

# TURNING BACK THE TIDE OF DIRECTOR AND OFFICER LIABILITY

*Theodore D. Moskowitz and Walter A. Effross\**

## TABLE OF CONTENTS

I. THE BUSINESS JUDGMENT RULE .....	898
II. STATUTORY INDEMNIFICATION .....	902
A. Scope of Indemnification .....	902
B. Mandatory Indemnification .....	904
C. Permissive Indemnification .....	905
1. Third Party Actions .....	906
2. Derivative Actions .....	907
D. Statutory Non-Exclusivity .....	909
E. Advance Payments .....	911
III. STATUTORY LIMITATIONS ON LIABILITY .....	912
IV. INSURANCE .....	917
A. Statutory Authorization .....	917
B. Insurance Shortcomings and Alternatives .....	919
1. Captive Insurance Companies .....	920
2. Insurance Pooling Arrangements .....	921
3. Fronting Arrangements .....	921
4. Trust Agreements .....	922
5. Self-Insurance .....	922
V. CONCLUSION .....	923

In the mid-1980s, increased judicial interference fomented a storm tide of director and officer (D&O) liability<sup>1</sup> that threatened to erode the business judgment rule's traditional insulation of corporate decisionmakers.<sup>2</sup> Although the D&O liability and in-

---

\* Mr. Moskowitz, a member of the New Jersey, New York and District of Columbia bars, and Mr. Effross, a member of the New Jersey and District of Columbia bars, practice law with McCarter & English in Newark, New Jersey. The authors would like to thank the Hon. Joseph E. Irenas of the District Court of New Jersey for his helpful comments and Lisa A. Chiappetta, Esq. for her assistance in the preparation of this Article.

<sup>1</sup> See Michael W. Mitchell, Comment, *North Carolina's Statutory Limitation on Directors' Liability*, 24 WAKE FOREST L. REV. 117, 118 (1989) ("The corporate community has endured a noticeable increase in the number and severity of claims that have been made against its directors over the last several years.").

<sup>2</sup> See James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207, 1207-08 (1988) ("as a result of [recent decisions], the almost reflexive deference of courts to boardroom

insurance crisis has not fully abated, the board room has been shored up by three extrajudicial trends: statutory indemnification of D&Os, statutory limitation of D&O liability and corporations' increased use of D&O liability insurance.<sup>3</sup>

This Article analyzes the structure and effect of these safeguards, with a particular focus on the incorporation of the first two into the statutes of New Jersey, Delaware, Pennsylvania and New York and into the Revised Model Business Corporation Act (RMBCA).<sup>4</sup>

### I. THE BUSINESS JUDGMENT RULE

The business judgment rule creates "a presumption that in making a business decision the directors . . . acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."<sup>5</sup> This rule generally insulates corporate boards from judicial second-guessing.<sup>6</sup>

---

decisions evaporated"). Cf. Joseph E. Irenas & Theodore D. Moskowitz, *Indemnification of Corporate Officers, Agents, and Directors: Statutory Mandates and Policy Limitations*, 7 SETON HALL LEGIS. J. 117 (1984) (discussing D&O liability as law began to emerge).

<sup>3</sup> See J. Phil Carlton & M. Guy Brooks, III, *Corporate Director and Officer Indemnification: Alternative Methods For Funding*, 24 WAKE FOREST L. REV. 53, 54 (1989) ("Broad indemnification protection is an important factor for a person who is considering whether to serve as a director or officer of a corporation . . .").

<sup>4</sup> A discussion of the effects of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) on directors and officers of financial institutions is beyond the scope of this Article.

<sup>5</sup> *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (citations omitted). See also Dennis J. Block et al., *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 BUS. LAW. 469, 489 (1990) (discussing *Aronson*).

<sup>6</sup> See Kristin A. Linsley, *Statutory Limitations on Directors' Liability in Delaware: A New Look at Conflicts of Interest and the Business Judgment Rule*, 24 HARV. J. ON LEGIS. 527, 527 (1987) (commenting that courts have traditionally declined to review corporate directors' decisions because the "judgment of an informed board is inherently superior to that of a judge viewing a given decision *ex post*"). The reasoning behind the business judgment rule is four-fold:

First, by recognizing human fallibility, the rule encourages competent individuals to assume directorships. Second, the rule recognizes that business decisions frequently entail risk, and thus provides directors the broad discretion they need in formulating dynamic and effective company policy without fear of judicial second-guessing. The rule "recognizes that shareholders to a very real degree voluntarily undertake the risk of bad business judgment; investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers." Third, the rule keeps courts from becoming enmeshed in complex corporate decision-making, a task which they are admittedly ill-equipped to handle. . . . Finally, the rule ensures that directors rather than shareholders manage corporations.

In 1985, however, the Delaware Supreme Court's decision in *Smith v. Van Gorkom*<sup>7</sup> severely curtailed directors' decisionmaking

---

DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGEMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 6-7 (3d ed. 1989)(quoting *Frances T. v. Village Green Owners Ass'n*, 723 P.2d 573, 582 n.14 (Cal. 1986)).

The Second Circuit has recognized the inherent flaw in judicial review of corporate decisions:

[A]fter-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.

*Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982) (conflict of interest, court's ability to evaluate issues and prospective nature of decision render business judgment rule inapplicable to recommendation of corporation's special litigation committee not to bring action against directors), *cert. denied*, 460 U.S. 1051 (1983). See also *International Ins. Co. v. Johns*, 874 F.2d 1447, 1458 n.20 (11th Cir. 1989) ("directors are, in most cases, more qualified to make business decisions than are judges"); *Starrels v. First Nat'l Bank of Chicago*, 870 F.2d 1168, 1174 (7th Cir. 1989) ("In the long run firms are better off when business decisions are made by business specialists, even granting the inevitable errors."); *Village Green Owners Ass'n*, 723 P.2d at 582 n.14 (one justification for business judgment rule is that "directors should be given wide latitude in their handling of corporate affairs because the hindsight of the judicial process is an imperfect device for evaluating business decisions"); *Kamin v. American Express Co.*, 383 N.Y.S.2d 807, 810-11 (1976) ("[t]he directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions"), *aff'd*, 387 N.Y.S.2d 993 (1st Dept. 1976).

For reasons supporting Block's fourth rationale behind the theory that directors, and not shareholders, should manage corporations, see Michael P. Dooley & Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503 (1989), where the authors comment:

The power to hold to account is the power to interfere and, ultimately, the power to decide. If stockholders are given too easy access to courts, the effect is to transfer decisionmaking power from the board to the stockholders or, more realistically, to one or a few stockholders whose interests may not coincide with those of the larger body of stockholders. By limiting judicial review of board decisions, the business judgment rule preserves the statutory scheme of centralizing authority in the board of directors. In doing so, it also preserves the value of centralized decisionmaking for the stockholders and protects them against unwarranted interference in that process by one of their number. Although it is customary to think of the business judgment rule as protecting directors from stockholders, it ultimately serves the more important function of protecting stockholders from themselves.

*Id.* at 522.

<sup>7</sup> 488 A.2d 858 (Del. 1985). See also Robert Roy, Annotation, *Duty of Corporate Director to Exercise "Informed" Judgment in Recommending Responses to Merger or Tender Offer*, 46 A.L.R. 4th 821 (1986).

autonomy. The court concluded that directors should be held to a standard of gross negligence for purposes of determining whether a particular business judgment was an informed one.<sup>8</sup> Under this standard, the directors of the Trans Union Corporation paid a \$23.5 million settlement for approving a negotiated merger without sufficient information and deliberation,<sup>9</sup> despite the absence of any indication that they had been motivated by bad faith, fraud or self-dealing.<sup>10</sup> The Delaware court acknowledged in passing that directors in today's corporations will often be subject to liability in deciding difficult or sensitive issues.<sup>11</sup>

*Van Gorkom* and similar decisions<sup>12</sup> alarmed corporate directors, who feared that their board memberships would jeopardize their personal assets. The decision also provoked insurance companies not only to increase the premiums and exclusions on their D&O liability policies, but to decrease the policy durations and their own operation in the area as a whole.<sup>13</sup> In certain instances, insurers stopped writing D&O policies altogether.<sup>14</sup> Thus, while the availability of D&O insurance coverage sharply decreased, the cost of obtaining such coverage soared to record levels.<sup>15</sup>

---

<sup>8</sup> *Van Gorkom*, 488 A.2d at 873 (footnote omitted). See also Linsley, *supra* note 6, at 527 ("[In *Van Gorkom*], the Delaware Supreme Court blew a hole in the board's traditional shield, holding that the business judgment rule does not protect directors from monetary liability for acts of gross negligence.").

<sup>9</sup> *Van Gorkom*, 488 A.2d at 876-77.

<sup>10</sup> *Id.* at 873.

<sup>11</sup> *Id.* at 881.

<sup>12</sup> See, e.g., *Fox v. Chase Manhattan Corp.*, No. 8192-85 (Del. Ch. Jan. 9, 1986) (chancery court approved settlement of \$32.5 million in personal damages in suit brought by Chase Manhattan against its own officers and employees).

<sup>13</sup> See BLOCK ET AL., *supra* note 6, at 603 (commenting on the D&O insurance crisis that erupted in the mid-1980s).

<sup>14</sup> *Id.* at 562.

<sup>15</sup> See Hanks, *supra* note 2, at 1208 (noting that D&O insurance may not be practically available for start-up or smaller companies). One commentator described the D&O insurance crisis as follows:

For corporate risk managers, the D&O market has become nightmarishly treacherous. Luckier risk managers now face premiums that range from two to ten times what they were last year. If they aren't so lucky, they may not be able to find insurance at any price, or they may be handed a policy so riddled with exclusionary clauses as to be virtually worthless anyway. And just to keep everyone on their toes, not only are the once standard three-year policies a thing of the dim and delightful past, but in this fast-changing, fickle market, even a one year policy is, as one broker says, "only as good as its cancellation clause. These days policies are good for 30, 60 or 90 days."

BLOCK ET AL., *supra* note 6, at 603-04 (quoting IPSEN, *The Crisis in Directors and Officers Insurance*, INSTITUTIONAL INVESTOR 231 (1985)).

This lack of affordable insurance was aggravated in the 1980s by sharp rises both in takeover activity and in corporate insolvency.<sup>16</sup> Because battles for corporate control usually spur a flurry of litigation by shareholders and others, and virtually any corporation is susceptible to such battles, litigation under the federal securities acts<sup>17</sup> targeted even more corporate decisions and decision makers. Moreover, the enactment of the Racketeer Influenced and Corrupt Organizations Act of 1984 (RICO)<sup>18</sup> exposed D&Os to complex civil litigation in which their boards could be characterized as "criminal enterprises" and their own assets could be forfeited.<sup>19</sup> The United States Supreme Court recognized the unique potency of this threat when it described RICO as a "tool for everyday fraud cases brought against 'respected and legitimate enterprises.'" <sup>20</sup>

In the face of these risks, numerous directors chose to resign or to decline reelection rather than continue to act for corporations that could not provide adequate protection (or, in some cases, any protection at all).<sup>21</sup> Indeed, even those directors who chose to remain were discouraged from making the kinds of decisions necessary to stimulate corporate growth and prosperity.<sup>22</sup> Increased D&O protection thus became necessary to ensure that directors would zealously perform their duties, assured that their corporations would bear the reasonable expenses necessary to defend the directors' honesty and integrity.<sup>23</sup>

---

<sup>16</sup> Hanks, *supra* note 2, at 1207-08 (observing that corporate takeovers and insolvencies have precipitated increased litigation against directors and officers).

<sup>17</sup> Wrongful actions taken pursuant to federal securities statutes are typically not entitled to indemnification because "[t]he Securities and Exchange Commission has taken the position that indemnification for any liability arising under the Securities Act of 1933, 15 U.S.C. § 77a *et seq.*, is against public policy." BLOCK ET AL., *supra* note 6, at 583 n.2 (citations omitted).

Generally, "[c]laims under the registration and anti-fraud provisions of the federal securities acts, under the Federal Corrupt Practices Act of 1977, and under other statutes such as some antitrust laws [and RICO], are not or may not be indemnifiable." WILLIAM E. KNEPPER & DAN A. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* § 21.01, at 686 (4th ed. 1988) (footnote omitted).

<sup>18</sup> 18 U.S.C. §§ 1961-1968 (1984 & Supp. 1990).

<sup>19</sup> BLOCK ET AL., *supra* note 6, at 606 (commenting that corporate directors are increasingly exposed to RICO liability).

<sup>20</sup> Sedima, S.P.R.L. v. Imrex Co., 473 U.S. 479, 499 (1985).

<sup>21</sup> BLOCK ET AL., *supra* note 6, at 606 (positing that a lack of, or inadequate, D&O insurance could result in an "exodus of talented individuals from corporate service") (footnote omitted).

<sup>22</sup> See Mitchell, *supra* note 1, at 118 (noting the stifling effect that corporate director liability has on director decisionmaking).

<sup>23</sup> See Hibbert v. Hollywood Park, Inc., 457 A.2d 339, 343-44 (Del. 1983).

In a series of developments designed to "encourage initiative in enterprise decisions, encourage qualified persons to serve as directors, encourage decision-making by independent directors, and give directors wide latitude in their handling of corporate affairs,"<sup>24</sup> however, the storm wall protecting directors and officers from D&O liability was not only repaired, but strengthened. First, legislatures increased the scope of actions for which corporations could provide indemnification.<sup>25</sup> Second, new statutes authorized or directly imposed limits on D&O liability.<sup>26</sup> The majority of these statutes allow a corporation to adopt charter provisions relieving D&Os from personal liability that may arise from their actions or decisions.<sup>27</sup> Third, corporations increasingly explored insurance policy arrangements, captive insurers and other alternatives to traditional sources of insurance.<sup>28</sup>

## II. STATUTORY INDEMNIFICATION

### A. *Scope of Indemnification*

Until the enactment of recent statutes, those few published decisions that directly addressed D&O indemnification predicated it on the directors' or officers' establishment of a successful defense to the underlying claim.<sup>29</sup> Some courts additionally required D&Os to prove that the outcome of the case had somehow been beneficial to the corporation.<sup>30</sup>

Early indemnification statutes reflected both a desire for pre-

---

<sup>24</sup> KNEPPER & BAILEY, *supra* note 17, § 6.03, at 183 (quoting *Cramer v. General Tel. & Elec. Corp.*, 582 F.2d 259, 274 (3d Cir. 1978)). See also *Western Fiberglass, Inc. v. Kirton, McConkie and Bushnell*, 789 P.2d 34, 38 (Utah App. 1990) ("A further justification for indemnity, beyond enhancing the quality of corporate management, is to allow and encourage agents to pursue activities on behalf of the corporation in a manner unfettered by fear of taking good faith risks in the search for profits.") (quoting *Irenas and Moskowitz*, *supra* note 2, at 117).

<sup>25</sup> BLOCK ET AL., *supra* note 6, at 608 (stating that one result of the D&O insurance crisis has been legislative action granting corporations wider latitude in providing indemnification).

<sup>26</sup> *Id.*

<sup>27</sup> Carlton & Brooks, *supra* note 3, at 54 n.5 (observing that North Carolina permits "broad indemnification protection against liability and expenses by charter or bylaw provision or by contract or resolution").

<sup>28</sup> BLOCK ET AL., *supra* note 6, at 607-08 (delineating the strategies adopted in response to the D&O insurance crisis).

<sup>29</sup> KNEPPER & BAILEY, *supra* note 17, § 21.01, at 647 (explaining that the common law of indemnification, now supplanted by statute, required directors to raise a successful defense).

<sup>30</sup> *Id.*

dictability and the trend towards viewing indemnification as a "reasonable and normal" part of corporate life.<sup>31</sup> Shortly after New York enacted the first such indemnification statute in 1941, all of the remaining states followed.<sup>32</sup> These statutes were limited, however, and generally precluded indemnification if a director was ultimately found negligent or liable for misconduct in carrying out a duty to the corporation.<sup>33</sup>

In 1967, Delaware repealed its previous indemnification statute and enacted a replacement<sup>34</sup> that would serve as a model for most modern indemnification statutes.<sup>35</sup> The Delaware statute authorizes a corporation to indemnify any director who has "acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation."<sup>36</sup> This protection is extended to "any person who is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise,"<sup>37</sup> if that person "was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding."<sup>38</sup>

Similarly, the New Jersey statute indemnifies "corporate agents,"<sup>39</sup> as well as agents of "other enterprises,"<sup>40</sup> thus including directors serving as trustees or other fiduciaries for an employee benefit plan,<sup>41</sup> and those whose liability arises under the

---

<sup>31</sup> See Joseph Warren Bishop Jr., *The Law of Corporate Officers and Directors: Indemnification and Insurance*, § 6.02, at 4-6 (1981 & Supp. 1988).

<sup>32</sup> KNEPPER & BAILEY, *supra* note 17, § 20.04, at 654 (detailing the evolution of statutory indemnification).

<sup>33</sup> 44 DEL. LAWS 125 § 1 (1943) & DEL. CODE ANN. tit. 8, § 122(10) (1949) (repealed 1967).

<sup>34</sup> Compare *id.* with DEL. CODE ANN. tit. 8, § 145 (1983 & Supp. 1991).

<sup>35</sup> KNEPPER & BAILEY, *supra* note 17, § 20.04, at 654.

<sup>36</sup> DEL. CODE ANN. tit. 8, § 145(a) (1983 & Supp. 1991).

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* § 145(b). The New York statute contains almost identical language. See N.Y. BUS. CORP. LAW § 722 (McKinney 1986 & Supp. 1993).

<sup>39</sup> N.J. STAT. ANN. § 14A:3-5(1)(a) (West 1969 & Supp. 1992) ("Corporate Agent" is defined to include past and present corporate directors, officers, employees and agents).

<sup>40</sup> *Id.* § 14A:3-5(1)(b).

<sup>41</sup> Other states that have in recent years included similar references are: California, CAL. CORP. CODE § 317 (West 1990); Colorado, COLO. REV. STAT. § 7-3-101.5 (1990); Connecticut, CONN. GEN. STAT. § 33-320a (West 1987 & Supp. 1992); Delaware, DEL. CODE ANN. tit. 8, § 145 (1983 & Supp. 1991); Hawaii, HAW. REV. STAT. § 415.5 (1985 & Supp. 1992); Illinois, ILL. REV. STAT. ch. 32, para. 8.75 (1985); Indiana, IND. CODE §§ 23-1-37-1 to 23-1-37-15 (1989); Iowa, IOWA CODE § 496A.4A (1991); Kansas, KAN. STAT. ANN. § 17-6305 (1988 & Supp. 1992); Kentucky, KY. REV. STAT. ANN. § 271A.026 (Michie 1989); Maryland, MD. CORPS. &

Employment Retirement Security Act of 1974 (ERISA).<sup>42</sup> By contrast, Pennsylvania's statute refers not to "directors, officers, employees or agents," but only to "a representative of the corporation."<sup>43</sup>

D&Os that fall within the statutory boundaries can be indemnified through mandatory indemnification, permissive indemnification or non-exclusionary indemnification permitted by statute.<sup>44</sup>

### B. *Mandatory Indemnification*

Indemnification statutes generally provide for mandatory indemnification if a party "has been successful on the merits or otherwise."<sup>45</sup> In such a case, D&Os are not required to establish any of the necessary elements for permissive indemnification, which include acting in good faith and in a manner reasonably believed to be in the best interest of the corporation.<sup>46</sup> The phrase "or otherwise" has been adopted by most states on the grounds that a director or officer should not be compelled to establish eligibility for mandatory indemnification on the merits if she has a valid procedural defense.<sup>47</sup> This broad scope of protection could possibly allow a director with a successful statute of limitations defense to be indemnified for conduct that would be

---

ASS'NS CODE ANN. § 2-418 (1993); Massachusetts, MASS. GEN. L. ch. 156B, § 67 (1992); Minnesota, MINN. STAT. § 302A.521 (1985 & Supp. 1992); Mississippi, MISS. CODE ANN. §§ 79-4-8.50 to 79-4-8.58 (1992); Missouri, MO. REV. STAT. § 351.355 (1991); Nebraska, NEB. REV. STAT. § 21-2004(15) (1991); New Mexico, N.M. STAT. ANN. § 53-11-4.1 (Michie 1983 & Supp. 1992); New York, N.Y. BUS. CORP. LAW §§ 721 to 726 (McKinney 1986 & Supp. 1993); North Carolina, N.C. GEN. STAT. §§ 55-8-50 to 55-8-57 (1992); North Dakota, N.D. CENT. CODE § 10-19.1-91 (1985); Oklahoma, OKLA. STAT. tit. 18 § 1031 (1986 & Supp. 1993); Rhode Island, R.I. GEN. LAWS § 7-1.1-4.1 (1992); South Dakota, S.D. CODIFIED LAWS §§ 47-2-58.1 to 47-2-58.7 (1991); Tennessee, TENN. CODE ANN. §§ 48-18-501 to 48-18-509 (1988 & Supp. 1992); and Virginia, VA. CODE ANN. §§ 13.1-696 to 13.1-704 (Michie 1989).

<sup>42</sup> 29 U.S.C. §§ 1001-1461 (1985 & Supp. 1992).

<sup>43</sup> PA. CONS. STAT. ANN. tit. 15, § 1741 (1967 & Supp. 1992).

<sup>44</sup> See Irenas & Moskowitz, *supra* note 2, at 118 (discussing different types of indemnification).

<sup>45</sup> N.J. STAT. ANN. § 14A:3-5(4).

<sup>46</sup> BLOCK ET AL., *supra* note 6, at 564.

<sup>47</sup> *Id.* at 565 (quoting REV. MODEL BUSINESS CORP. ACT § 8.52 official cmt. at 250 (1984)). See also I ERNEST L. FOLK, III ET AL., *Folk on the Delaware General Corporation Law*, § 145.4 (3d ed. 1992) ("This avoids forcing on a director or officer (and ultimately on the indemnifying corporation) the additional expense of litigating an issue on the merits where a preliminary technical defense will suffice.") (citation omitted).



prohibited by either statute or common law.<sup>48</sup> In the past few years, almost every jurisdiction has adopted the "or otherwise" phrase rather than requiring an agent to prevail unnecessarily "on the merits."<sup>49</sup>

The Delaware model permits partial mandatory indemnification for a director who is only partially successful.<sup>50</sup> In 1986, New York allowed partial indemnification by deleting the "wholly successful" requirement in its mandatory provision.<sup>51</sup> The drafters of the Model Act, which still calls for a defendant to be wholly successful on the merits, noted that "a defendant is 'wholly successful' only if the entire proceeding is disposed of on a basis which involves a finding [of] non-liability."<sup>52</sup>

Whether the statute empowers a corporation to indemnify its directors partially, or to indemnify them only if they are "wholly successful," mandatory indemnification does not apply at all unless a final judgment has been entered in the director's favor.<sup>53</sup> If the judgment is appealed, indemnification will not be granted until an appellate decision affirms nonliability.<sup>54</sup> A Pennsylvania federal court has held that a settlement, especially one in which there is no assumption of director liability, is sufficiently "final" that it clearly satisfies success either on the merits or otherwise.<sup>55</sup>

### C. *Permissive Indemnification*

Indemnification statutes also generally provide for permissive indemnification in both third party and derivative suits. Un-

---

<sup>48</sup> BLOCK ET AL., *supra* note 6, at 564-65.

<sup>49</sup> KNEPPER & BAILEY, *supra* note 17, app. B-2, at 830-33. Only two states, California and Connecticut, do not include the "or otherwise" language in their statutes. See CAL. CORP. CODE § 317(d) (West 1990 & Supp. 1993); CONN. GEN. STAT. ANN. § 33-320a(11)(b) (West 1987 & Supp. 1992).

<sup>50</sup> BLOCK ET AL., *supra* note 6, at 565. See DEL. CODE ANN. tit. 8, § 145(c) (1983 & Supp. 1991) ("To the extent that [the person to be indemnified] has been successful . . . he shall be indemnified. . ."); see also *Green v. Westcap Corp. of Delaware*, 492 A.2d 260 (Del. Super. Ct. 1985) (court allowed corporation to indemnify director for successful criminal defense even though related civil litigation was still pending).

<sup>51</sup> Compare N.Y. BUS. CORP. LAW § 723(a) (McKinney 1963) with N.Y. BUS. CORP. LAW § 724(a) (McKinney 1986 & Supp. 1993).

<sup>52</sup> REV. MODEL BUSINESS CORP. ACT § 8.52 official cmt. at 250 (1992).

<sup>53</sup> BLOCK ET AL., *supra* note 6, at 567.

<sup>54</sup> *Id.*

<sup>55</sup> *Id.* (quoting *B&B Inv. Club v. Kleinert's Inc.*, 472 F. Supp. 787, 789-91 (E.D. Pa. 1979) (applying the Pennsylvania statute which mirrors the Delaware model's mandatory indemnification provision)). For further discussion of *B&B Investment Club*, see Irenas and Moskowitz, *supra* note 2, at 122.

like mandatory indemnification, which is automatic, permissive indemnification must be authorized on a per-case basis, and "[s]uch authorization requires a finding that the [party] has met the applicable standards of conduct."<sup>56</sup> The requisite standards for both third party and derivative suits are separately stated within each statute, although they are similarly worded.<sup>57</sup>

### 1. Third Party Actions

In third party actions, indemnification may be authorized if the director "acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation."<sup>58</sup> In criminal actions, the director is additionally required not to have had any "reasonable cause to believe his conduct was unlawful."<sup>59</sup> Public policy precludes indemnification of directors who have engaged in intentional, illegal conduct or in deliberate violations of federal criminal laws.<sup>60</sup> An action that has been terminated by judgment, order, settlement, conviction or plea of *nolo contendere* does not alone create a presumption that the requisite standard of conduct has not been fulfilled.<sup>61</sup> Finally, typical third party provisions empower indemnification of judgments, fines, penalties, amounts paid in settlement and reasonable expenses, including attorneys' fees.<sup>62</sup>

---

<sup>56</sup> KNEPPER & BAILEY, *supra* note 17, § 20.09, at 663.

<sup>57</sup> BLOCK ET AL., *supra* note 6, at 567. *Bul see* REV. MODEL BUSINESS CORP. ACT § 8.51(d) (1992) (precluding indemnification in 1) derivative suits in which director is adjudged liable to corporation, and 2) third-party suits in which director is "adjudged liable on the basis that personal benefit was improperly received by him.")

<sup>58</sup> DEL. CODE ANN. tit 8, § 145(a) (1983 & Supp. 1991). The New York statute authorizes indemnification for the director who acts "for a purpose which he reasonably believed to be in . . . the best interests of the corporation," and then adds that an action taken on behalf of the corporation but for the service of another entity (such as another corporation, partnership, joint venture, trust or employee benefit plan) need only be "not opposed to . . . the best interests of the corporation." N.Y. BUS. CORP. LAW § 722(a) (McKinney 1986 & Supp. 1993). *See also* REV. MODEL BUSINESS CORP. ACT § 8.51(a)(2) (1992) (authorizing indemnification for a director who "reasonably believed: (i) in the case of conduct in [the director's] official capacity with the corporation, that his conduct was in [the corporation's] best interests; and (ii) in all other cases, that his conduct was at least not opposed to [the corporation's] best interests . . .").

<sup>59</sup> DEL. CODE ANN. tit 8, § 145(a) (1983 & Supp. 1991).

<sup>60</sup> KNEPPER & BAILEY, *supra* note 17, § 20.08, at 661 (footnote omitted).

<sup>61</sup> *See* DEL. CODE ANN. tit. 8, § 145(a) (1983 & Supp. 1991); N.Y. BUS. CORP. LAW § 722(b) (McKinney 1986 & Supp. 1993); N.J. STAT. ANN. § 14A:3-5(2)(b) (West 1969 & Supp. 1992); REV. MODEL BUSINESS CORP. ACT § 8.51(c) (1992).

<sup>62</sup> *See* DEL. CODE ANN. tit. 8, § 145(a) (1983 & Supp. 1991); N.Y. BUS. CORP. LAW § 722(b) (McKinney 1986 & Supp. 1993); N.J. STAT. ANN. § 14A:3-5(2) (West 1969 & Supp. 1992); REV. MODEL BUSINESS CORP. ACT §§ 8.50(4) & 8.51(a) (1992).

## 2. Derivative Actions

The standards applicable to third party actions are also relevant in derivative actions, with exceptions that typically prohibit indemnification of directors "adjudicated liable to the corporation unless a court, upon application, determines that indemnification is appropriate."<sup>63</sup> Before the statutory revisions of the late 1980s, D&Os could not be indemnified without court approval when they were "adjudicated to be liable *for negligence or misconduct in the performance of a duty* to the corporation."<sup>64</sup> The amendments deleted the language italicized above, thereby denying indemnification to D&Os who were "liable to the corporation" in any way.<sup>65</sup> The legislative intent of the revision was not to alter the law substantively, but instead to reconcile the statutory standard with the Delaware Supreme Court decisions that had required a showing of gross negligence to demonstrate a breach of the duty of care.<sup>66</sup> Prior to New York's 1986 amendment, its statute did not require an adjudication of liability, but only a judicial determination that a duty had been breached.<sup>67</sup>

Until recently, liabilities incurred pursuant to judgments and settlements of derivative actions were precluded from indemnification.<sup>68</sup> This restriction stems from "the belief by many that it would be circular if funds received by the corporation (the ultimate plaintiff on whose behalf a derivative action is brought) were simply returned to the defendant director who paid them."<sup>69</sup> This indemnification in effect "place[s] [the corporation] in a worse economic position than if it simply had sustained the loss without the costs of recovery and subsequent reimbursement."<sup>70</sup>

The Delaware statute authorizes indemnification only for ex-

---

<sup>63</sup> See, e.g., DEL. CODE ANN. tit. 8, § 145(b) (1983 & Supp. 1991); N.J. STAT. ANN. § 14A:3-5(3) (West 1969 & Supp. 1992); N.Y. BUS. CORP. LAW § 722(c) (McKinney 1986 & Supp. 1993); REV. MODEL BUSINESS CORP. ACT § 8.51(d) (1984).

<sup>64</sup> DEL. CODE ANN. tit. 8, § 145(b) (1983); N.J. STAT. ANN. § 14A:3-5(3) (West 1969) (emphasis added).

<sup>65</sup> See DEL. CODE ANN. tit. 8, § 145(b) (Supp. 1991); N.J. STAT. ANN. § 14A:3-5(3) (West Supp. 1992).

<sup>66</sup> DEL. CODE ANN. tit. 8, § 145(b) official cmt. (Supp. 1988).

<sup>67</sup> See N.Y. BUS. CORP. LAW § 722(a) (McKinney 1986 & Supp. 1993).

<sup>68</sup> BLOCK ET AL., *supra* note 6, at 570.

<sup>69</sup> *Id.* (footnote omitted). See also Mitchell, *supra* note 1, at 122 ("The concern in requiring or permitting indemnification against settlements and adverse judgments in derivative suits is its circularity.").

<sup>70</sup> James J. Hanks Jr., *Director Liability*, 2 INSIGHTS 1, 24 (1988).

penses (including attorneys' fees) incurred in derivative suits.<sup>71</sup> Over the past few years, however, New Jersey,<sup>72</sup> New York,<sup>73</sup> Pennsylvania and many other states<sup>74</sup> have amended their statutes to allow indemnification of judgments and/or settlements in derivative actions.<sup>75</sup> Jurisdictions are split over whether to authorize such indemnification without court approval.<sup>76</sup> For example, New York amended its statute in 1986 to permit a corporation to indemnify D&Os not only for expenses, but also for settlements in derivative suits for actions taken in good faith, in the best interests of the corporation, or otherwise "as the court deems proper."<sup>77</sup>

Beyond permitting the indemnification of defendants in derivative suits, the New Jersey and Pennsylvania statutes also allow corporations to exceed the derivative suit indemnification limits specified by the statutes themselves.<sup>78</sup> New Jersey's "non-exclusivity" statute allows indemnification in derivative suits greater than that provided by the statute, pursuant to a certificate of incorporation, bylaw, agreement, vote of shareholders or otherwise, "including the right to be indemnified against liabilities . . . by or in the right of the corporation."<sup>79</sup> The statute prohibits such indemnification, however, when the director's conduct was a

---

<sup>71</sup> DEL. CODE ANN. tit. 8, § 145(b) (1983 & Supp. 1991). In 1986, a proposal to revise § 145(b) to permit indemnification in derivative suits of judgments and amounts paid in settlement was denied by the General Corporation Law Section of the Delaware Bar Association. BLOCK ET AL., *supra* note 6, at 571 n.40.

<sup>72</sup> N.J. STAT. ANN. § 14A:3-5(8) (West Supp. 1992).

<sup>73</sup> N.Y. BUS. CORP. LAW § 722(c) (McKinney Supp. 1993).

<sup>74</sup> PA. CONS. STAT. ANN. tit. 15, § 1746(c) (Supp. 1992).

<sup>75</sup> BLOCK ET AL., *supra* note 6, at 571 n.40. Several states, other than New Jersey, New York and Pennsylvania, authorize indemnification of liabilities in derivative suits: Arizona, ARIZ. REV. STAT. ANN. §§ 10-005(B)&(D)(3) (1990); California, CAL. CORP. CODE § 317(c)(1) (1990); Florida, FLA. STAT. ANN. § 607.0850(2) (1993); Georgia, GA. CODE ANN. §§ 14-2-856(a)&(b) (Michie 1989); Louisiana, LA. REV. STAT. ANN. § 12:83(A) (Supp. 1993); Maryland, MD. CORPS. & ASS'NS CODE ANN. §§ 2-418(b)(1)&(2) (1993); Massachusetts, MASS. GEN. L. ch. 156B, § 67 (1992); Michigan, MICH. COMP. LAWS § 450.1562 (1990); Minnesota, MINN. STAT. § 302A.521(2) (1985 & Supp. 1993); Nevada, NEV. REV. STAT. § 78.751(2) (1991); North Carolina, N.C. GEN. STAT. § 55-8-57(a) (1986); North Dakota, N.D. CENT. CODE § 10-19.1-91(2) (1985); Tennessee, TENN. CODE ANN. § 48-18-502 (1988); Vermont, VT. STAT. ANN. tit. 11, § 1852(15) (1984 & Supp. 1992); and Wyoming, WYO. STAT. § 17-1-105.1(a) (1986).

<sup>76</sup> *Id.*

<sup>77</sup> N.Y. BUS. CORP. LAW § 722(c) (McKinney 1986 & Supp. 1993).

<sup>78</sup> BLOCK ET AL., *supra* note 6, at 618. See also Paula Walters, *Statutory Indemnification and Insurance Provisions for Corporate Directors—to What End?*, 38 DRAKE L. REV. 241, 246 (1988-89) (questioning the lack of boundaries in non-exclusive indemnification statutes).

<sup>79</sup> N.J. STAT. ANN. § 14A:3-5(8) (West Supp. 1992).

breach of a duty of loyalty, was taken in bad faith, was a knowing violation of the law, or resulted in an improper personal benefit.<sup>80</sup>

Pennsylvania's statute allows for similar indemnification, except where there is a judicial determination that the director's action was a result of "willful misconduct or recklessness."<sup>81</sup> The statute also expressly states that indemnification of liabilities in derivative actions is consistent with Pennsylvania's public policy.<sup>82</sup>

#### D. Statutory Non-Exclusivity

More generally, statutory non-exclusivity permits corporations to formulate their own programs for indemnification beyond the limitations of the statute.<sup>83</sup> A corporate program may be established pursuant to a certificate of incorporation, shareholder resolution or an indemnification agreement or contract.<sup>84</sup> Most jurisdictions, including Delaware, New Jersey, New York and Pennsylvania, have adopted either this approach or a variation.<sup>85</sup>

---

<sup>80</sup> *Id.*

<sup>81</sup> PA. CONS. STAT. ANN. tit. 15, §§ 1746(a) & (b) (1967 & Supp. 1992).

<sup>82</sup> *Id.* § 1746(c).

<sup>83</sup> KNEPPER & BAILEY, *supra* note 17, § 20.13, at 669.

<sup>84</sup> BLOCK ET AL., *supra* note 6, at 580, 616.

<sup>85</sup> *Id.* at 617. Several jurisdictions other than New Jersey, New York, Delaware and Pennsylvania have adopted some form of non-exclusivity: Alabama, ALA. CODE § 10-2A-21 (1975); Arizona, ARIZ. REV. STAT. ANN. § 10-005 (1990); Arkansas, ARK. CODE ANN. §§ 4-26-814, 4-27-850, 4-27-1621 (Michie 1987); District of Columbia, D.C. CODE ANN. § 29-304(16) (1981); Hawaii, HAW. REV. STAT. § 415-5 (1985 & Supp. 1992); Illinois, ILL. REV. STAT. ch. 32, para. 8.75 (1985); Indiana, IND. CODE §§ 23-1-37-1 to 23-1-37-15 (1989); Iowa, IOWA CODE § 496A.4A (1991); Kansas, KAN. STAT. ANN. § 17-6305 (1988); Louisiana, LA. REV. STAT. ANN. § 12.83 (West 1969 & Supp. 1993); Maine, ME. REV. STAT. ANN. tit. 13A, § 719 (West 1981 & Supp. 1992); Maryland, MD. CORPS. & ASS'NS CODE ANN. § 2-418 (1993); Massachusetts, MASS. GEN. L. ch. 156B, § 67 (1992); Michigan, MICH. STAT. ANN. §§ 450.1561 to 450.1569 (Callaghan 1990); Mississippi, MISS. CODE ANN. §§ 79-4-8.50 to 79-4-8.58 (1988); Missouri, MO. REV. STAT. § 351.355 (1991); Nevada, NEV. REV. STAT. § 78.751 (1991); New Hampshire, N.H. REV. STAT. ANN. § 293-A:5 (1987); New Mexico, N.M. STAT. ANN. § 53-11-4.1 (Michie 1983 & Supp. 1992); North Carolina, N.C. GEN. STAT. §§ 55-8-51, 55-8-55, 55-8-56 (1990); Ohio, OHIO REV. CODE ANN. § 1701.13(E) (Anderson 1992); Oklahoma, OKLA. STAT. tit. 18, § 1031 (1986 & Supp. 1993); Puerto Rico, P.R. LAWS ANN. tit. 14, § 1202(10) (1989); South Dakota, S.D. CODIFIED LAWS §§ 47-2-58.1 to 47-2-58.7 (1991); Tennessee, TENN. CODE ANN. §§ 48-18.501 to 48-18.509 (1988); Utah, UTAH CODE ANN. §§ 16-10a-841, 16-10a-902 (Supp. 1992); Vermont, VT. STAT. ANN. tit. 11, § 1852(15) (1984); Virginia, VA. CODE ANN. §§ 13.1-696 to 13.1-704 (Michie 1989); Virgin Islands, V.I. CODE ANN. tit. 13, § 67a (Supp. 1992); Washington, WASH. REV. CODE § 23B.02.020(ff) (Supp. 1993); West Virginia, W. VA. CODE § 31-1-9 (1988);

Specifically, the Delaware statute, which was one of the first to utilize non-exclusivity, provides for non-exclusive indemnification without any restrictions.<sup>86</sup> The typical statute, however, allows non-exclusive indemnification only to the extent that D&O conduct falls within certain limits.<sup>87</sup> For example, the New Jersey statute allows indemnity beyond the minimum statutory coverage, but excludes any acts or omissions that are breaches of the duty of loyalty,<sup>88</sup> are taken in bad faith, are a knowing violation of the law or which result in improper personal benefit.<sup>89</sup> Pennsylvania bars such indemnification "where the act or failure to act giving rise to the claim for indemnification is determined by a court to have constituted willful misconduct or recklessness."<sup>90</sup>

The RMBCA mandates that indemnification of directors pursuant to articles of incorporation, bylaws, resolutions of shareholders or directors, a contract or otherwise, be "consistent" with the Act.<sup>91</sup> The Official Comment explains that "consistent" is not synonymous with "exclusive" and does not prohibit the amendment of statutory permissive indemnification to mandatory indemnification, or the use of procedural devices inconsistent with the statute.<sup>92</sup> The former New York statute required similar consistency, but was amended in 1986 and now mirrors the Delaware non-exclusivity provision.<sup>93</sup> The New York statute contains limitations similar to those of the New Jersey statute,<sup>94</sup> but omits the exception involving breaches of the duty of loyalty.<sup>95</sup> The New York statute also includes a limitation for conduct resulting from active or deliberate dishonesty.<sup>96</sup>

---

Wisconsin, WIS. STAT. § 180.0852 (1992); and Wyoming, WYO. STAT. § 17-1-105.1 (1986).

<sup>86</sup> DEL. STAT. ANN. tit. 8, § 145(f) (1983 & Supp. 1991).

<sup>87</sup> BLOCK ET AL., *supra* note 6, at 617.

<sup>88</sup> An act or omission in breach of a person's duty of loyalty is defined as "an act or omission which that person knows or believes to be contrary to the best interests of the corporation or its shareholders in connection with a matter in which he has a material conflict of interest." N.J. STAT. ANN. § 14A:2-7(3) (West 1969 & Supp. 1992).

<sup>89</sup> *Id.* § 14A:3-5(8).

<sup>90</sup> PA. CONS. STAT. ANN. tit. 15, § 1746(b) (1967 & Supp. 1992).

<sup>91</sup> REV. MODEL BUSINESS CORP. ACT § 8.58(a) (1992).

<sup>92</sup> *Id.* § 8.58 official cmt. at 289.

<sup>93</sup> See N.Y. BUS. CORP. LAW § 721 (McKinney 1986 & Supp. 1993).

<sup>94</sup> For discussion of the New Jersey statute, see *supra* notes 78-80 and accompanying text.

<sup>95</sup> N.Y. BUS. CORP. LAW § 721 (McKinney 1986 & Supp. 1993).

<sup>96</sup> *Id.*

*E. Advance Payments*

Indemnification statutes generally also provide for advance payments of fees and expenses before the final adjudication of the litigation.<sup>97</sup> Amended statutes have been more lenient in recent years than in the prior decade in authorizing advance payments.<sup>98</sup> Before its 1986 amendment, the Delaware statute allowed advancement of expenses "as authorized by the board of directors in the specific case upon receipt of an undertaking<sup>[99]</sup> by or on behalf of such director or officer to repay such amount unless it shall ultimately be determined that he is entitled to be indemnified."<sup>100</sup> The amended statute no longer requires authorization by the board of directors.<sup>101</sup> The amendment also provides that the director repay advance expenses only if there is an ultimate determination that he is *not* entitled to indemnification.<sup>102</sup> The former statute obligated a director's repayment upon receipt of the advance payments, but the amendment delays such obligation until a director's liability is clearly established.

The RMBCA and many states, including New Jersey, New York and Pennsylvania, have followed the Delaware model.<sup>103</sup> The RMBCA furnishes two additional requirements. First, the

---

<sup>97</sup> KNEPPER & BAILEY, *supra* note 17, § 20.12, at 667.

<sup>98</sup> *Id.* The Official Comment to the Revised Model Business Corporation Act has recognized that:

It is often critically important to a director who is made a party to a complex proceeding that the corporation he served have power to make advances for expenses at the beginning of and during the proceeding. Adequate legal representation and adequate preparation of a defense may require substantial payments of expenses before a final determination, and unless the corporation may make advances for expenses, a defendant may be unable to finance his own defense.

REV. MODEL BUSINESS CORP. ACT § 8.53 official cmt. at 284 (1992).

<sup>99</sup> The term "undertaking" was defined by a Delaware draftsman as simply "a promise to repay." See Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 883 (1969) (citing interview with Ernest L. Folk).

<sup>100</sup> DEL. CODE ANN. tit. 8, § 145(e) (1974) (emphasis added).

<sup>101</sup> *Id.* § 145(e) (Supp. 1991).

<sup>102</sup> *Id.* The amended statute states:

Expenses (including attorneys' fees) incurred by an officer or director in defending any . . . suit or proceeding may be paid by the corporation in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of such director or officer to repay such amount if it shall ultimately be determined that he is *not* entitled to be indemnified by the corporation as authorized in this section.

*Id.* (emphasis added).

<sup>103</sup> See N.J. STAT. ANN. § 14A:3-5(6) (West Supp. 1992); N.Y. BUS. CORP. LAW § 725(a) (McKinney Supp. 1993); PA. CONS. STAT. ANN. tit. 15, § 1745 (Supp. 1992); REV. MODEL BUSINESS CORP. ACT §§ 8.53(a)(1)-(3) (1992).

director receiving the advance payment must provide the corporation with a writing affirming his good faith belief that his conduct fell within the standards of permissive indemnification.<sup>104</sup> Second, the facts of the case that are already known must not establish that indemnification would be prohibited under the statute.<sup>105</sup>

Like the Delaware statute, the New York and Pennsylvania statutes do not condition advance payment upon stockholder approval, do not require that the director meet the appropriate standard of conduct and do not require that the decision to provide advance payment follow the procedures<sup>106</sup> specified for permissive indemnification.<sup>107</sup> The New Jersey statute also follows the Delaware model except that it requires the board of directors to authorize advancement of funds.<sup>108</sup> In addition, Delaware, New Jersey, New York and Pennsylvania have amended their statutes to allow advancement of expenses on a non-exclusive basis.<sup>109</sup>

### III. STATUTORY LIMITATIONS ON LIABILITY

Helpful as they were, statutory indemnification statutes were flawed in two important respects. First, smaller corporations still could not afford to indemnify their directors.<sup>110</sup> Second, indemnification statutes did not relieve a director from personal liability for a breach of a duty of care, even if the director otherwise had acted in good faith.<sup>111</sup> To address these situations, legislatures enacted statutes authorizing corporations to adopt their own policies limiting or extinguishing the personal liability of di-

---

<sup>104</sup> REV. MODEL BUSINESS CORP. ACT § 8.53(a)(1) (1992).

<sup>105</sup> *Id.* § 8.53(a)(3).

<sup>106</sup> Until 1986, the New York statute did require permissive indemnification procedures to be followed. Compare N.Y. BUS. CORP. LAW § 724(c) (McKinney 1963) with N.Y. BUS. CORP. LAW § 724(c) (McKinney 1986 & Supp. 1993). For a detailed discussion of the procedures required for permissive indemnification in New Jersey, a state which utilizes the basic statutory procedures, see Irenas & Moskowitz, *supra* note 2, at 121-24.

<sup>107</sup> See N.Y. BUS. CORP. LAW §§ 723(c) & 725(a) (McKinney 1986 & Supp. 1993); PA. CONS. STAT. ANN. tit. 15, § 1745 (1967 & Supp. 1992).

<sup>108</sup> N.J. STAT. ANN. § 14A:3-5(6) (West 1969 & Supp. 1992).

<sup>109</sup> See DEL. CODE ANN. tit. 8, § 145(f) (Supp. 1991); N.J. STAT. ANN. § 14A:3-5(8) (West Supp. 1992); N.Y. BUS. CORP. LAW § 721 (McKinney 1986 & Supp. 1993); PA. CONS. STAT. ANN. tit. 15, § 1746(a) (Supp. 1992). For a discussion of non-exclusivity, see *supra* notes 83-96 and accompanying text.

<sup>110</sup> See Mitchell, *supra* note 1, at 120 ("The ability to provide indemnity does not solve the problems of the directors at smaller and less capitalized corporations because those corporations often will be unable to afford the promised indemnity.").

<sup>111</sup> See Linsley, *supra* note 6, at 528.



rectors and officers for breaching their duty of care.<sup>112</sup>

The Delaware provision<sup>113</sup> was enacted as a direct response to *Smith v. Van Gorkom*.<sup>114</sup> In that case, a corporation's board of directors approved its sale after a two-hour meeting.<sup>115</sup> Prior to the meeting, the directors had not been informed of the purpose of the meeting; nor had they received in advance any documents relevant to the sale.<sup>116</sup> Rather, their decision to approve the transaction was based solely on the board chairman's twenty-minute oral presentation and the chief financial officer's report that the transaction was fair.<sup>117</sup>

Although the court found no proof of bad faith, fraud, self-dealing or acting in opposition to the corporation's best interests, it nonetheless determined that the directors had failed to make a properly informed decision and thus had breached their duty of care.<sup>118</sup> The case was subsequently settled for \$23.5 million.<sup>119</sup>

*Van Gorkom*'s emphasis on information over motivation particularly troubled "outside directors," whose primary interests lie with other firms and who are not necessarily involved in the day-to-day management of the corporation.<sup>120</sup> Such directors, to an even greater extent than those who were more deeply aware of the corporation's interests, ran the risk of personal liability each time they made what they believed to be an adequately informed, good-faith decision.<sup>121</sup>

To encourage the participation of outside directors,<sup>122</sup> Dela-

---

<sup>112</sup> Dale A. Oesterle, *The Effect of Statutes Limiting Directors' Due Care Liability on Hostile Takeover Defenses*, 24 WAKE FOREST L. REV. 31, 32 (1989).

<sup>113</sup> DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1991).

<sup>114</sup> 488 A.2d 858 (Del. 1985). For further discussion of *Smith v. Van Gorkom*, see *supra* notes 7-11 and accompanying text.

<sup>115</sup> *Id.* at 869.

<sup>116</sup> *Id.* at 868.

<sup>117</sup> *Id.* at 877.

<sup>118</sup> *Id.* at 890.

<sup>119</sup> BLOCK ET AL., *supra* note 6, at 53-54.

<sup>120</sup> Linsley, *supra* note 6, at 531.

<sup>121</sup> See Oesterle, *supra* note 112, at 32-33.

<sup>122</sup> There is a general view in all states that outside directors are beneficial to a corporation:

Delaware's concern over the availability of qualified outside directors reflects the general view that the presence of outside directors on a corporate board provides certain protections for the shareholders. Those who are not involved in the day-to-day management of a corporation are considered better able to take a more dispassionate view when the board is called on to make a decision. In addition, a director's experience in "outside" matters (for instance, as an officer of

ware in 1986 added a liability limitation provision to its existing corporate code.<sup>123</sup> Delaware's section 102(7)(b), which has served as a model for more than thirty other states,<sup>124</sup> authorizes a corporation to include in its charter, either originally or

---

another company in the same or a related industry) may be an asset to the corporation, providing new information and insight to the decision-making process. More to the point, outside directors are thought to perform an important monitoring function, checking actions that may be taken in the interests of management and at the expense of the corporation and its shareholders. Whether or not these goals are achieved in practice, the presence of independent directors at the very least lends an air of legitimacy to corporate decisions.

Linsley, *supra* note 6, at 531-32 (footnotes omitted).

<sup>123</sup> See KNEPPER & BAILEY, *supra* note 17, § 7.01, at 209 (observing that Delaware added a liability limitation provision because the lack of insurance protection may deter directors "from making entrepreneurial decisions").

<sup>124</sup> *Id.* § 7.04, at 215. Directorial liability limitation provisions have been promulgated in several states. States that have followed the Delaware paradigm include: Alaska, ALASKA STAT. § 10.06.210(1)(N) (1989); Arizona, ARIZ. REV. STAT. ANN. § 10-054(A)(9) (1990); Arkansas, ARK. CODE ANN. § 4-27-202(B)(3) (1987); Colorado, COLO. REV. STAT. § 7-3-101(1)(u) (1990); Connecticut, CONN. GEN. STAT. ANN. § 33-290(c)(2) (West 1987 & Supp. 1992); Georgia, GA. CODE ANN. § 14-2-202(b)(4) (Michie 1989); Hawaii, HAW. REV. STAT. § 415-58A (1985 & Supp. 1992); Idaho, IDAHO CODE § 30-1-54(2) (1980 & Supp. 1992); Iowa, IOWA CODE § 491.5(8) (1991); Kansas, KAN. STAT. ANN. § 17-6002(b)(8) (1988 & Supp. 1992); Kentucky, KY. REV. STAT. ANN. § 271B.2-020(2)(d) (Michie 1989); Louisiana, LA. REV. STAT. ANN. § 12:24(C)(4) (West 1969 & Supp. 1993); Maryland, MD. CORPS. & ASS'NS CODE ANN. §§ 2-104(b)(8) & 2-405.2 (1993); Massachusetts, MASS. GEN. L. ch. 156B, § 13(b)(1-1/2) (1992); Michigan, MICH. COMP. LAWS § 450.1209(c) (1990); Minnesota, MINN. STAT. § 302A.251(4) (West 1985 & Supp. 1992); Nebraska, NEB. REV. STAT. § 21-2035(2) (1991); Nevada, NEV. REV. STAT. ANN. § 78.037(1) (1991); New Jersey, N.J. STAT. ANN. §§ 14A:2-7(3) & 14A:6-14(3) (West 1969 & Supp. 1991); New Mexico, N.M. STAT. ANN. § 53-12-2(E) (Michie 1983 & Supp. 1992); New York, N.Y. BUS. CORP. LAW § 402(b) (McKinney 1986 & Supp. 1993); North Carolina, N.C. GEN. STAT. § 55-2-02(b)(3) (1990); Oklahoma, OKLA. STAT. tit. 18, § 1006(B)(7) (1986 & Supp. 1993); Rhode Island, R.I. GEN. LAWS § 7-1.1-48(a)(6) (1992); South Carolina, S.C. CODE ANN. § 33-2-102(e) (1990); South Dakota, S.D. CODIFIED LAWS ANN. § 47-2-58.8 (1991); Tennessee, TENN. CODE ANN. § 48-12-102(b)(3) (Supp. 1992); Texas, TEX. CORPS. & ASS'NS CODE ANN. § 7.06(B) (West 1988); Utah, UTAH CODE ANN. § 16-10a-841 (Supp. 1991); Virginia, VA. CODE ANN. § 13.1-692.1 (Michie 1989); and Washington, WASH. REV. CODE ANN. § 23B.02.020(bb)-(ff) (West Supp. 1993). BLOCK ET AL., *supra* note 6, at 615.

Eight of the above states follow the Delaware model verbatim: Alaska, Kansas, Louisiana, Massachusetts, Michigan, Minnesota, Oklahoma and South Dakota. *Id.* A few other states, as well as Kentucky and Virginia, both of which, as noted above, have also adopted Delaware-like statutes, have taken a more radical approach by enacting direct legislation which has tightened the standards of directorial culpability. See, e.g., Florida, FLA. STAT. ANN. § 607.0831 (West 1993); Indiana, IND. CODE ANN. § 23-1-35-1(e) (West 1978 & Supp. 1992); Ohio, OHIO REV. CODE ANN. § 1701.59(D) (1992). BLOCK ET AL., *supra* note 6, at 616, 673. These provisions "authorize individual corporations to 'opt out' of this standard (as opposed to the Delaware model, which allows corporations to 'opt in') by [adopting a] charter pro-

through an amendment, a provision limiting or completely eliminating a director's personal liability for a breach of a fiduciary duty.<sup>125</sup> The provision does not take effect unless it is accepted by the shareholders as an amendment to the corporation's certificate of incorporation.<sup>126</sup>

The charter provision may be broad enough to eliminate liability for breaches of a director's duty of care, or may be more narrow and only serve to limit directorial liability.<sup>127</sup> In either case, Delaware's statute precludes limiting or eliminating such liability when a director's conduct was a result of a breach of a duty of loyalty, was not taken in good faith, involved intentional misconduct or a knowing violation of the law, occurred prior to the time the charter provisions became effective or resulted in an improper personal benefit to the director.<sup>128</sup> Furthermore, the statute does not pertain to liability for violations of federal statutes, such as RICO and the federal securities laws, liabilities for the payment of unlawful dividends, stock purchases or redemptions, or claims for nonmonetary or equitable relief, such as rescission or an injunction.<sup>129</sup>

In addition, the Delaware model applies only to directors and not to officers or other employees or agents.<sup>130</sup> If a director is also an officer, he can still be held personally liable for his actions as an officer, a status not protected by the statute.<sup>131</sup> New Jersey, however, authorizes a corporation to adopt a charter that may protect an officer as well as a director from personal liability.<sup>132</sup> The New Jersey statute also differs from the Delaware model in that it does not include a specific exception for inten-

---

vision." *Id.* at 616, 673-74. For further discussion of specific state approaches, see *id.* at 673-88.

<sup>125</sup> DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1991). See KNEPPER & BAILEY, *supra* note 17, § 7.04, at 215 (reviewing the Delaware legislation).

<sup>126</sup> KNEPPER & BAILEY, *supra* note 17, § 7.04, at 215.

<sup>127</sup> *Id.* at 215-16.

<sup>128</sup> DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1991).

<sup>129</sup> See *id.*

<sup>130</sup> BLOCK ET AL., *supra* note 6, at 614 (citation omitted). This standard has been said to:

[R]eflect again the limited purpose of the statute to right the balance and encourage outside directors to serve. It was not felt 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.

*Id.*

<sup>131</sup> Oesterle, *supra* note 112, at 33 n.8.

<sup>132</sup> N.J. STAT. ANN. § 14A:2-7(3) (West Supp. 1990). States other than New

tional misconduct or unlawful dividends, stock purchases and redemptions.<sup>133</sup>

The Pennsylvania statute differs slightly from the Delaware model by providing that a corporation has the power to eliminate directorial liability, even though this statute makes no specific reference to a limitation *only* of directorial liability.<sup>134</sup> Pennsylvania allows a corporation to eliminate a director's liability only if the director's conduct does not entail a breach of a duty constituting self-dealing, willful misconduct or recklessness.<sup>135</sup>

Caselaw in this area has focused on excluding directorial breaches of the duty of loyalty from actions protected by the statutory limitation on liability.<sup>136</sup> Because the duty of loyalty is a very broad restriction, its breach is a popular allegation among plaintiffs. For example, in *A.C. Acquisitions Corp. v. Anderson, Clayton & Co.*,<sup>137</sup> the Delaware Chancery Court granted a preliminary injunction to enjoin the defendant company's board from proceeding with a self-tender offer.<sup>138</sup> In support of its ruling, the court determined that the defendants' actions were "*likely* to be found to constitute a breach of a duty of loyalty."<sup>139</sup> The court further noted that a defendant's good faith belief is not enough to preclude liability when the defendant, by his conduct, breached his duty of loyalty.<sup>140</sup> In 1989, however, a Delaware Chancery Court implied that a corporation might amend its certificate of incorporation to eliminate or limit directorial liability when a breach of the duty of loyalty occurs, in contrast to section 102(b)(7) of the Delaware Code.<sup>141</sup>

The statutory limitation on liability has given state courts the

---

Jersey that also include officers within the protections of their statutes include Louisiana, Maryland and Nevada.

<sup>133</sup> *See id.*

<sup>134</sup> *See* PA. CONS. STAT. ANN. tit. 15, §§ 1741, 1742 (Purdon 1967 & Supp. 1990) (referring to a "representative of the corporation").

<sup>135</sup> *Id.* § 1746(b).

<sup>136</sup> KNEPPER & BAILEY, *supra* note 17, § 7.04, at 216.

<sup>137</sup> 519 A.2d 103 (Del. Ch. 1986).

<sup>138</sup> *Id.* at 107.

<sup>139</sup> *Id.* at 114 (emphasis added).

<sup>140</sup> *Id.* at 115.

<sup>141</sup> *See* *Siegman v. Tri-Star Pictures, Inc.*, No. 9477, 1989 WL 48746 (Del. Ch. May 30, 1989), *reprinted in* 15 DEL. J. CORP. L. 218 (1990). The court observed that "at least one scenario (and perhaps others) could plausibly be constructed where [Tristar's Certificate of Incorporation] would eliminate or limit the liability of Tri-Star directors for breach of their fiduciary duty of loyalty — a result proscribed by § 102(b)(7). That possibility alone is sufficient to warrant the denial of [Tristar's motion to dismiss Siegman's derivative suit for failure to state a claim]." *Id.* at 236. The court reserved, however, "[a]ny more comprehensive or definitive declaration

delicate task of defining a director's wrongful conduct.<sup>142</sup> If the director had a conflict of interest, courts could choose to define such behavior as a breach of the director's duty of loyalty.<sup>143</sup> This categorization would remove the director from the protection of the statute and thereby expose him to the likelihood of personal liability.<sup>144</sup> The statute, however, would insulate the director from liability if his conduct were characterized as a breach of the duty of care.<sup>145</sup> As a third option, the court could rely on its equitable powers, such as granting injunctive relief, because these powers are not restricted by the statutory limitation on liability.<sup>146</sup>

Although in choosing among these approaches to determining liability a court may be guided by the specific facts of the case, directors remain caught between the Scylla of "increased personal exposure to damages" and the Charybdis of "an increase in court interference."<sup>147</sup>

#### IV. INSURANCE

##### A. Statutory Authorization

Almost every state indemnification statute authorizes a corporation to purchase and maintain some form of D&O liability insurance.<sup>148</sup> A majority of jurisdictions have followed the Delaware model, which declares: "A corporation shall have the power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent . . . whether or not the corporation would have the power to indemnify him against such liability under this section."<sup>149</sup> The Delaware statute encourages corporations to insure their directors except where prohibited by public policy.<sup>150</sup> Therefore, Dela-

---

of the validity of [that provision of the Certificate]" until "a later procedural stage where the merits may be explored in greater depth than was done here." *Id.*

<sup>142</sup> Oesterle, *supra* note 112, at 48.

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> KNEPPER & BAILEY, *supra* note 17, at 688. The only state that does not statutorily authorize D&O liability insurance is Vermont. *Id.*

<sup>149</sup> DEL. CODE ANN. tit. 8, § 145(g) (1983 & Supp. 1991).

<sup>150</sup> See KNEPPER & BAILEY, *supra* note 17, § 21.03, at 689 (while the Delaware statute does not expressly mention public policy, "[f]rom the language of the statutes authorizing D&O insurance it appears that public policy would provide the only restriction on the protection that could be made available by insurance. Generally,

ware allows corporate insurance funding to offset indemnification, but does not allow it to preempt state insurance laws outlining conduct that is restricted from coverage or limited on public policy grounds.<sup>151</sup>

The New York statute authorizes the purchase of insurance more narrowly than does the Delaware model.<sup>152</sup> Specifically, the statute approves insurance in "instances in which [D&Os] may not otherwise be indemnified . . . provided the . . . insurance . . . provides, in a manner acceptable to the superintendent of insurance, for a retention amount and for co-insurance."<sup>153</sup> The New York statute excludes insurance coverage of liability payments of a director who is adjudicated liable and whose actions were a product of deliberate dishonesty or illegal personal gain.<sup>154</sup>

The New Jersey statute, on the other hand, is more limited than the Delaware statute because it specifically authorizes a corporation to purchase insurance from, or reinsure insurance through, an insurer "owned by or otherwise affiliated with the corporation, whether or not such insurer does business with other insureds."<sup>155</sup>

Some state statutes specifically refer to the maintenance of self-insurance or other similar forms of protection.<sup>156</sup> For instance, the Pennsylvania statute provides that a corporation may "create a fund of *any nature*, which may, but not need be, under the control of a trustee, or otherwise secure or insure in any manner its indemnification obligations."<sup>157</sup>

---

public policy prohibits coverage for willful or intentional wrongdoing, fraud or knowing violation of law.") (footnote omitted).

<sup>151</sup> J. Erik Groves, Comment, *Corporate Law and Director Liability: Who's Really Sitting on the Three-Legged Stool and Why North Carolina Should Care*, 24 WAKE FOREST L. REV. 141, 160 (1989).

<sup>152</sup> See N.Y. BUS. CORP. LAW § 726 (McKinney 1986 & Supp. 1993).

<sup>153</sup> *Id.* § 726(a)(3).

<sup>154</sup> *Id.* § 726(b)(1).

<sup>155</sup> See N.J. STAT. ANN. § 14A:3-5(9) (West Supp. 1992).

<sup>156</sup> See PA. CONS. STAT. ANN. § 1746(a) (Purdon 1967 & Supp. 1992). States with a similar approach include Arizona, Hawaii, Louisiana, Maryland, Nevada, New Mexico and Ohio.

<sup>157</sup> *Id.* (emphasis added). See also PA. CONS. STAT. ANN. § 1747 (Purdon 1967 & Supp. 1992) ("Unless otherwise restricted in its bylaws, a business corporation shall have power to purchase and maintain insurance on behalf of a director or officer . . . whether or not the corporation would have the power to indemnify him against that liability under the provisions of this subchapter.").

*B. Insurance Shortcomings and Alternatives*

Although broadened statutory indemnification and liability limitation rights have somewhat alleviated the anxiety of the 1980s' insurance crisis, the insurance problem still has not been fully resolved. Insurance, when it is actually available, is generally costly and subject to various exclusions and coverage exceptions.<sup>158</sup> A greater amount of coverage is necessary to protect directorial conduct that is statutorily restricted from protection or limited by public policy considerations.<sup>159</sup> Specifically, certain directorial behavior remains completely unprotected because it is excluded from indemnification statutes<sup>160</sup> or subject to public policy limitations imposed by federal statutes.<sup>161</sup> Other insurance problems include a newly installed corporate board's refusal to authorize indemnification of former directors,<sup>162</sup> and creditors seizing all corporate assets upon the corporation's declaration of bankruptcy.<sup>163</sup>

In short, insurance provides D&Os with benefits that they cannot obtain through indemnification or liability limitation statutes.<sup>164</sup> In the absence of public policy limitations, insurance can be a director's or officer's only available source of relief when a corporation is unwilling or unable—legally or financially—to extend indemnification.<sup>165</sup> Consequently, an increasing number of today's corporations are exploring indemnification funding alternatives as substitutes for traditional commercial insurance coverage or as supplements to their existing insurance policies.<sup>166</sup> Corporations generally employ one or more of these alternatives in conjunction with corporate charters and bylaws<sup>167</sup> or with sep-

---

<sup>158</sup> Carlton & Brooks, *supra* note 3, at 55.

<sup>159</sup> *Id.*

<sup>160</sup> *Id.* at 59. These restrictions essentially include acts that do not fulfill the "reasonable belief" and "good faith" standards, expenses for directors adjudicated liable to the corporation and, in some statutes, judgments and amounts paid in settlement of derivative actions. KNEPPER & BAILEY, *supra* note 17, § 21.01, at 686.

<sup>161</sup> Carlton & Brooks, *supra* note 3, at 58 n.34.

<sup>162</sup> BLOCK ET AL., *supra* note 6, at 584. This possibility is more of a reality today, especially in situations involving hostile takeovers.

<sup>163</sup> *Id.*

<sup>164</sup> Groves, *supra* note 151, at 160.

<sup>165</sup> *Id.* at 160-61.

<sup>166</sup> Carlton & Brooks, *supra* note 3, at 56.

<sup>167</sup> *Id.* at 56-57. More specifically:

[C]orporate charters and bylaws typically provide for indemnification protection for directors and officers "to the fullest extent authorized by law." Moreover, these indemnification provisions often attempt to turn indemnification protection that is permissive under applicable

arate indemnification contract agreements.<sup>168</sup>

Alternative insurance methods are beneficial when viewed not simply as another form of indemnification, but as an alternative form of insurance that is not subject to the same policy restrictions that apply to indemnification by statute, charter, bylaw or contract.<sup>169</sup> Alternative methods include captive insurance companies, insurance pooling arrangements, trust funds, fronting arrangements and self-insurance.

### 1. Captive Insurance Companies

Captive insurance companies are wholly-owned subsidiaries that have been established to maintain insurance on behalf of parent and affiliated companies.<sup>170</sup> Yet, while captive insurance companies represent an alternate means of obtaining insurance, these companies may not adequately replace traditional commercial insurance. Captive insurance is generally viewed as a form of self-insurance because it is usually capitalized by the parent corporation and because there is no risk-sharing between separate entities.<sup>171</sup> Consequently, captive insurance is often treated as indemnification, and is therefore subject to the same statutory and public policy restrictions that apply to indemnification.<sup>172</sup> The corporation may also experience tax problems because insurance premiums are typically not deductible.<sup>173</sup> To diminish these pitfalls, commentators have advised corporations to maintain a clearly separate corporate status for the subsidiary and to

---

state law into indemnification protection that is mandatory under a corporation's governing documents.

*Id.* (footnotes omitted).

<sup>168</sup> *Id.* at 57. Separate indemnification agreements are said to:

[O]ffer corporate directors and officers an opportunity to insure that they have indemnification protection in the form of a direct, bargained-for agreement giving them specific contract rights, which are enforceable against the corporation if they are involved in litigation. These specific contract rights should be more reassuring to a corporate official than mere charter or bylaw indemnity rights. These rights also should provide greater protection against unilateral corporate action rescinding or denying indemnity protection, such as in connection with a change in control of management of the corporation and/or the termination of employment of the director or officer.

*Id.* at 57-58 (footnotes omitted).

<sup>169</sup> *Id.* at 58-59.

<sup>170</sup> *Id.* at 59-60.

<sup>171</sup> *Id.* at 61.

<sup>172</sup> For a discussion of these restrictions, see *infra* notes 176-79 and accompanying text.

<sup>173</sup> BLOCK ET AL., *supra* note 6, at 621.



establish a concrete risk distribution.<sup>174</sup>

## 2. Insurance Pooling Arrangements

To escape the hazards associated with the captive insurer, some corporations have explored insurance pooling arrangements (or captive groups) as an alternative to commercial D&O insurance.<sup>175</sup> Captive groups are composed of separate corporations that jointly establish an insurance company to provide insurance to all the D&Os of the corporations.<sup>176</sup> Because this alternative spreads the risk among the various corporations in the group, it avoids the public policy limitations and tax problems of the captive insurer.<sup>177</sup> The captive group option, however, is usually available only to the financially stable corporations that can afford its high costs.<sup>178</sup> Captive groups also may be difficult to maintain effectively because consensus may be hard to reach among a group's constituents.<sup>179</sup>

## 3. Fronting Arrangements

A third alternative to traditional D&O liability insurance is for a corporation to form a fronting arrangement in connection with a separate insurance company.<sup>180</sup> In a fronting arrangement, the commercial insurer would issue a typical policy to the corporation. In return, the corporation or its captive insurer would either reimburse or reinsure the carrier for some or all of

---

<sup>174</sup> *Id.* at 622. Recommendations for risk distribution include:

- (1) Maintenance of a separate corporate identity for the captive, with a legitimate business purpose and professional insurance management;
- (2) adequate capitalization of the captive in amounts reasonably necessary for reserves and expenses without the necessity of additional capital from the parent (other than periodic insurance premiums);
- (3) provisions for executive management of the captive, independent of the parent;
- (4) third-party equity ownership in the captive;
- (5) compliance with standard industry practices and use of standard policy forms, but without some of the exclusions added during the recent insurance crisis;
- (6) use of reinsurance from established reinsurers, if possible;
- (7) maintenance of an arm's length relationship between parent and captive; and
- (8) provision of insurance by the captive to unrelated third parties.

Carlton & Brooks, *supra* note 3, at 62-63 (footnote omitted).

<sup>175</sup> BLOCK ET AL., *supra* note 6, at 623.

<sup>176</sup> *Id.*

<sup>177</sup> Carlton & Brooks, *supra* note 3, at 63.

<sup>178</sup> *Id.* at 63-64.

<sup>179</sup> *Id.* at 64.

<sup>180</sup> KNEPPER & BAILEY, *supra* note 17, § 19.11, at 638.

the amount paid in excess of the premium.<sup>181</sup> The carrier would also be paid a non-refundable fee for agreeing to the fronting arrangement, and the corporation would be compensated when premiums exceeded losses.<sup>182</sup>

A fronting agreement, however, is subject to the same public policy restrictions and tax problems as is the captive insurance approach.<sup>183</sup> Indeed, some commentators argue that "instead of true insurance, a fronting arrangement is merely a mechanism by which a corporation provides indemnification to its directors and officers."<sup>184</sup>

#### 4. Trust Agreements

As another option, a corporation could create a trust fund whose trustee is a separate entity, such as a bank.<sup>185</sup> The corporation would deposit funds in trust, which would be used only to protect those of its D&Os who are entitled to be indemnified.<sup>186</sup> The trust agreement would outline the procedures and obligations of all parties.<sup>187</sup> The trust, however, cannot be classified as insurance because it does not include any risk sharing; therefore, it suffers the same pitfalls that have been discussed in connection with other alternatives.<sup>188</sup>

#### 5. Self-Insurance

A final alternative, which is frequently employed in conjunction with commercial insurance, is for a corporation to establish a self-insurance program.<sup>189</sup> Some corporations fund such a program out of the corporation's own cash-flow.<sup>190</sup> Most corporations, though, form a separate liability reserve fund that is set

---

<sup>181</sup> Carlton & Brooks, *supra* note 3, at 64.

<sup>182</sup> *Id.*

<sup>183</sup> For a discussion of these policy and tax concerns, see *supra* notes 172-74 and accompanying text.

<sup>184</sup> Carlton & Brooks, *supra* note 3, at 64.

<sup>185</sup> *Id.* at 67. Furthermore, banks can issue irrevocable letters of credit that are used to pay indemnity claims. This funding device is subject to the same limitations and problems as a trust fund. The letter of credit, however, may be preferable to the trust fund because it commits bank assets to pay indemnity claims whether or not the corporation itself is capable of advancing the money. *Id.* at 71.

<sup>186</sup> *Id.*

<sup>187</sup> *Id.*

<sup>188</sup> *Id.* at 69. For discussion of these pitfalls, see *supra* notes 172-174 and accompanying text.

<sup>189</sup> Carlton & Brooks, *supra* note 3, at 65.

<sup>190</sup> *Id.*

aside to pay only indemnity claims.<sup>191</sup>

Self-insurance has historically been viewed as a type of indemnification because the risk of loss is borne solely by the corporation.<sup>192</sup> Consequently, self-insurance programs have the same public policy limitations and tax problems applicable to the other alternative insurance devices.<sup>193</sup>

## V. CONCLUSION

The response to court decisions imperiling the assets of corporate directors and officers has been decidedly non-judicial: New legislation indemnifies D&Os and limits their liability, while corporations explore emerging alternatives to traditional D&O insurance. Significantly, non-exclusivity provisions,<sup>194</sup> charter option provisions<sup>195</sup> and alternative insurance devices<sup>196</sup> all permit the corporation to take its own decision-making culture into account when choosing a policy of indemnification.

Corporations should fully avail themselves of the new safeguards<sup>197</sup> emerging in the wake of the D&O liability and insurance crisis. When navigating today's choppy legal waters, appropriate protection can and should be provided for those at the corporate helm.

---

<sup>191</sup> *Id.*

<sup>192</sup> KNEPPER & BAILEY, *supra* note 17, § 19.11, at 640.

<sup>193</sup> *Id.* For a discussion of these limitations and problems, see *supra* notes 172-174 and accompanying text. Since 1986, a few states have amended their statutes to authorize corporations to maintain self-insurance without statutory restrictions. These states include: Arizona, ARIZ. REV. STAT. ANN. §§ 10-005(G) & (H) (1990); Colorado, COLO. REV. STAT. § 7-3-101.5(9) (1990); Louisiana, LA. REV. STAT. ANN. § 12:83(F) (West 1969 & Supp. 1993); Maryland, MD. CORPS. & ASS'NS CODE ANN. §§ 2-418(k)(2)&(3) (1993); Nevada, NEV. REV. STAT. § 78.752 (1991); New Jersey, N.J. STAT. ANN. § 14A:3-5(9) (West 1969 & Supp. 1991); New Mexico, N.M. STAT. ANN. § 53-11-4.1(J) (Michie 1983 & Supp. 1991); Ohio, OHIO REV. CODE ANN. § 1701.13(E)(7) (Anderson 1992); and Texas, TEX. CORPS. & ASS'NS CODE ANN. § 2.02-1(R) (West 1980 & Supp. 1993). BLOCK ET AL., *supra* note 6, at 620.

<sup>194</sup> For a discussion of non-exclusivity provisions, see *supra* notes 83-96 and accompanying text.

<sup>195</sup> For a discussion of charter option provisions available to a corporation to help limit or eliminate directorial liability, see *supra* notes 123-47 and accompanying text.

<sup>196</sup> For a discussion of alternative insurance devices, see *supra* notes 148-93 and accompanying text.

<sup>197</sup> See E. Norman Veasey et al., *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399, 421 (1987) (advising corporations to take advantage of "the full benefits of the . . . scheme of protection").