and the government. Such a collision can, by the same token, inflict enormous damage upon the machine itself—a machine which does not belong to the operators but to thousands or even millions of people who have little knowledge of, and less control over, the manner of its operation. All these victims have rights which they may vindicate in court. In short, the managers of a publicly held company can hardly avoid exposing themselves to litigation and to liability which is measured not in terms of the personal fortunes of the individual managers but according to the vastly larger scale of the corporation's operations.

Bishop, *New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability*, 22 BUS. LAWYER 92, 92-93 (1966).

2. "One good measure of just how worried [corporate executives] are is that in the last five years the amount of liability insurance sold to directors and officers has increased from practically nothing to over 1 billion dollars." *The Law: Trouble for the Top*, FORBES, Sept.

ance upon insurance in this area, Stewart, Smith Mid-America, Inc. has reported that between 1963 and 1970, more than $2.5 billion of directors' and officers' liability insurance has been sold through its offices to some seven hundred of the largest corporations in the United States.[3]

The most obvious factor contributing to this increase in the purchase of directors' and officers' liability insurance is the development of what might be called an increased claims consciousness, with a resultant increase in exposure to liability. Informal shareholders' groups critical of corporate management have arisen at a remarkable rate. While irate stockholders who denounce management at annual meetings have been ever present in the business world, some are now "telling it to the judge," rather than merely attempting to convince fellow shareholders to vote objectionable directors out of office. The result has been a dramatic increase in the number of suits brought against directors and officers to recover damages for real or fancied wrongs. This increasing volume of claims and suits may also be attributable in part to the increase in the number of stockholders. Persons holding publicly traded corporate shares have increased from 6.5 million in 1952 to 31.9 million in 1970 — an increase of 390 percent in eighteen years.[4] In Wisconsin alone, the number of individual shareholders between 1965 and 1970 had increased by 198,000, bringing the 1970 total to 558,000 stockholders. This increase brought the percentage of Wisconsin's population owning stock from 8.7 to 12.6 percent during that period,[5] and these figures are ever increasing. It has been estimated that the number of individual shareholders in the United States will grow to nearly 50 million in 1980.[6]

Another factor contributing to the increased reliance upon liability insurance is that the 1960's and early 1970's were periods of business boom, evidenced by corporate expansion, diversification, and acquisitions — ventures which usually involve the incurrence of corporate indebtedness. In addition, many companies of questionable financial stability went public during the new issue markets of 1961-62 and 1967-68. When a boom collapses, commercial

1, 1968, at 23.

3. Stewart, Smith Mid-America, Inc. Brochure (1970). *See* The 1974 Wyatt Directors and Officers Liability Survey at 15, analyzing the prevalence of D & O liability insurance.

4. Milwaukee Journal, March 22, 1971, § 2, at 15, col. 6.

5. *Id.*

6. *Id.*

failures and bankruptcies run rampant, opening a fertile field for stockholders' suits.[7] The 1974 Wyatt Directors and Officers Liability Survey examines claim frequency as a function of corporate profitability.[8] The more profitable companies are sued much less than those encountering financial problems.

Corporate management's expanded exposure to financial risk is also attributable, in part, to a growing trend on the part of courts to construe with increasing strictness the role of management in the modern publicly held business enterprise, whose characteristic separation of ownership and control departs from the traditional factual pattern in which fiduciary duties were defined. In most instances, a statutory standard of care describes the duty of the corporate officer or director in terms of that "degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions."[9] While officers and directors may be protected in some respect by this so-called "business judgment rule,"[10] recent court decisions have employed more stringent standards of care in relation to corporate acts of commission and omission. Thus, although various causes of action have been filed in the past,[11] the future may well see the development of additional

7. Dunn & Bradstreet statistics indicate that there was an increase of commercial failures and bankruptcies filed during the new issue markets of the 1960's. *See* 94 STATISTICAL ABSTRACT OF THE UNITED STATES 484-488 (1973).

8. The 1974 Wyatt Directors' and Officers' Liability Survey at 9 (hereinafter 1974 Wyatt Survey).

9. Briggs v. Spaulding, 141 U.S. 132 (1891). *See* IDAHO CODE ANN . § 30-142 (1967); LA. REV. STAT. § 12:36 (1969); MINN. STAT. § 301.31 (1969); N.C. GEN. STAT. § 55-35 (1965). *See also* Adkins & Janis, *Some Observations on Liabilities of Corporate Directors*, 20 BUS. LAWYER 811 (1965).

10. *See* Pollitz v. Wabash R.R., 207 N.Y. 113, 100 N.E. 721 (1912). *See also* H. HENN, LAW OF CORPORATIONS 482-483 (2d ed. 1970); Note, *The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint*, 35 GEO. WASH. L. REV. 562 (1967).

11. As examples of the most common charges relied upon in the past, see Otis & Co. v. Pennsylvania R.R., 155 F.2d 522 (3d Cir. 1946) (failure to obtain competitive bids where required by prudent business practice); Rankin v. Cooper, 149 F. 1010 (S.D.N.Y. 1906) and Trustees Mutual Bldg. Fund & Dollar Savings Bank v. Bosseiux, 3 F. 817 (E.D. Va. 1880) (continual absence from directors' meetings, thereby allowing improper acts to be committed by others); Booth v. Dexter Steam Fire-Engine Co. No. 1, 118 Ala. 369, 24 So. 405 (1898) (failure to exercise reasonable care in selection of a depository bank which subsequently fails); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963) (failure to discover and prevent anti-trust violations); Black v. Parker Mfg. Co., 329 Mass. 105, 106 N.E.2d 544 (1952) (improvident expansion of corporate activities into new fields with resultant losses); Helfman v. American Light & Traction Co., 121 N.J. Eq. 1, 187 A. 540 (1936) (improvident investment of corporate funds); Brown v. Watson, 285 App. Div. 587, 139 N.Y.S.2d 629 (1955) (issuance of stock without receipt of valid consideration).

theories of liability aimed at officers and directors. Causes of action grounded upon infringements of civil rights, tort claims for pollution, expanding product liability, and failure to comply with E.E.O.C., O.S.H.A., or Consumer Product Safey Act standards represent just a few.

In addition to the changing interpretation of the due diligence concept, many state statutes specify prohibitions which invoke strict liability. In Wisconsin, for example, statutory liability is imposed upon directors for unlawful dividend distribution,[12] purchase of the corporation's own shares when its capital is impaired,[13] loans to corporate officers until the time of repayment,[14] and distribution of assets during liquidation without adequate provision for debts or obligations.[15]

Perhaps the most serious concern is caused by the Securities Act of 1933 and the Securities and Exchange Act of 1934, which, when coupled with vigorous administration by the Securities and Exchange Commission and recent judicial interpretations, have enlarged earlier concepts of directors' and officers' liability.[16] In particular, section 10(b)[17] of the 1934 Act and rule 10b-5,[18] promulgated by the Securities and Exchange Commission, have engen-

12. WIS. STAT. § 180.40(1)(a) (1973).

13. *Id.* § 180.40(1)(b).

14. *Id.* § 180.40(1)(d).

15. *Id.* § 180.40(1)(c).

16. Professor Joseph W. Bishop, Jr. of Yale University warns of the risks and hazards attributable to involvement in such action.

> It must be admitted that no one today can accurately forecast the size of the risk which is created by the prospect of increasingly vigorous enforcement of the federal securities laws, both by the Securities and Exchange Commission and by private litigants. That risk includes, of course, not only fines and amounts paid in satisfaction of judgment or to compromise claims, but also legal expenses which are likely to be high in this kind of litigation.

J. Bishop, *Protecting Corporate Executives Against Liability and Expense under the Federal Securities Law*, EMERGING FEDERAL SECURITIES LAW: POTENTIAL LIABILITY 155-169 (Institute of Continuing Legal Education 1969).

17. 15 U.S.C. § 78j(b) (1971). This section prohibits use of "any manipulative or deceptive device or contrivance" in the purchase or sale of securities.

18. 17 C.F.R. 334, § 240.10b-5 (1964). This regulation makes it unlawful for any person, though the mails, interstate commerce, or any national securities exchange:

> (a) to employ any device, scheme, or artifice to defraud.
>
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

dered a spectacular growth in the law relating to civil liability arising out of securities transactions. As one court noted:

> While other federal securities anti-fraud provisions are important, none have become as far-reaching as Rule 10b-5 which, although used little in its early years, now represents approximately one-third of all current cases, public and private, brought under the whole array of SEC statutes. It generates almost as much litigation as all other anti-fraud provisions combined.[19]

The increase of litigation under section 10(b) and rule 10b-5 is partially the result of the ease with which aggrieved individuals may bring suit. Section 10(b) may be invoked as a basis for claims only where the prerequisites to attachment of federal jurisdiction have been met, that is, where there has been a use of the mails, of any means or instrumentality of interstate commerce, or of stock exchange facilities. However, as one of these is apt to be present in most securities transactions, it is difficult to escape from the rule even in transactions which are purely intrastate.[20]

In addition, a plaintiff is afforded considerable substantive and procedural advantages in bringing a suit based upon section 10(b). Because this section provides for a federal cause of action, diversity of citizenship is not necessary. Jurisdiction is conferred by section 27 of the Exchange Act of 1934, which gives to the district courts of the United States exclusive jurisdiction over violations of the rules and regulations of the Commission. Such suits may be brought in any district in which any act or transaction constituting the violation occurred, or in the district where the defendant is found or transacts business. Process in such cases may be served wherever the defendants may be found. Further, a shareholder need not post security[21] in a so-called derivative suit (wherein an

19. Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968).

20. Many states have enacted laws, similar to the federal statute, prohibiting the employment of fraudulent practices in the sale and purchase of securities in intrastate transactions. *See, e.g.*, ALA. CODE tit. 53, § 28 (Supp. 1973); ARIZ. REV. STAT. tit. 44, § 44-1991 (1956); ARK. STAT. § 67-1235 (1966); COLO. REV. STAT. ch. 125, § 1-1 (1963); IDAHO CODE tit. 30, § 30-1403 (1967); IND. ANN. STAT. § 25-866 (1970); KAN. STAT. ANN. § 17-1253 (Supp. 1970); KY. REV. STAT. § 292.320 (1969); MD. ANN. CODE art. 32(a), § 13 (1970); MO. REV. STAT. § 409.101 (1974); NEB. STAT. § 8-1102 (1970); NEV. REV. STAT . § 90.110 (1969); N.J. REV. STAT. ANN. § 49:3-52 (1970); N.M. STAT. ANN. § 48-18-29 (Supp. 1969); OKLA. STAT. ANN. tit. 71 § 101 (Supp. 1970); ORE. REV. STAT. § 59.135 (1973); S.C. CODE ANN. § 62-201 (Supp. 1970); UTAH CODE ANN. § 61-1-2 (1969); WIS. STAT. § 551.41 (1973).

21. McClure v. Borne Chemical Co., 292 F.2d 824 (3d Cir. 1961) *cert. denied* 368 U.S. 939 (1961); Levine v. Bradlee, 248 F. Supp. 395 (E.D. Pa. 1965). State security-for-expense

individual stockholder brings the action on his own behalf or on behalf of a group of shareholders to enforce a corporate right). The intent to defraud, an essential element in common law fraud, need not be proven in private damage actions under rule 10b-5.[22] Fraudulent motive need not be present. Knowledge itself may be sufficient. Furthermore, under rule 10b-5, privity need not be present between the plaintiff and defendant; that is, they need not both be parties to the transaction or deal with each other.[23]

Finally, the increase of litigation under section 10(b) may be attributed to the breadth of coverage of such an action. Rule 10b-5 makes it unlawful for "any person" to engage in the prohibited act or omissions. Although referred to as an "insider" rule, it is much broader in application than section 16(b)[24] of the Securities an Exchange Act of 1934. Included are the corporation and its directors, officers, and controlling stockholders.[25] In addition, the rule covers persons who have access to material information which is unavailable to the public[26] and persons to whom the material information has been transmitted ("tippees").[27]

Despite the growing importance of rule 10b-5, it should not be considered the only source of potential liability for corporate direc-

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statutes, which generally cover derivative suits, are inapplicable to derivative claims under 10b-5 because of the primacy of federal interest.

22. Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Wellington Computer Graphics, Inc. v. Modell, 315 F. Supp. 24 (S.D.N.Y. 1970); Astor v. Texas Gulf Sulphur Co., 306 F. Supp. 1333 (S.D.N.Y. 1969).

23. New Park Mining Co. v. Cranmer, 225 F. Supp. 261 (S.D.N.Y. 1963); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962).

24. 15 U.S.C. § 78p(b) (1970):

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. . . .

25. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); Baumen v. Rosen, 283 F. Supp. 128 (D. Md. 1968); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

26. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). *See also* A. BROMBERG, SECURITIES LAW: FRAUD SEC RULE 10B-5, § 12 (1967).

27. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); Kuehnert v. Texstar Corp., 286 F. Supp. 340 (S.D. Tex. 1968).

tors. Recent cases have expanded directors' liability under section 11 of the Securities Act of 1933[28] for filing false registration statements with the Securities Exchange Commission. For example, in *Escott v. Bar Chris Construction, Inc.*,[29] holders of debentures issued by a corporation which was later adjudged bankrupt discovered in the registration statement serious errors which had not been detected by the underwriters, accountants, or outside directors. In a subsequent bondholder's suit filed under section 11, the court held that these defendants had not made a reasonable investigation of the facts and, hence, were unable to satisfy the standard of due diligence—a defense available to all parties to a security issuance other than the issuer under section 11(b) (3) of the Securities Act of 1933. Thus, the court held all signatories to the registration statement personally responsible for losses suffered, even though they did not intentionally deceive the debenture holders.

In a subsequent case, *Globus v. Law Research Service, Inc.*,[30] the failure to disclose the loss of a programming contract in the corporation's registration statement resulted in an award for actual damages for which the directors and officers were personally liable. The New York District Court (for the first time) also awarded punitive damages to be satisfied out of the personal assets of the president and underwriters of the stock. The Second Circuit, on appeal, overruled the punitive damage award. Nevertheless, this case represents an impressive example of the growing trend by the courts to expand the personal exposure of those having fiduciary obligations to shareholders.

Whatever the cause, this increase in exposure to personal liability will undoubtedly result in some hesitancy on the part of prospective directors to accept positions with corporations.[31] Al-

28. 15 U.S.C. § 77k (1970). This section imposes civil liabilities, on account of having filed a false registration statement, upon every person who signed the registration statement, every underwriter of such security, all directors or partners at the time of filing or named in the statement as about to become such, and "every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him," where such person has, with his consent, been named as having prepared or certified any part of the statement or any report or valuation used in connection with the registration statement.

29. 283 F. Supp. 643 (S.D.N.Y. 1968).

30. 287 F. Supp. 188 (S.D.N.Y. 1968), *aff'd in part*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

31. This result has already been reported:

> While these and a scattered number of other directors are resigning, scores of men are politely declining offers they once would have jumped at to serve on prestigious boards. The reason are many. Recent court decisions have broadened the duties

though being named a director is considered an honor, it entails immense responsibility. In the minds of many, the burden is not balanced by the small financial remuneration which usually accompanies the post.

II. PRESENT FORM OF PROTECTION - INDEMNIFICATION

At the present time, the most widely utilized method of shifting the financial risk of liability from the executive to the corporation is through indemnification. Although there is no common law rule entitling directors to reimbursement out of corporate funds, one early Wisconsin decision accepted the proposition that a director or officer would be entitled to have the corporation he served pay the cost of defense of a lawsuit if he were successful.[32] However, in 1939, the New York court in *New York Dry Dock v. McCollom*[33] held that a corporation had no power to pay the expenses of defending a derivative suit, even though the defendant directors were vindicated on the merits. In the opinion of the court, the directors were not entitled to reimbursement since they derived their authority from the state, not from the corporation or its shareholders. They were found not to be in the position of an agent entitled to recovery for necessary expenses, but were rather *sui generis*. Therefore, the corporation was not legally obligated to reimburse them. In addition, there were no equitable considerations, such as those of conserving some substantial corporate interest or bringing some definite benefit to the corporation, which would justify reimbursement or payment.

McCollom has been criticized by those who would argue that indemnification is essentially part of the director's compensation and that the real benefit to the corporation is the obtaining of the directors' services. Agreeing with this argument, other courts have rejected the *McCollom* rationale and have held that corporations not only can, but should indemnify directors who prevail on the

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and liabilities of a director. Stockholder suits, costly and time consuming to defend, have been filed increasingly against directors. And as more companies expand into wide-ranging fields, more and more men have to rule themselves out for board posts because of conflicts of interest. The result: there is now a relative shortage of competent men willing and able to serve as directors.

Wall Street Journal, March 13, 1969 at 1.

32. The court allowed recovery for no other reason than "if no case is made against defendants, it is not improper or unjust that the corporation should pay for the defense of the action." Figge v. Bergenthal, 130 Wis. 594, 625, 109 N.W. 581, 592 (1907).

33. 173 Misc. 106, 16 N.Y.S.2d 844 (Sup. Ct. 1939).

merits in derivative litigation.[34] Thus, recognizing the problems of corporate management in this area, one court indicated that the purpose of indemnification was to encourage innocent directors to resist unjust charges, to provide them an opportunity to hire competent counsel, to induce responsible businessmen to accept the post of director, and to discourage stockholders' litigation of the strike variety.[35]

By far the most noticeable effect of *McCollom* was the subsequent proliferation of indemnification statutes, which have been enacted in forty-eight states,[36] the District of Columbia, Puerto Rico, and the Virgin Islands. Because these enactments vary in the nature and extent of protection provided, and analysis of the particular statute involved must be made. In conducting such an analysis, consideration of the following questions should be useful in determining the breadth of protection afforded:[37]

1. *Exclusiveness.*
   a. Is the statutory provision exclusive?
   b. If not, how can indemnification be provided in cases not covered by the law?
      1) By charter or by-law provision?
      2) By resolution of the stockholders?
      3) By resolution of the board of directors?
   c. Can the statutory indemnification be narrowed?
      1) How?
      2) By whom?
2. *Mandatory or Discretionary?*
   Is indemnification:
   a. Mandatory?

34. *In re* E.C. Warner Co., 232 Minn. 207, 45 N.W.2d 388 (1950); *cf.* Monney v. Willys-Overland Motors, Inc., 204 F.2d 888 (1953); Solimine v. Hallander, 129 N.J. Eq. 264, 19 A.2d 344 (1941).

35. *In re* E.C. Warner Co., 232 Minn. 207, 45 N.W.2d 388 (1950). One author notes that the principle of corporate indemnification has been defended:

> on the ground that it would enable directors of limited means to enlist the services of competent counsel on the assurance that if successful payment would be forthcoming from the corporate treasury, it would also encourage men to accept the responsibilities of the post of director, the emoluments of which would otherwise not be commensurate with the risk of loss involved.

13 W. FLETCHER, CYCLOPEDIA OF CORPORATIONS § 6045.1, at 575 (1970).

36. Idaho and Illinois have no provisions authorizing indemnification of officers and directors.

37. See W. CASEY, CORPORATE PLANNING § 62.313.1 (1971).

b. Permissive or discretionary?
c. Mandatory in some cases and not in others?

3. *Suits Covered.*
Is indemnification available in:
a. Derivative actions (suits on behalf of the corporation)?
b. Third party actions?
c. Civil actions, criminal actions, or both?
d. Administrative or investigative proceedings?
e. Actions proceeding—wherein officers, directors, or others appear in a role other than that of defendant?
f. Appeals?
g. Threatened litigation?

4. *Costs and Expenses Covered.*
a. All expenses actually and necessarily incurred?
b. Criminal fines?
c. Satisfaction of judgments?
d. Settlements?
e. Attorney fees?
f. Advancement of expenses?

5. *"Persons" Covered.*
a. Officers and/or Directors?
1) Present?
2) Former?
b. Others?
c. Heirs, executors, or administrators of "persons covered"?
d. "Persons covered" serving in:
1) Foreign corporations?
2) Constituent corporations absorbed in merger or consolidation?
3) Another corporation at the request of the corporation?

6. *Standard of Care Required.*
Indemnification will be allowed if the person:
a. Acted in good faith and reasonably believed his conduct to be within the scope of his authority?
b. Acted in a manner he reasonably believed to be in or not opposed to the best interests of the corporation?
c. Had no reason to believe his conduct to be unlawful?
d. Was not derelict in the performance of his duties?

e. Was not adjudged liable for negligence or misconduct in performance of his duties?

7. *Determination of Whether Applicable Standard was Met.* Whether the required standard of care was met is to be determined by:
   a. The court?
   b. The Board of Directors?
   c. Independent legal counsel?
   d. The shareholders?

In February, 1967, the Committee on Corporate Law of the American Bar Association approved a new section of the Model Business Corporation Act, dealing with indemnification of directors and officers. This provision represents an attempt to update, clarify, and liberalize preexisting statutory indemnification in light of modern-day conditions. Under the Model Act, as revised, a corporation is empowered to indemnify a director or officer involved in an action other than one by or in the right of the corporation against "expenses (including attorneys' fees), judgments, fines and amounts paid in settlement," provided he acted in good faith.[38] Where liability results from a suit brought by or in the right of the corporation, the corporation is empowered to indemnify the officer or director only for expenses (including attorneys' fees); and if the director or officer has been adjudged liable for negligence or misconduct in the performance of his duties, he can be indemnified only if, and to the extent that, the court adjudging him liable determines that he is nevertheless entitled to indemnity—and then, for only such expenses as the court deems proper.[39] However, if the director or officer was successful on the merits or otherwise in defense of the action, he is entitled to indemnification against expenses in any event.[40] Where indemnification is conditioned upon a finding that the director or officer acted in good faith, such determination may be made by the board of directors, the stockholders, or independent legal counsel.[41] The Model Act further contains provisions concerning entitlement to advance payment of expenses,[42] inurement of benefits to the director's or offi-

38. ABA-ALI MODEL BUS. CORP. ACT § 5(a) (1969).
39. *Id.* § 5(b).
40. *Id.* § 5(c).
41. *Id.* § 5(d).
42. *Id.* § 5(e).

cer's heirs,[43] and empowerment of the corporation to purchase insurance.[44]

Many states have already adopted provisions which are either identical or comparable to the Model Business Corporation Act. Wisconsin has such a statute[45] which incorporates into Wisconsin law both the Model Act's indemnification provision and its provision granting authority to purchase insurance. Most states will undoubtedly follow suit, resulting eventually in substantial uniformity in state indemnification provisions.

III. STATUTORY AUTHORIZATION FOR PURCHASE OF INSURANCE

Originally, expenditure of corporate funds for director's and officers' liability insurance was said to be *ultra vires* because its purchase was not for the benefit of the corporation. This controversy however, was ended at least in those jurisdictions which legislatively empowered corporations to purchase and maintain liability insurance for their management personnel.[46]

The trend began with the 1967 amendments to the Model Business Corporation Act, which generally provided that any corporation could purchase insurance on behalf of a director, officer, employee, or agent against liability incurred by him in such capacity or arising out of his status as such regardless of whether the corporation could have indemnified him.[47] Later that same year, Delaware added an almost indentical statutory authorization to its

43. *Id.* § 5(f).

44. *Id.* § 5(g).

45. WIS. STAT. § 180.05 (1973).

46. ALA. CODE tit. 10, § 21(64a)(g) (Supp. 1973); ALASKA STAT. § 10.05.010(g) (Supp. 1974); ARK. STAT. § 64-309(g) (Supp. 1973); CAL. CORP. CODE § 830(h) (West. Supp. 1974); CONN. GEN. STAT. ANN. § 33-320a (f) (West. Supp. 1975); DEL. CODE ANN. tit. 8, § 145(g) (1974); FLA. STAT. ANN. § 608.13(17) (West. Supp. 1974); GA. STAT. ANN. § 22-717(g) (1970); IA. CODE ANN. § 496A.4(19)(g) (West. Supp. 1974); KAN. STAT. ANN. § 17-6305(g) (1974); KY. REV. STAT. ANN. § 271A.025(7) (1973); LA. REV. STAT. ANN. § 12.83(F) (1969); ME. REV. STAT. ANN. § 13A-719(7) (1974); MD. ANN. CODE art. 23, § 64(g) (1973); MASS. GEN. LAWS ANN. ch. 156B, § 67 (1970); MICH. COMPILED LAWS ANN. § 450.1567 (1973); MINN. STAT. ANN. § 301.095(7) (1969); ANN. MO. STAT. § 351.355(7) (West. Supp. 1974); NEB. REV. STAT. § 21-2004(15)(g) (1970); NEV. REV. STAT. § 78.75 (7) (1973); N.J. ANN. § 14A: 3-5(9) (1969); N.Y. BUS. CORP. LAW § 727 (McKinney Supp. 1974); N.C. GEN. STAT. § 55-19(c) (Supp. 1974); OHIO REV. CODE § § 1701.13(E)(3), 1702.12(E) (3) (Supp. 1974); OKLA. STAT. ANN. tit. 18, § 1.43a(g) (West. Supp. 1974); ORE. REV. CODE § 57.260(4) (1973); PA. STAT. tit. 15, § 1410(g) (West. Supp. 1974); R.I. GEN. LAWS § 7.1-1.4-1(g) (1970); TENN. CODE ANN. § 48-406 (Supp. 1974); TEX. BUS. CORP. ACT art. 2.02(16) (West Supp. 1974); UTAH CODE ANN. § 16-10-4(0) (7) (1973); VA. CODE § 13.1-3.1(g) (1973); WASH. REV. CODE § 23A.08.025 (7) (West. Supp. 1975).

47. ABA-ALI MODEL BUS. CORP. ACT § 5(g) (1969).

corporate indemnification statute,[48] which has served as a national prototype.[49] Unlike the authors of the Model Act, however, Delaware saw fit to further extend insurance coverage to personnel of constituent corporations absorbed in a consolidation or merger.[50]

Rather than directly provide that a corporation may purchase liability insurance for its management personnel, the Ohio legislature chose to place in its indemnification statute a provision to the effect that indemnification is not to be deemed exclusive of other rights to which a director or officer may be entitled under insurance purchased by the corporation.[51] Thus it appears that, although the statute does not expressly dictate, a corporation may purchase insurance for the indemnification of its officers and directors; the power may be inferred under the broad general powers conferred by the law of the state and the non-exclusive provision. Such power is subject to modification through articles of incorporation, corporate by-laws, or an agreement or vote of the shareholders.

Most restrictive of all the present statutes in this area is that of New York. Under the law of that state, a corporation may purchase insurance in three instances only:

> (1) To indemnify the corporation for any obligation which it incurs as a result of the indemnification of directors and officers . . . ,
> (2) To indemnify directors and officers in instances in which they may be indemnified by the corporation . . . , and
> (3) To indemnify directors and officers in instances in which they may not otherwise be indemnified by the corporation . . . provided the contract of insurance covering such directors and officers provides, in a manner acceptable to the superintendent of insurance, for a retention amount and for co-insurance.[52]

In addition, no insurance may provide for any payment, other than that for defense costs, on behalf of any director or officer if (1) a final adjudication established that the director or officer engaged in deliberately dishonest acts which were material to the cause of action or that he personally gained an advantage to which he was

48. DEL. CODE ANN. tit. 8, § 145(g) (Supp. 1968).

49. Delware's reason for enacting such a statute was that it would remove any doubt as to the power to carry insurance and to maintain it on behalf of directors, officers, employees and agents.

50. DEL. CODE ANN. tit. 8 § 145(h) (Supp. 1974).

51. OHIO REV. CODE ANN. § 1701.13(E)(7) (1973).

52. N.Y. BUS. CORP. LAW § 727(b)(2) (McKinney Supp. 1974).

not legally entitled; [53] or (2) the loss resulted from a risk, the insurance of which was prohibited under the state insurance laws.[54] Further, to be covered, the act of the officer or director must have occurred after the purchase of the policy.[55] Finally, the New York statute requires notice and disclosure to stockholders of information concerning the insurance.[56]

By way of contrast, the California statute is permissive. Corporations are free to purchase insurance on behalf of any officer, director, or employee of the corporation or of a subsidiary against liability resulting from misfeasance or nonfeasance, be it actual or only alleged.[57]

The power to purchase insurance extends not only to business corporations, but also to financial institutions such as savings and loan associations and national banks.[58]

IV. THE UNDERWRITING PROCESS

A. Selection of Risks

Although Lloyds of London has been the forerunner in the field of providing insurance protection for directors and officers,[59] many companies offer such coverage today.[60] Despite the growing num-

53. *Id.* § 727(b)(1).

54. *Id.* § 727(b)(2).

55. *Id.* § 727(c).

56. Section 726(e) of the New York Statutes provides for notice to shareholders when direct indemnification payments are made by the corportion. Section 727(d) requires a corporation purchasing or renewing an indemnification insurance policy to notify the shareholders as to the name of the carrier, the date of the contract, and the corporate positions insured. Further, the corporation must furnish a statement explaining all sums paid under any indemnification policy. It should be noted that under this statute the amount of coverage need not be disclosed, as such knowledge might unfairly affect the position of an insurer in the defense of a claim against an insured director or officer. Time limitations for providing this information are established as being no later than the next annual meeting of shareholders, unless the meeting is within three months from the date of such payment, but, in any event, within fifteen months from the date of payment.

57. CAL. CORP. CODE ANN. § 830(h) (West. Supp. 1974).

58. *See* 12 C.F.R. § 545.25(c) (1971).

59. W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 17.01 at 429 (2d ed. 1973).

60. Companies offering such coverage include American Home Assurance Company, New York, New York; American States Insurance Company, Indianapolis, Indiana; Continental Insurance Company, New York, New York; Employers Insurance of Wausau, Wausau, Wisconsin; Kemper Insurance Company, Chicago, Illinois; Liberty Mutual Insurance Company, Boston, Massachusetts; and St. Paul Fire and Marine Insurance Company, St. Paul, Minnesota. *See* W. KNEPPER, *supra* note 59, § 17.05 at 435-436 n. 25 (1973); T. SHEEHAN, THE LIABILITIES OF DIRECTORS AND OFFICERS: WITH PRACTICAL SOLUTIONS FOR THEIR DISCHARGE 17 (1970).

ber of insurers presently in the field, however, there are only two significantly different types of forms: one used by the London insurers written as a two-part form — the first part being a corporate reimbursement contract and the second part being the actual D & O contract, both being issued on the basis of a single application for a single premium and constituting a single transaction; the second type is a one part form used by St. Paul Fire and Marine Insurance Company and Stewart, Smith Mid-America (written by CNA) which combines the coverages.[61]

An application for directors' and officers' coverage usually consists of a notarized statement, which ultimately becomes part of the policy, if any is in fact issued. Normally, the applicant must provide the following information:

1. The length of time the applying company has been in business;
2. The date on which the company began to pay cash dividends on common and preferred stock on a continuous basis;
3. The number of common shares outstanding; the number of common shareholders, the number of common shares owned by directors directly or beneficially, and the number of common shares owned by officers who are not directors;
4. The total number of wholly owned subsidiaries and the total number of controlled subsidiaries;
5. Whether there is any claim outstanding or pending against any person proposed for insurance in the capacity of officer or director;
6. Whether similar insurance on behalf of the company has ever been declined, canceled, unrenewed, or refused;
7. Whether any person proposed for directors' and officers' insurance is cognizant of any error, act, or omission which he has reason to suppose might afford valid grounds for any future claim such as would fall within the scope of the proposed insurance;
8. Whether the company and/or its directors and officers have been involved in or have any knowledge of any anti-trust, tax, or copyright litigation or any governmental regulatory or administrative proceedings;
9. Whether the company at the present time contemplates any acquisitions, tender offers, or mergers; and
10. Whether the company filed with the Securities and Ex-

61. W. KNEPPER, note 59 *supra*, § 17.05 at 435-436.

change Commission within the past eighteen months or contemplates filing within the next twelve months any registration statement for a public offering of securities.[62] The application form, which must be signed and declared as containing true statements by either the chairman of the board or the president, thereafter forms the basis of the contract and will be attached to and become part of the policy itself.

In addition to a completed application form, most insurers require a copy of the latest annual report to stockholders providing operating figures for the past five years or, in the alternative, an audited financial statement. In addition,a copy of any indemnification agreement as contained in the corporate charter or by-laws, a copy of notice of stockholders' meeting and proxy request for either the last or next annual meeting, and a current Dunn and Bradstreet analytical report must be forwarded to the insurer.[63]

All this information, and any information gathered by the underwriter in his own investigation, enter into the evaluation of the risk's acceptability. The most critical of factors in determining suitability include the company's stability in growth (as opposed to wide fluctuations in earnings), previous involvement in lawsuits, susceptibility to mergers, profitability, size and type of operations, and market served.[64] Companies whose business makes them specifically subject to patent infringement suits or companies largely dependent upon a single customer may have difficulties in obtaining coverage. In an even worse position are "close corporations," which at this time are probably unacceptable for ordinary directors' and officers' insurance.[65] Other corporations, such as those which do substantial business in government contracts, those in the electronics field, those which have completed a number of mergers in the past five years, and those which are newly formed are carefully scrutinized before accepted.[66]

As can be seen, underwriters exercise considerable selectivity in accepting risks. It has been estimated that of every one hundred

62. Stewart, Smith Mid-America, Inc., Form SS-4 (hereinafter cited as Stewart, Smith Form).

63. Form letter from Paul W. Sult, Vice-President, Stewart, Smith, Mid-America, Inc., March 8, 1971.

64. MACHINERY & ALLIED PRODUCTS INSTITUTE, DIRECTORS' AND OFFICERS' LIABILITY INSURANCE 11 (1969).

65. *Id.*

66. MONTHLY POLICY & MANUAL ANALYSIS: DIRECTORS' AND OFFICERS' LIABILITY INSURANCE § 273.26 (1968).

applicants, no more than twenty-five companies are finally successful in acquiring directors' and officers' liability insurance. Of all applicants, it has been further estimated that fifty percent are eliminated by underwriters and that twenty-five percent eliminate themselves either because the premium is too high, the coverage is considered inadequate, the policy limit desired is unobtainable, or the deductible offered is too high or too low.[67]

B. Types of Policies Offered

Presently available are two basic types of policies, based on the size of the insured corporation. Late in 1969, the American States Insurance Company introduced what it called a "mini" directors' and officers' policy designed for small commercial, financial, and industrial risks — to be more specific, for financial institutions with assets of $40 million or less and for modest-sized nonfinancial corporations with assets of not more than $10 million nor less than $5 million.[68] Since that time, other insurers have made available similar programs, with varying size limitations.[69] In most cases, the minimum retention[70] under the "mini" policy is $5,000. Although not ordinarily required in a "mini-program," coinsurance with five percent participation by the insured may be necessary. As a general rule, all risks must be in business at least five years with a profit history and a record of dividend payments.[71] Despite these factors however, the "mini" program has opened the liability insurance field to certain closely held corporations.[72]

The other type of policy available is that offered to the larger firms under what has come to be known as the "maxi program."

67. MACHINERY & ALLIED PRODUCTS INSTITUTE, *supra* note 64; *See also* The 1974 Wyatt Directors' and Officers' Liability Survey at 16.

68. BUSINESS INSURANCE, Dec. 8, 1969 at 53.

69. American Home Insurance Company writes a similar "mini" policy. See BUSINESS INSURANCE, Jan. 19, 1970, at 58. Wholreich & Anderson, Ltd. markets a policy of like type especially designed for savings and loan associations. Stewart, Smith makes its "mini" program available to financial institutions with deposits of not less than $10 million nor more than $100 million and to corporations with assets not over $7.5 million and a net worth of at least $1 million, and to nonprofit organizations having assets not over $100 million. A customary maximum coverage of $1 million is written in this "mini" program, although quotations will be offered for $2 million and $3 million upon request.

70. Retention or "deductible" is an amount deducted from a loss and paid by the insured before the insurer is required to pay.

71. Form letter, *supra* note 63.

72. Mr. Sult indicates that even country clubs, colleges and universities, Blue Cross-Blue Shield plans and hospitals are now underwritten.

Qualification under this plan, to quote a standard response given by one of the insurers in this field, requires that a corporation be a:

> publicly owned company that has a steady history of earnings with $5,000,000 or more in assets, $10,000,000 or more in sales, and has been in business at least five years. There must also be continuity of management, a low, long term indebtedness ratio compared to capitalization, and an absence of current litigation.[73]

As a general rule, any financial institution with deposits of $100 million or more will qualify.

Unlike the "mini" program, the "maxi" policy is individually underwritten and rated by all insurers, quotations usually remaining in force for three years. As a general rule, a minimum retention (*i.e.* deductible) of $20,000 is required, although in some cases the deductible may be varied on the basis of underwriting judgment and increased to $100,000 or more. Higher corporate retentions might be applied, with corresponding policy discounts, to risks which are subject to considerable litigation, such as conglomerates, real estate holding and development corporations, and companies susceptible to antitrust charges. The retention prevents an inordinate increase in a premium by eliminating the insurer's responsibility for the smaller and more frequent claims. Consistent also with considerations of public policy, it serves as a costly deterrent to executive carelessness or misconduct.

In addition to the retention provision, the policy usually provides for participation in, or coinsurance of, covered risks. For example, the Lloyds' policy form obliges the underwriters to pay ninety-five percent of the loss in excess of the amount of the retention, up to the limit of liability. The remaining five percent of each and every loss is to be absorbed by the assureds at their own risk. The purpose of participation in the loss is to provide both an additional deterrent to negligence or misbehavior and an added incentive for vigorous defense against questionable or unfounded claims. This five percent participation, when combined with the retention provision, could have significant financial impact on directors and officers in a large claim, notwithstanding the existence of coverage.

Further restricting the amount of actual protection officers'

73. Form letter, *supra* note 63.

and directors' insurance can afford is the policy limit. Although a minimum limit of $1 million is usually imposed, that figure hardly represents the amount actually sought by the larger corporations. In the early days of its development, this type of insurance was most commonly issued in a range of coverage between $3 million and $5 million. Today, corporate directors have come to the realization that the limits of insurance should be large enough to cover the entire potential exposure, if such coverage is obtainable. Thus, it is no longer uncommon to find a policy limit of $50 million.[74] As might be expected, the amount of coverage purchased tends to vary directly with the size of the company.

Recent developments have occasioned new offerings which provide coverage specifically aimed at the needs of particular business groups. Policies tailored specifically for financial institutions, savings and loan associations, association executives, trustees of pension and welfare funds, condominium and co-operative boards, nonprofit and charitable organizations, and a new "Maximan" policy covering directors and officers only for a reduced rate are now available.[75]

C. *Cost of Coverage*

Directors' and officers' liability policies are usually written on a three-year basis, the premium being payable either in advance or in annual installments at an increased rate, usually from eleven to twenty percent of the total premium.[76] Although the premium for

74. Hatzel, *Directors' and Officers' Liability Insurance*, THE NATIONAL INSURANCE BUYER, Jan., 1965, at 24. To illustrate changes in policy limits, one study conducted by the Machinery & Allied Institute indicated that of fifty-one firms represented, thirty-six purchased directors' and officers' insurance. Among these thirty-six, the amount of coverage ranged from $1 million to slightly over $20 million. Twenty-one of the thirty-six companies (or sixty percent) carried $5 million or less; ten companies (or twenty-nine percent) carried $10 million; one company (or three percent) carried $15 million; and three companies (or eight percent) carried $20 million or more in insurance coverage. The 1974 Wyatt study indicates that of the 1,321 participants, 763 (57.8%) carried D & O insurance. The average limit for 1974 was $7,071,000, with approximately ten percent of all those companies carrying insurance insuring with limits of $15 million or more. The highest limit carried on a pure D & O form was $50 million (two companies); and one company reported a total limit of coverage in excess of $100 million, as a combination of primary D & O with excess and umbrella coverage. (*See* the 1974 Wyatt report at page 18 with accompanying tables).

75. W. KNEPPER, NOTE 59 *supra*, § 17.05 at 100-106 (2d ed. 1974 Supp.); *see also* Knepper, *Officers and Directors: Indemnification and Liability Insurance—An Update*, 30 BUS. LAWYER 951, 963-66 (1975).

76. W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS, § 10.04 (1st ed. 1969).

this coverage is high, whether it is "too high" is a question that can only be answered by individual experience. There is no "book" on this risk — no body of actuarially proven loss experience from which a schedule of premiums can be derived — and, hence, there is no standard premium. Consequently, each applicant is individually underwritten and premium rated. In general, the premium will depend upon such factors as the size of the company, the number and size of subsidiaries, the type of industry, the deductible accepted, the total policy limit, the governing state corporation statute, the indemnification agreement subsisting between the corporation and its directors and officers, the company's labor practices and history, the stability and experience of management, the extent of public ownership, and the firm's susceptibility to merger or other combination.[77]

As previously indicated, the cost of coverage is subject to extreme variations. In 1966, it was reported that a premium of $15,000 to $50,000 might be charged for a three-year policy with a limit of $5 million.[78] During the period between 1965 and early 1969, premium rates approximately tripled.[79] In early 1970, one source stated that three-year premiums on "maxi" policies began at $12,500 for a $1 million policy and increased $2,500 for each additional $1 million coverage.[80] It should be noted, however, that these figures are described as minimum rates and may not exemplify what the policies would actually cost after individual underwriting and rating.

With reference to the cost of coverage, one representative of a leading broker has commented:

> In fact it [D&O coverage] is the most expensive single insurance, other than group and workman's compensation, that most corporations have. But the risks are high also. Underwriters are not reaching for D&O business.[81]

Payment of the premium is usually shared by management and the corporation, the ration (usually set rather arbitrarily and gener-

77. MACHINERY & ALLIED PRODUCTS INSTITUTE, *supra* note 64, at 12; The 1974 Wyatt Directors' and Officers' Liability Survey at 23.

78. *A Shield Against Stockholders Suits*, BUSINESS WEEK, July 2, 1966, at 57.

79. Knepper, *Let the Director Beware*, 37 INS. COUNSEL J. 27, 34 (1970).

80. T. SHEEHAN, THE LIABILITIES OF DIRECTORS AND OFFICERS: WITH PRACTICAL SOLUTIONS FOR THEIR DISCHARGE 18 (1970).

81. Stanley I. Wallace, of Johnson & Higgins, New York, PROTECTING THE CORPORATE OFFICER AND DIRECTOR FROM LIABILITY-2D, Practicing Law Institute publication No. B4-2586 at 122 (1971).

ally controlled by local law) ranging from 10:90 to as high 50:50.[82] Recently, some states have enacted statutes which would empower a corporation to pay the entire premium.[83] Where such a statute is present, the by-laws or charter might prove to be the only obstacle to a company's payment of the entire amount.

Questions often arise as to whether premium payments made by the corporation are deductible and whether directors or officers must in their returns include as income the amount paid by the corporation to the insurer. In a relatively recent ruling,[84] the Internal Revenue Service declared that a corporation may deduct, as an ordinary and necessary business expense under section 162(a) of the Internal Revenue Code, premiums paid by the firm for insurance policies indemnifying the corporation against damages for the wrongful acts of its officers and directors in their official capacity and reimbursing the latter for their expenses arising from such wrongful acts. Further, the IRS indicated that the premiums paid by the corporation would not be includable as "income" but, would rather be considered "noncompensatory fringe benefits" —payments made by the corporation in fulfillment of an obligation incurred in obtaining the services of its officers and directors.[85] Viewed in this manner the premiums can be said to be connected with the corporation's business and, hence, "ordinary and necessary." Remaining unanswered, however, is the question of how the Internal Revenue Service will treat amounts received by officers and directors as reimbursement for legal expenses incurred when suit is brought as a result of a business decision.

V. A LOOK AT THE POLICY: STEWARD, SMITH FORMS SS-4

For purposes of analysis, the CNA form utilized by Steward, Smith as Form SS-4 (Directors' and Officers' Liability Including Company Reimbursement Policy) will be examined. It should be noted at the outset that the Steward, Smith policy is written on a bi-policy format. The corporate reimbursement portion actually reimburses the corporation for payment made to its directors and

82. See Brook, *Officers' and Directors' Liability Insurance*, FORUM, July, 1967, at 228; Anderson, *Directors' and Officers' Liability Insurance*, 47 CHICAGO BAR RECORD 31, 32 (1965).

83. For example, CAL. CORP. CODE § 830(h) (West 1955), permits a corporation to pay the premium for indemnity insurance.

84. Rev. Rul. 69-491, 1969-2 CUM. BULL. 22.

85. *Id.*

officers under an indemnification agreement. The Directors' and Officers' Liability portion insures directors and officers against liabilities not covered by corporate indemnification.

A. Definitions

As is essential in any discussion utilizing terms of art, the groundwork for assuring common understanding must first be laid. Hence, this section on definitions — paralleling the third section in the insurance policy itself.

"Directors and officers" are generally defined as persons who were, now are, or shall be directors and/or officers of the company including estates, heirs, and legal representatives or assigns of directors and/or officers in the event of their death, incompetency, insolvency or bankruptcy. Also included within this definition are directors and officers of any subsidiaries acquired or created after the inception of the policy, subject, again, to written notice and the exaction of an additional premium.[86]

"Loss" as used in the policy means any amount the directors and officers are legally obligated to pay and for which they are not indemnified as a result of claims made against them for "wrongful acts," including (but not limited to) amounts paid for damages, judgments, settlements with costs, attachment or similar bonds, and investigation and defense of legal actions, claims or preceedings and appeals therefrom.[87] In light of its use of the term "wrongful acts," this definition, itself, requires further explanation. A "wrongful act" within the meaning of the loss provision is defined as:

> . . .any actual or alleged error or misstatement or misleading statement or act or omission or neglect or breach of duty by the Directors or Officers in the discharge of their duties individually or collectively or any other matter not excluded by the terms and conditions of this policy claimed against them solely by reason of their being Directors or Officers of the Company.[88]

Prior to leaving the definition of "loss," it should be noted that this term does not include fines or penalties imposed by law and matters which may be deemed uninsurable under the law pursuant to which the policy is to be construed.[89]

86. Stewart, Smith Form SS-4 ¶ III(b).
87. *Id.* ¶ III(d).
88. *Id.* ¶ III(c).
89. *Id.* ¶ III(d).

The last term which should be defined is "policy year," which means either "the period of one year following the effective date and hour of this policy or any anniversary thereof" or, if the period between the effective date or anniversary and the date of termination of the policy is less than one year, then such lesser period.[90]

B. Insuring Clause

Although the language of the insuring clause may vary in different policies, in substance all provide that if, during the policy period, any claim is made against the insureds (officers and directors or company as defined) for any wrongful conduct while acting in their capacities as directors or officers, the insurance company will pay, on behalf of the insureds, their executors, administrators, and assigns, all loss which the insureds shall become legally obligated to pay, in excess of the retention stated in the declarations of the policy and up to the limit of liability except for such loss which the company shall indemnify such directors and officers.[91]

C. Exclusions

Excluded from coverage in the directors and officers policy are losses resulting from certain types of conduct. Most commonly excluded by this provision are losses resulting from:

1. A claim of libel or slander;[92]

2. An action arising from charges of seepage, pollution or contamination and based upon or attributed to violation of any federal, state, municipal or other governmental statute, regulation or ordinance prohibiting or providing for the control or regulation of emissions or effluents of any kind into the atmosphere or any body of land, water, waterway or watercourse or arising from any action or proceeding brought for enforcement purposes by any public official, agency, commission, board of pollution control administration pursuant to any such statutes, regulations or ordinances or arising from any suits alleging seepage, pollution or contamination based upon common law nuisance or trespass.[93]

3. A claim based upon any insured's gaining in fact any personal profit or advantage to which he was not legally entitled;[94]

90. *Id.* ¶ III(f).
91. *Id.* ¶ I.
92. *Id.* ¶ IV(b)(1)
93. *Id.* ¶ IV(a)(4).
94. *Id.* ¶ IV(b)(2).

4. An action for the return by those insured of any remuneration paid to them without the previous approval of the stockholders of the corporation, provided that such payment has been held by the courts to have been illegal.[95]

5. An action for an accounting of profits made from the purchase or sale by those insured of securities of the corporation within the meaning of section 16(b) of the Securities Exchange Act of 1934 and amendments thereto or similar provision of any state statutory or common law;[96]

6. A claim brought about by the dishonesty of those insured; however, notwithstanding the foregoing, it should be noted that this exclusion does not apply unless a judgment or other final adjudication adverse to those insured establishes that acts of active and deliberate dishonesty committed by them with actual dishonest intent were material to the cause of action so adjudicated;[97] and

7. A claim for bodily injury, sickness, disease, or death of any person, or for damage to or destruction of any tangible property, including loss of use thereof.[98]

Also excluded is any loss which is insured by any other existing valid policy or policies, where payment of the loss is actually made by the other insurer or insurers, with the exception that should there be any excess beyond the amount of payments under such other policy or policies, the directors' and officers' policy will cover.[99] Similarly excluded are losses for which those insured are to be indemnified by the corporation, pursuant to the statutory and common law or the charter or by-laws of the corporation.[100] Finally, also excluded are losses for which the insureds are entitled to indemnity or payment by reason of their having given notice of any circumstance which might give rise to a claim under any other policy or policies, the term of which expired prior to the issuance of the directors' and officers' policy.[101]

D. Deductibles — Retention and Coinsurance Provisions

As discussed earlier, the policy also contains a retention and

95. *Id.* ¶ IV(b)(3).
96. *Id.* ¶ IV(b)(4).
97. *Id.* ¶ IV(b)(5).
98. *Id.* ¶ IV(a)(3).
99. *Id.* ¶ IV(a)(1).
100. *Id.* ¶ I(a).
101. *Id.* ¶ IV(a)(2).

coinsurance clause, wherein the insurer assumes liability for but ninety-five percent of the loss in excess of the amount of retention up to the policy limit.[102] Thus, for example, should X Corporation purchase a directors' and officers' liability policy with a $40,000 retention and a $1 million limit, and should its directors become liable for a $240,000 claim, the insurer would cover only ninety-five percent of the amount of the claim in excess of $40,000 — in other words, ninety-five percent of $200,000 (or a total of $190,000). The remaining $50,000 loss would have to be borne by the directors, without benefit of any insurance. Of this $50,000, $40,000 would represent the retention, and $10,000 would represent the coinsurance feature (five percent participation in the $200,000 excess over the retention). Should multiple losses result from the same act or from interrelated acts of one or more of the insureds, only one retention is deducted, as such losses are considered for insurance purposes to constitute but a single loss.[103]

E. Costs, Charge, and Expenses

Under the policy, no costs, charges, and expenses may be incurred without the insurer's consent, which in turn is not to be unreasonably withheld.[104] If consent is given, the underwriter is to pay ninety-five percent of all such costs, subject to the same limitations contained in the limits of liability section of the policy.[105] It should be noted that the insurer's payment of costs, charges, and expenses is intended to limit its liability to the policy limit otherwise applicable under the policy.[106] In other words, these charges are subject to the payment of the retention by the insured, and are paid only to the extent they do not exceed the policy limits.[107]

As is evident, these clauses are rather confusing and, thus, can best be understood by referring to a hypothetical situation. Assume that X Corporation has purchased a directors' and officers' policy with a $20,000 retention and a $500,000 liability limit. If, to dispose of a claim, the defendant must pay $480,000 plus costs in the amount of $90,000, under the policy, the insurance company would pay ninety-five percent of $460,000 (or $437,000) plus ninety-five

102. *Id.* ¶ V(a).
103. *Id.* ¶ V(c).
104. *Id.* ¶ VI.
105. *Id.* See text accompanying note 103 *supra.*
106. W. KNEPPER, *supra* note 59, § 17.13 at 451.
107. *Id.*

percent of $90,000 up to the $500,000 limits of the policy (or ninety-five percent of $90,000 which is $85,500, which would exceed the $500,000 limits by $22,500; when combined with the $437,000 therefore the excess $22,500 will be uninsured). The insured would pay the deductible of $20,000 plus five percent of $460,000 (or $23,000) plus the excess $22,500, or a total of $65,500.

Assuming the same policy were in effect, if the insured successfully resisted the claim but incurred costs, charges, and expenses of $90,000, the insurance company would pay ninety-five percent of $70,000 (or $66,500), while the directors of X Corporation would pay the deductible of $20,000 plus five percent of the $70,000 in excess of the retention (or $3,500) — a total of $23,500.

F. Notice Requirements and the Extended Discovery Clause

Under the terms of the policy, as a condition precedent to indemnification, an insured or the corporation named in the declarations must give to the insurance company both written notice of any claim made as soon as practicable and such information and cooperation as the insurer may reasonably require.[108]

Also included in the directors and officers policy is an extended discovery clause. Basically, this clause provides that if the insurer cancels or refuses to renew the policy, the insured has, upon payment of an additional premium in the amount of ten percent of the three year premium, the right to an extension of coverage granted by the policy. This extension provides coverage for claims which may be made against the insured during the ninety day period following the date of cancellation or nonrenewal, provided the wrongful act upon which the claim is based was committed prior to the date of cancellation or non-renewal.[109]

Extended coverage may be affected by notice provisions. If written notice is given to the insurer during the policy or extended discovery period, claims made thereafter are treated as having been made during the time coverage was afforded. For example, if during the policy or extended discovery period the insured notifies the insurer in writing of a third party's intent to hold the insured liable for the results of a specified wrongful act committed or alleged to have been committed by the insured while acting in his capacity as director, any claim subsequently made by the third party for

108. Stewart, Smith Form ¶ VII(a).
109. *Id.* ¶ II.

such wrongful act is treated as a claim made during a period in which coverage was afforded.[110] Similarly, if the insured becomes aware of any occurrence which may subsequently give rise to a claim being made against the insured and gives written notice thereof to the insurance company, any claim made after expiration of the policy or extended discovery period but based on such occurrence is treated as having been made during the policy or extended discovery period.[111]

G. Cancellation

The cancellation clause provides that the policy may be cancelled by the insureds or by the company named in the declaration, at any time, by written notice or surrender of the policy. The insurer may cancel the policy by delivering or mailing (by registered, certified, or other first-class mail) a thirty day written notice of cancellation. What amount of the premium is returned is dependent upon who terminates the relationship. If the insured cancels, the insurer retains the short-rate proportion of the premium. If the insurer cancels, on the other hand, it retains the pro rata portion of the premium.[112]

H. Subrogation

In the event that the insurer makes payment under the policy, it is subrogated, to the extent of such payment to all the insureds' rights of recovery. The insureds are under a duty to execute all papers and perform all acts required to secure such rights — including the execution of such documents needed to enable the insurer to bring suit in the name of the insureds.[113]

VI. Public Policy Considerations

A. Corporations' Power to Purchase Insurance

The propriety of insurance for officers and directors has been the subject of some controversy. It has been alleged that insurance now covers acts for which the legislature has prohibited indemnification, that is, the corporation is doing indirectly through insur-

110. *Id.* ¶ VII(b).
111. *Id.*
112. *Id.* ¶ VIII(c).
113. *Id.* ¶ VIII(d).

ance that which it is prohibited from doing directly through indemnification.[114]

> So long as the law imposes on directors duties of good faith and due care, it should not permit them to evade those duties through the device of insurance purchased by the corporation.[115]

Agreeing with this argument, the Minnesota Legislature adopted a statute which specifically prohibits a corporation's purchase of insurance covering management in areas where the corporation is not permitted to indemnify.[116] Underlying this argument was the belief that accomplishing prohibited corporate indemnity indirectly though insurance would abrogate the deterrent effect of liability.[117] It has also been argued that public policy would prevent a corporation from reimbursing a director or officer through the purchase of insurance when there exists a judgment in favor of the corporation itself. The effect of such payment would be to nullify the award.[118]

Furthermore, by the passage of the Securities Acts of 1933 and 1934, Congress intended "to promote careful adherence to the statutory requirements."[119] The SEC, as part of a consistent administrative policy, has indicated that any indemnification by the corporation for Securities Act liability is against public policy.[120] A condition to the acceleration of the registration statement is the requirement that unless all claims for indemnification are waived, the registrant must state it recognizes these arrangements are contrary to public policy and therefore unenforceable.[121] In addition, the registrant must include a concise description of any indemnification provision in the registration statement and agree that unless the matter is settled by controlling precedent, it will submit any claim for indemnification for Securities Act liability (other than

114. W. KNEPPER, note 59 *supra*, § 17.02 at 432; *See also* Note, *Public Policy and Directors' Liability Insurance*, 67 COLUM. L. REV. 716, 719 (1967); Bishop, 22 BUS. LAWYER, *supra* note 1, at 111.

115. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1091 (1968).

116. MINN. STAT. ANN. § 301.095(7) (1969).

117. Note, 67 COLUM. L. REV., *supra* note 11, at 717.

118. Bishop, 22 BUS. LAWYER, *supra* note 1, at 109-112; Note, 67 COLUM. L. REV., *supra* note 114, at 716-717.

119. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 35 (1959).

120. W. KNEPPER, *supra* note 59, § 16.03 at 410.

121. Note (a), S.E.C. Rule 410, 17 C.F.R. § 230.460; *Id.*

the payment of expenses of a successful defense) to a court for adjudication of the issue and to be bound by the result.[122]

Insurance has been treated differently however. The SEC has stated that insurance against liabilities arising under the 1933 Securities Act, regardless of who bears the cost, is not against public policy and no waivers or undertakings need to be supplied with respect to such coverage.[123]

Also of note are public policy arguments against insuring a person for intentional wrongdoing or misconduct resulting in criminal penalties. While insurance against liability resulting from such conduct might promote the compensation of the insured victims, the deterrent purpose of this type of liability has usually been regarded as more important, and courts have generally held insurance against this type of liability is inconsistent with public policy.[124]

> Thus any act which offends the public policy is uninsurable in most cases, such as acts of wilful neglect, gross negligence, and fraud, with certain exceptions. Likewise an act which calls for fine and imprisonment is uninsurable insofar as the criminal aspect of such acts is concerned.[125]

However, insurance coverage for liability for one's intentional or criminal conduct might be permissible in certain situations in which the deterrent effect of potential liability is minimal and the policy favoring the compensation of the victim is considerable.[126] With respect to this question, one author stated:

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122. *Id.*

123. W. KNEPPER, *supra* note 59, § 16.03 at 411 n. 34, citing SEC Releases No. 33-4936, Dec. 9, 1968, 33 F.R. 18671, and No. 33-3791, Jan. 28, 1957, 22 F.R. 4075.

124. Messersmith v. American Fidelity Co., 232 N.Y. 161, 133 N.E. 432 (1921) (Cardozo, J.); Fidelity-Phoenix Fire Ins. Co. v. Murphy, 226 Ala. 226, 146 So. 387 (1933); Haser v. Maryland Cas. Co., 78 N.D. 893, 53 N.W.2d 508 (1952); Note, *Liability Insurance for Corporate Executives*, 80 HARV. L. REV. 648, 655 (1967).

125. Snow, *Liability of Directors and Officers of Corporations*, 17 DEFENSE L.J. 521, 541 (1968).

126. Wolff v. General Cas. Co. of America, 68 N.M. 292, 361 P.2d 330 (1961) (assault and battery on sudden impulse); *c.f.* New Amsterdam Cas. Co. v. Jones, 135 F.2d 191, 195 (6th Cir. 1943); Wheeler v. O'Connell, 297 Mass. 549, 9 N.E.2d 544 (1937); Hartford Accid. & Indem. Co. v. Wolbarst, 95 N.H. 40, 57 A.2d 151 (1948); Nationwide Mut. Ins. Co. v. Roberts, 261 N.C. 285, 134 S.E.2d 654 (1964) (compulsory auto insurance statute, intentional wrongs: insurable); Sheehan v. Goriansky, 321 Mass. 200, 72 N.E.2d 538 (1947) (wanton and reckless conduct in auto accident: insurable). *See generally* Comment, *Liability Insurance and Assault and Battery: Coverage and Damage Problems*, 50 CORNELL L.Q. 506 (1965); Note, *Automobile Insurer's Liability for Damage Intentionally Caused*, 48 COLUM. L. REV. 799, 800 (1948).

> I have no difficulty with indemnification when, in the language of the New York statute, the director, although guilty, "acted in good faith, for a purpose which he reasonably believed to be in the best interests of the corporation and, in criminal actions or proceedings, in addition, had no reasonable cause to believe that his conduct was unlawful." Indenmification of an agent in such circumstances has long been regarded as permissible, if not mandatory. (Citations omitted.)[127]

Unlike fines or penalities, however, expenses associated with the defense of a criminal suit should be insurable as a matter of public policy. An analogy in support of this proposition may be made by reference to tax case law. In *Commissioner v. Tellier,*[128] the United States Supreme Court held that a taxpayer may deduct as an "ordinary and necessary" business expense under Internal Revenue Code section 162 the cost of unsuccessfully defending a criminal prosecution for numerous fraudulent acts relating to securities transactions. In answering the contention that this would frustrate public policy, the Court noted "in an adversary system of criminal justice, it is a basic of our public policy that a defendant in a criminal case have counsel to represent him."[129] That public policy which encourages criminal representation and vigorous defense would seem to outweigh the minimal deterrent effect possibly gained by forbidding insurance coverage of defense litigation costs.

While these arguments raise interesting questions, they are for the most part academic today. The statutes enacted by numerous state legislatures throughout the county seem to quash speculation that a corporation cannot legally purchase directors' and officers' liability insurance, simply by empowering corporations to do so.[130] In addition, the insurance companies offering D & O coverage have refined policy language to specifically exclude coverage for objectionable conduct. As previously noted, the Stewart, Smith form excludes "fees or penalties imposed by law and matters which may be deemed uninsurable under the law pursuant to which the

127. Bishop, 22 BUS. LAWYER, note 1 *supra* at 102 citing N.Y. BUS. CORP. LAW § 723(a) (McKinney Supp. 1974); RESTATEMENT, AGENCY 2D § 439, Comments g & h (1958); Simon v. Socony-Vacuum Oil Co., 179 Misc. 202, 38 N.Y.S.2d 270 (Sup. Ct. 1942), *aff'd mem.* 267 App. Div. 890, 47 N.Y.S.2d 589 (1944). For similar statutes see CAL. CORP. CODE § 830(f) (West. Supp. 1974); KY. REV. STAT. ANN. § 271A.025(1) (1973); WIS. STAT. § 180.05(1) (1973).

128. 383 U.S. 687 (1966).

129. 383 U.S. at 694.

130. See statutes cited in note 46 *supra.*

policy is to be construed" in its definition of the term loss.[131] The policy also excludes coverage for claims based on self-dealing,[132] violations of section 16(b),[133] and claims brought about by the dishonesty of those insured (upon proof of active and deliberate dishonesty committed with actual dishonest intent).[134] Furthermore, the purchase of this type of insurance appears to be sanctioned by both the IRS[135] and the SEC.[136] In addition the weight of some public policy arguments is substantially diminished by virtue of the retention and co-insurance features of the D & O policies now being offered.

One related question which remains in this area is whether the term "penalties" includes punitive damages within its meaning and therefore excludes them from coverage. Punitive damages have been defined as:

> damages over and above such sum as will compensate a person for his actual loss . . . [permitted by law] in proper cases at the discretion of the jury, not because the party injured is entitled to them as a matter of right, but as punishment to the wrongdoer, for the purpose of deterring him and others committing similar violations of the law, from such wrongdoing in the future."[137]

Such damages are only assessed on the basis of aggravated misconduct exhibiting a particular malice, wantonness or outrageousness on the part of the defendant.[138]

Viewing punitive damages in this manner, one could legitimately argue that insurance covering punitive damages is subject to the same public policy considerations as those involved in the question of insurance covering liability for intentional wrongdoing. Indeed, notable case law and commentary on the subject seems to indicate that insurance covering punitive damages would frustrate the very purpose of their imposition and should therefore be considered contrary to public policy.[139] However, notwithstanding a

131. See text accompanying note 89 *supra*.

132. See text accompanying note 94 *supra*.

133. See text accompanying note 96 *supra*.

134. See text accompanying note 97 *supra*.

135. See text accompanying note 84 *supra*.

136. See text accompanying note 123 *supra*.

137. Florida East Coast Ry. Co. v. McRoberts, 111 Fla. 278, 282, 149 So. 631, 632, 94 A.L.R. 376 (1933).

138. PROSSER, LAW OF TORTS § 2, at 9 (4th ed. 1971).

139. Northwestern Nat. Cas. Co. v. McNulty, 307 F.2d 432 (5th Cir. 1962) (see p. 436 n. 11); Esmond v. Liscio, 224 A.2d 793 (Pa. Super. 1966); OLECK, DAMAGES TO PERSONS

dearth of case law, the majority of cases treating this issue have held that there was coverage.[140] Basically, there are three justifications for this position. First, the policyholder is paying a premium commensurate with the insurer's assumption of the added risk. Second, the deterrent effect of punitive damages is generally considered to be weak when there is a simultaneous threat of criminal liability. As one judge noted:

> If criminal penalties provided by such statutes fail to deter the wrongdoers, I seriously doubt that closing the market to insurance coverage will do so. As a matter of fact, it is my judgment that the opposite result will follow.[141]

Third, the insurance contract is a private contract between insured and insurer. To hold that the insured, as a matter of public policy, is not protected on his claim for punitive damages would have the effect of partially voiding the contract, a proposition many courts wish to avoid.

It may also be difficult to determine whether treble damages (assessed for example in a section 4 Clayton Act anti-trust action) are "punitive,"[142] "compensatory,"[143] or both.[144] Perhaps the first third should be considered compensatory and the other two-thirds punitive for the purpose of determining insurability. It appears that the treble damages concept occupies a place somewhere on the thin line of demarcation between punitive and compensatory damages affording no easy answer to the question of insurability.

VII. CONCLUSION

The liability of a director and/or officer in the performance of his corporate duties is vulnerable to a host of complicated kinds

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AND PROPERTY § 275c, at 560 (1961); PROSSER, *supra* note 138 at 13; Note, *Liability Insurance for Corporate Executives*, 80 HARV. L. REV. 648 (1967).

140. *E.g.* Carroway v. Johnson, 245 S.C. 200, 139 S.E.2d 908 (1965); Lanzenby v. Universal Underwriters Ins. Co., 214 Tenn. 639, 383 S.W.2d 1 (1964).

141. Lanzenby v. Universal Underwriters Ins. Co., 214 Tenn. 639, 383 S.W.2d 1, 4 (1964) (quoting Judge Gewin's separate concurring opinion in Northwestern National Casualty Co. v. McNulty, 307 F.2d 432 (5th Cir. 1962).

142. Commissioner v. Obear-Nester Glass Co., 217 F.2d 56, 61-62 (7th Cir. 1954), *cert. denied*, 348 U.S. 982 (1955).

143. Vold, *Are Threefold Damages Under the Anti-Trust Act Penal or Compensatory?*, 28 KY. L.J. 117 (1940).

144. Julius M. Ames Co. v. Bostitch, Inc., 240 F. Supp. 521, 525 (S.D.N.Y. 1965) (dominant purpose is to provide added incentive to injured persons to litigate their claims — in effect promoting both punitive and compensatory functions).

of exposure, the consequences of which can be disastrous. Diverse interests are involved. First, the shareholders desire a corporation, profitably run by responsible persons, who should in turn answer to the shareholders for the performance of their duties. The shareholders want both to entice responsible persons to serve as directors and officers and at the same time hold these persons accountable when things go wrong. Secondly, corporate management requires protection for the exercise of its business judgment in the efficient running of the corporation and from unduly litigious stockholders and third parties. Many responsible persons are justifiably unwilling to risk personal liability to the extent the potential exposure indicates. Lastly, the interest of the public demands accountability in the form of damages for injuries suffered as a result of the use of a corporate product or corporate activity.

Directors' and officers' liability has arisen to meet the needs of these competing interests. Ideally, its protection induces responsible persons to continue serving as directors while its retention and co-insurance features deter wrongful conduct. Policy limits and exclusions also serve as reminders of the potential exposure for objectable conduct. In addition, this insurance provides a fund to which an injured shareholder or third party can look for damages resulting from corporate misconduct, a fund which would otherwise not be available in all probability.

It has been suggested that the present system of indemnification and insurance be supplanted by a system whereby the measure of liability of a corporate officer or director be in direct proportion to what he gains from his position — the amount a prudent man in similar circumstances would be willing to risk, rather than the measure of loss proximately caused by his conduct.[145] It has also been suggested that a no-fault plan be substituted.[146] However, as the fruition of these alternative suggestions does not appear to be forthcoming, and as the types of exposure to which corporate directors and officers may be subjected continue to expand, more corporations are showing an interest in securing insurance.[147] While the cost and strict qualification requirements have been ques-

145. Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L.J. 895 at 916-918.

146. *Id.* at 919.

147. The 1974 Wyatt Survey at page 16 indicates an 18.3% increase in the purchase of insurance by companies participating in both the 1973 and 1974 surveys not carrying this insurance in 1973.

tioned,[148] and while the extent of coverage has at times been ambiguous as to what conduct is covered (due in part to the unsettled theories of law upon which complicated causes of action are brought and also in part to conduct which violates public policy and therefore is not entitled to relief) insurers have made and continue to make valiant efforts to provide effective insurance. These efforts take form in constant refining of policy language, many times producing policies tailored to the specific needs of a particular business group.[149] In this manner D & O liability insurance serves a valuable function in accommodating the interests of corporate management, shareholders, and the public.

148. *Is D & O Worth It?*, BUS. INS. at 16 (March 15, 1971).

149. See note 75 *supra* and accompanying text.