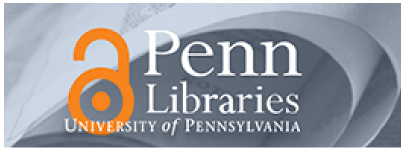

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The Capricious Cushion: The Implications of the Directors and Insurance Liability Crisis on Canadian Corporate Governance

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Note: At the time of publication, the author Ronald Daniels was affiliated with the University of Toronto. Currently, he is Provost of the University of Pennsylvania.

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The Capricious Cushion: The Implications of the Directors and Insurance Liability Crisis on Canadian Corporate Governance

Abstract

One of the clearest legacies of the growing concern expressed over the international competitiveness of Canadian and American businesses has been the urgency it has lent to a very old debate respecting the efficacy of the apparatus used to govern the business and affairs of large, public corporations. For instance, Michael Porter, one of the most articulate - if not the most prolific - of the new competitiveness scholars, has suggested that American economic performance could be improved by enhancing the performance of the traditional corporate governance apparatus. In this respect, his suggestions closely track the thrust of recent reform initiatives proposed by investors and regulators who seek to increase the performance of the board by making it more responsive, indeed responsible, to shareholder interests. Although some of the current critics of the corporate board have placed exclusive faith in the ability of market mechanisms to ensure heightened board effectiveness, most initiatives rely to some extent on strengthened legal duties and responsibilities to achieve this task. And, as measured by the growing willingness of both courts and securities regulators to impose liability on directors for failing to review diligently various corporate transactions (i.e., self-interested transactions, public financings, etc.), it is clear that the reformist calls made by these critics are slowly but surely being heeded. Paralleling the trend to increased legal liability of boards for actions that are inimical to shareholder interests has been an equally clear trend towards enhanced legal responsibility for corporate conduct deemed contrary to broader stakeholder or community interests.

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THE CAPRICIOUS CUSHION: THE IMPLICATIONS OF THE DIRECTORS' AND OFFICERS' INSURANCE LIABILITY CRISIS ON CANADIAN CORPORATE GOVERNANCE

Ronald J. Daniels and Susan M. Hutton *

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I. INTRODUCTION

One of the clearest legacies of the growing concern expressed over the international competitiveness of Canadian and American businesses has been the urgency it has lent to a very old debate respecting the efficacy of the apparatus used to govern the business and affairs of large, public corporations.[1] For instance, Michael Porter, one of the most articulate — if not the most prolific — of the new competitiveness scholars, has suggested that American economic performance could be improved by enhancing the performance of the traditional corporate governance apparatus.[2] In this respect, his suggestions closely track the thrust of recent reform initiatives proposed by investors and regulators who seek to increase the performance of the board by making it more responsive, indeed responsible, to shareholder interests.[3] Although some of the current critics of the corporate board have placed exclusive faith in the ability of market mechanisms to ensure heightened board effectiveness, most initiatives rely to some extent on strengthened legal duties and responsibilities to achieve this task. And, as measured by the growing willingness of both courts and securities regulators to impose liability on directors for failing to review diligently various corporate transactions (*i.e.*, self-interested transactions, public financings, etc.), it is clear that the reformist calls made by these critics are slowly but surely being heeded.[4] Paralleling the trend to

[1] The intellectual antecedents of the current debate can be found in A. Berle and G. Means, *The Modern Corporation and Private Property* (Harcourt, Brace & World rev. ed., 1968).

[2] M. Porter, *The Competitive Advantage of Nations* (New York, The Free Press, 1990), pp. 110-13. Mature American corporations are less capable of sustaining a commitment to certain espoused goals because of infirmities in the governance process that lead to "harvesting of competitive positions and an inadequate level of investment to sustain improvement and innovation" (*ibid.*, at p. 112).

[3] Chancellor William Allen, Delaware Court of Chancery, "Redefining the Role of Outside Directors In an Age of Global Competition", presented at Ray Garrett Jr., Corporate and Securities Law Institute, Northwestern University, Chicago (April, 1992). See, for instance, M. Lipton and J. Lorsch, "A Modest Proposal for Improved Corporate Governance" (1992) 48 Business Lawyer 59.

[4] A recent example of the expansive range of legal duties being imposed on Canadian boards is the Ontario Securities Commission's revised Policy 9.1, Disclosure, Valuation, Review and Approval Requirements and Recommendations for Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions. The Policy stipulates a set of procedures (*e.g.*, valuation requirements, special committee review and minority shareholder approvals) that must be followed by corporate boards in order to sanitize conflict of interest transactions such as insider bids, issuer bids, going private transactions and related party transactions.

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increased legal liability of boards for actions that are inimical to shareholder interests has been an equally clear trend towards enhanced legal responsibility for corporate conduct deemed contrary to broader stakeholder or community interests.[5]

Nevertheless, as must be plainly obvious, invoking the board as an instrument of public policy is not uncontroversial, and raises perplexing moral questions regarding the appropriate deference to be accorded to notions of fault and personal responsibility in policy formulation.[6] However, controversy over the appropriate scope of board responsibility extends also to the economic realm, particularly in terms of the commensurability of the costs and benefits of enhanced directorial liability. Central to the determination of this issue is the subsidiary issue of whether insurance is available to directors and officers to cover (even on a co-insurance basis) the risks of increases in expected liability. This issue is of fundamental importance given the natural disinclination of directors, both managerial and outside, to assume firm-specific risks.[7] That is, if for some reason insurance markets are not complete and, as a consequence, directors are unable to source insurance, then, following the dictates of agency theory, boards can be expected to refrain from engaging in activities which — although justified on an *ex ante* economic calculus — are deemed to be too costly because they raise the spectre of personal bankruptcy for directors. Alternatively, directors may agree to assume these risks so long as they can shift them to some outside parties, usually professional advisers. In either case, insurance

[5] See discussion in Part IV 2.(2), *infra*.

[6] See, for instance, R. Epstein, *A Theory of Strict Liability: Toward a Reformulation of Tort Law* (San Francisco, Cato Institute, 1980). For a discussion of the limits of Epstein's theory, see J. Coleman, "Moral Theories of Torts: Their Scope and Limits: Part 1", and chapter 2 in M. Bayles and B. Chapman, *Justice, Rights and Tort Law* (Dordrecht, Holland, D. Reidel Publishing Co., 1983).

[7] M. Jensen and W. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976), 3 J. Financial Economics 305 ("managers of large, publicly held corporations seem to behave in a risk averse way to the detriment of the equity holders" (*ibid.*, at p. 353)). See also B. Holmstrom, "Moral Hazard and Observability" (1979), 10 Bell J. Economics 74; Y. Amihud and B. Lev, "Risk Reduction as a Managerial Motive for Conglomerate Mergers" (1981), 12 Bell J. Economics 605 ("mergers . . . viewed as a managerial perquisite intended to decrease the risk associated with managerial human capital. Accordingly, the consequences of such mergers may be regarded as an agency cost" (*ibid.*, at p. 606)); and A. Marcus, "Risk Sharing and the Theory of the Firm" (1982), 13 Bell J. Economics 369 ("constrained managers overspend on variance reducing activities, thereby imposing a welfare loss on the other owners, and by this definition, exhibit excessive risk aversion" (*ibid.*, at p. 375)).

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availability impacts powerfully on corporate performance: in the risk-avoidance case, by reducing the riskiness (thus profitability) of the firm's investment set and, in the risk-shifting case, by reducing the stake of directors in corporate decision making through artful delegation.

In this article we explore the dynamics of the Canadian directors' and officers' insurance market by focusing on the crisis that afflicted that market in the mid-1980s (the "D&O crisis"). The crisis involved a dramatic and unanticipated contraction in the availability of D&O insurance. By understanding the roots of that crisis, one can make some informed predictions respecting the availability and pricing of directors' and officers' insurance in Canada. Our conclusions are somewhat troubling for enthusiasts of enhanced legal liabilities for directors. Close examination of the D&O crisis reveals that the market is vulnerable to cyclical industry-wide fluctuations in capacity and pricing that greatly undermine the ability of directors to insure against the future costs of legal liability. These problems are exacerbated by market conventions which limit the effective duration of coverage (short policy and post-policy discovery periods).

Although a number of different independent theories have been proffered to explain the occurrence of the mid-1980s crisis in liability insurance, following Romano's study of the American D&O crisis, we prefer a multi-factorial explanation that draws on an amalgam of endogenous (industry) and exogenous (legal and market) components.[8] This approach is congenial to the determination of the extent to which linkages between the American and Canadian economies affected the Canadian crisis. While we find evidence that American trends are being used to inform risk prediction in the Canadian D&O market, we argue that this is not evidence of undue market power possessed by American insurers (essentially a story positing cross subsidies from Canadian to American consumers), but is simply the result of statistical imperatives which limit the predictive significance of the Canadian loss experience.

Our argument is developed in several stages. In Part II, we

[8] R. Romano, "Directors' and Officers' Liability Insurance: What Went Wrong?" in W. Olson, ed., *New Directions in Liability Law* (New York, The Academy of Political Science, 1988). See also Romano, "What Went Wrong With Directors' and Officers' Liability Insurance?" (1989), 14 Delaware J. Corp. L. 1; and "Corporate Governance in the Aftermath of the Insurance Crisis" (1990), 39 Emory L. J. 1155.

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outline the nature of D&O liability insurance — the risks it is meant to insure and the operations of the different levels of the insurance market. Part III establishes the features which characterized the 1985-86 crisis in the D&O liability market in Canada. Part IV examines the causes posited to explain the United States D&O crisis, but in the context of their applicability to the Canadian market. Part V uses the conclusions drawn as to the causes of the D&O crisis to evaluate recent regulatory initiatives of the federal Office of the Superintendent of Financial Institutions and to consider the implications of incomplete insurance markets on the quality of Canadian corporate governance.

II. THE RATIONALE FOR AND STRUCTURE OF D&O LIABILITY INSURANCE

By and large, most liberal scholars are willing to support government intervention designed to internalize the non-negotiated external costs of a given activity pursuant to Kaldor-Hicks notions of efficiency.[9] Typically, this intervention takes the form of either property rights or liability rules that attempt to reconstruct the allocation of resources that fully informed parties would conclude through their transaction-costs-free bargaining.[10] However, when the party generating external costs is a corporation, special problems are posed for courts and legislatures in determining the extent to which individual parties within the corporation should be held legally responsible for this activity, and the way in which this responsibility should interact with enterprise liability.[11]

[9] See J. Coleman, *Markets, Morals and the Law* (Cambridge, Mass., Cambridge University Press, 1988) and M. Trebilcock, *The Limits of Freedom of Contract* (Cambridge, Mass., Harv. University Press, 1993), chapters 1 and 3.

[10] G. Calabresi and A. D. Melamed, "Property Rules, Liability Rules, and Inalienability: One View of the Cathedral" (1972), 85 Harv. L.Rev. 1089.

[11] An extremely thoughtful exposition of the interaction between gatekeeper and enterprise liability can be found in R. Kraakman, "Corporate Liability Strategies and the Costs of Legal Controls" (1984), 93 Yale L.J. 857; and "Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy" (1986), 2 J. Law, Economics and Org. 53. See also J. Coffee, " 'No Soul to Damn; No Body to Kick': An Unscandalized Inquiry Into the Problem of Corporate Punishment" (1981), 79 Mich. L.Rev. 386; and P. Halpern, M. Trebilcock and S. Turnbull, "An Economic Analysis of Limited Liability in Corporation Law" (1980), 30 U.T.L.J. 117. For a recent discussion in the Canadian context see: R.J. Daniels, "Must Boards go Overboard: An Economic Analysis of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance", draft article dated June 20, 1993, on file with the authors.

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The issue of the appropriate scope for enterprise and personal liability is heightened in the case of directors[12] who may not have been directly responsible for ordering the corporation to engage in certain socially undesirable types of activity, but are nevertheless held legally responsible for the consequences of this activity by virtue of their corporate status. This liability is commonly referred to as "gatekeeper liability", and is found in the various common law and statutory duties that officers and directors owe to shareholders, employees, creditors, suppliers and communities. The rationale for gatekeeper liability is based on the belief that the existing array of traditional sanctions and rewards pinpointing liability on the enterprise and on the actual wrongdoer within the enterprise are incapable of reducing the level of corporate wrongdoing to socially optimal levels. It is therefore necessary to enlist the services of third-party monitors, albeit under the threat of personal liability, to score further reductions in corporate wrongdoing.[13]

Like other forms of civil liability, gatekeeper liability for corporate delicts will affect both the care and activity levels of targeted individuals. This is both the intended and obvious effect of deterrence-based liability rules. However, there is a danger that the rules imposing this liability will be given overly zealous interpretation by the courts, resulting in excessive levels of deterrence. This is of particular concern in the corporate case given managerial risk aversion[14] and the prospect that the application of gatekeeper liability will be governed by compensatory rather than deterrence objectives.[15]

To temper excessive care and activity level reactions to potential gatekeeper liability, modern corporate law statutes permit a corporation to indemnify a director for any expense reasonably incurred in defending, settling or satisfying a judgment for any action, provided that the director's fiduciary duty to act "honestly and in good faith and with a view to the best interests of the corporation" has been fulfilled.[16] For indemnity with respect

[12] For convenience, the term "directors" will be used throughout this paper in place of the more cumbersome, but correct, term "directors and officers" when referring to the objects of the liability which D&O insurance covers.

[13] See Kraakman (1986), *supra*, footnote 11, at pp. 55-7.

[14] See *supra*, footnote 7.

[15] For a discussion of the tension between deterrence and compensation objectives in the tort context, see M. Trebilcock, "The Social Insurance-Deterrence Dilemma of Modern North American Tort Law: A Canadian Perspective on the Liability Insurance Crisis" (1987), 24 San Diego L.Rev. 929.

[16] Canada Business Corporations Act ("CBCA"), R.S.C. 1985, c. C-44, s. 124(1)(a). Ontario Business Corporations Act ("OBCA"), R.S.O. 1990, c. B. 16, s. 136(1)(a).

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to criminal or administrative actions enforceable by fines, there must also have been reasonable grounds for believing that the conduct was lawful.[17] This option to indemnify becomes an obligation if the director is substantially successful on the merits of the defence to any action, again so long as he or she acted honestly and in good faith with a view to the best interests of the corporation; and had reasonable grounds for believing that his or her conduct was lawful.[18] The quality of corporate governance is upheld by this obligation since winning on a technicality, such as the expiration of a limitation period barring the action in question, does not give rise to a mandatory duty for the corporation to indemnify the successful director.

Modern corporations statutes also permit a corporation to purchase insurance for the benefit of a director against any liability which may be incurred in his or her capacity as a director, provided always that such liability does not result from a failure to act honestly and in good faith with a view to the best interests of the corporation.[19] Corporations can, therefore, purchase insurance for directors with coverage for a wider range of behaviour than that for which direct corporate indemnification is allowed. Actions which are insurable but not indemnifiable include those for which objectively reasonable grounds did not exist, but in respect of which the director none the less acted honestly and in good faith; an example would be a successful shareholders' derivative action for negligence where the court refuses to permit indemnification.[20]

Due to the different coverages of indemnification and D&O insurance, corporations typically purchase two types of D&O liability insurance coverage: Corporate Reimbursement Coverage, to cover losses to the corporation arising from the corporation's indemnification of a director, and Personal Coverage to cover the liability of a director for which he or she is not indemnified by the corporation and would otherwise be personally responsible.[21] In addition to coverage for legal liabil-

[17] CBCA, s. 124(1)(b); OBCA, s. 136(1)(b).
[18] CBCA, s. 124(3); OBCA, s. 136(3).
[19] CBCA, s. 124(4); OBCA, s. 136(4).
[20] When the corporation itself is the plaintiff, indemnification is subject to the approval of the court: CBCA, s. 124(2); OBCA, s. 136(2).
[21] Although both Corporate and Personal coverage are normally purchased at once, they are often written as separate policies.

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ities not permitted at law to be covered through corporate indemnification, Personal Coverage assures directors that they will not be forced to bear costs for which the corporation may lawfully indemnify them, but owing to financial hardship (*e.g.*, insolvency) cannot. Such coverage will also protect the officer and director against the failure of the corporation to remit withheld taxes to Revenue Canada[22] or to pay employee wages that are due.[23]

The supply side of the D&O insurance market is two-tiered, with "primary" insurers writing the policies and then reselling the coverage in excess of a certain designated loss liability (the so-called "excess" layer) to what are known as "reinsurers". The reinsurers are liable for a particular claim only after the original insurer has paid a designated amount — this retained amount is known as the "primary" layer. The reinsurers receive a portion of the premium commensurate to their portion of the risk, but also pay what is known as a "ceding" commission to the insurer that brings them the business. The capacity of the reinsurance market to underwrite risks has a profound effect upon the capacity of the primary insurers, particularly for such large and specialized risks as D&O policies, since it is through reinsurance that insurers themselves spread their risks and limit their potential liability.

III. CRISIS IN THE D&O INSURANCE MARKET

The market for D&O insurance began to develop in North America in the 1930s with the passage of securities legislation in the United States which provided for personal liability of directors in certain circumstances. D&O liability insurance was introduced to Canada in the early 1960s, but it was not until the mid-1970s that D&O coverage became widespread. At that time, an expansion in the supply capacity of the international reinsurance market and a concomitant reduction in the price of reinsurance led to an influx of participants to the D&O field in both Canada and the United States. At the same time, more stringent enforcement of the securities laws and a greater propensity for litigation, particularly in the United States, saw more companies buying D&O liability insurance in order to attract and retain high quality directors and senior corporate officers.

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[22] Canadian Income Tax Act ("ITA"), R.S.C. 1952, c. 148, as amended, s. 227.1.
[23] CBCA, s. 119(1); OBCA, s. 131(1).

The latter half of the 1970s and the early 1980s saw a gradual increase in the amount of effective insurance coverage as measured by a reduction in premiums and deductibles for D&O coverage in both countries, as well as an increase in the magnitude and scope of insurance policies.[24] Although Canadian corporations have been historically less likely than their U.S. counterparts to purchase D&O insurance,[25] and although both policy limits and premiums have historically been much smaller than those prevailing south of the border, the same pattern of gradual expansion of product in the insurance industry prevailed.[26]

The mid-1980s witnessed a sudden change in the markets for general liability insurance and for D&O insurance in Canada and the United States, referred to colloquially as the Insurance Crisis. The Insurance Crisis was denoted by increased premiums, lower coverage limits, increased exclusion of some previously insurable risks, a movement toward claims-based from occurrence-based policies, and higher industry profits.[27] The Tort Policy Working Group of the U.S. Department of Justice reported that municipalities faced a doubling or tripling of premiums, often accompanied by lower policy limits and higher deductibles.[28] Forty percent of U.S. daycare centres' insurance policies were simply cancelled, as insurers refused to insure them at any price. Sudden and accidental pollution coverage was excluded from all general liability insurance policies. Similar difficulties in obtaining

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[24] *The Wyatt 1987 Directors' and Officers' and Fiduciary Liability Survey* (the "1987 Wyatt Survey"), the Wyatt Co. (Chicago, 1987).

[25] In 1978, 93% of the companies listed on the New York Stock Exchange had coverage, while only 43% of the companies listed on the Toronto Stock Exchange had purchased D&O insurance. By 1987, 96.8% of the NYSE companies surveyed had purchased D&O coverage, and 87.7% of the TSE respondents were covered. In both countries, companies with assets of $100 million or more, hospitals and educational institutions were most likely to have D&O coverage (1987 Wyatt Survey, *supra*, footnote 24, at p. 50). Since a majority of claims under D&O policies are brought by shareholders (65% of claims in Canada in 1989 and 50% in the U.S.: *1989 Wyatt Canadian Directors' and Officers' Liability Survey* (the "1989 Wyatt Canadian Survey"), the Wyatt Co. (Toronto, 1989)), and public corporations tend to be larger than private corporations, the correlation between asset size and D&O coverage is not surprising.

[26] For a detailed comparison of the claims and premium histories of the Canadian and U.S. D&O markets, see the 1987 Wyatt Survey, *supra*, footnote 24.

[27] Ralph A. Winter, "The Liability Crisis and the Dynamics of Competitive Insurance Markets" (1988), 5 Yale J. on Regulation 455.

[28] U.S. Department of Justice, *Report of the Tort Policy Working Group on the Causes, Extent and Policy Implications of the Current Crisis in Insurance Availability and Affordability* (February, 1986), chapter 1, as cited in Trebilcock, *supra*, footnote 15, at p. 933.

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affordable coverage were reported by businesses in almost every conceivable activity — from publishers and engineers, to dentists and toy manufacturers.

As Trebilcock notes, there was evidence of a similar but more subdued crisis in liability insurance in Canada.[29] The Ontario Task Force on Insurance (the Slater Task Force) reported that nearly half of the members of the Canadian Manufacturers' Association experienced a doubling of liability insurance premiums and a reduction in coverage in 1986; some Canadian manufacturers who exported to the United States were unable to renew their coverage at all.[30] In 1985, commercial liability insurance premiums increased by 15% in Canada, as compared to 72% in the United States.[31] *Per capita* liability insurance premiums (excluding auto insurance premiums) in Canada in 1985 were $16, as compared to $60 in the U.S.[32] These changes were reflected within a year by an increase in the after-tax return on equity for property and casualty insurers in Canada from 6.95% (2.94% in real terms) in 1985 to 15.77% (11.76% in real terms) in 1986, and 15.32% (11.23% in real terms) in 1987.[33]

Thus, D&O liability insurance was but one of various liability product lines to experience a severe supply squeeze in North America beginning in 1985. Once again, although the Canadian market was starting from a position of lower premiums, it exhibited the same pattern of skyrocketing premiums, increased deductibles, lower limits, increased exclusions, stricter claims policies, and increased profits as did the U.S. market. As reported in the 1987 Wyatt Survey,[34] for instance, D&O policy limits in the U.S. fell markedly from 1984 to 1987, but still remained slightly higher than their 1982 level. In Canada, the average policy limit also fell and was, in fact, significantly lower in 1987 than in 1982. The highest policy limit reported in the Wyatt Survey in 1987 for U.S. respondents was 35% lower than in 1984, while the highest Canadian limit had been reduced by 16%. Policy limits for

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[29] *Ibid.*, at p. 936.

[30] Ministry of Financial Institutions, *Ontario Task Force on Insurance* (1986), pp. 31-5, as cited in Trebilcock, *ibid.*, at p. 935.

[31] *Ibid.*

[32] *Ibid.*

[33] *The Belton Report on Property and Casualty Insurance in Canada* (Tillinghast, Toronto, January, 1991) Vol. 2, No. 3, p. 4.

[34] *Supra*, footnote 24, at p. 57.

coverage of the smallest companies, those with assets of less than $25 million, fell by 18.3% in the United States and by 66.0% in Canada between 1984 and 1987. Policy limits for the largest companies, those with assets of over $2 billion, fell by 14.9% in the U.S. and by 17.8% in Canada. The biggest squeeze on coverage seems to have taken place during the last quarter of 1985 and the first quarter of 1986, when 67% of renewals were for lower limits and the average reduction was 50%.

Accompanying the lower limits was a reduction in the range of risks covered by the D&O insurance policies. As Table 1 shows, there was an increase in the prevalence of exclusions of every kind between 1984 and 1987 as well as the appearance of many new policy exclusions. Some of the new exclusions appear to be for the very situations which created the risk of liability in the first place. As the 1987 Wyatt Survey points out, "little reason exists for purchase of the insurance if all identifiable exposures are excluded.[35] To the extent to which the excluded risk is out of the control of the corporation or its directors, the exclusion represents a partial, if somewhat hidden, withdrawal of insurance. An example of such a withdrawal is the exclusion for tender offers and rejections, which was unknown in 1984 but was contained in 16% of U.S. policies and 6% of Canadian policies in the 1987 Wyatt Survey.[36]

[35] *Ibid.*, at p. 68.

[36] An illustrative comment is contained in the 1987 Wyatt Survey, *ibid.*, at p. 68: "To draw an analogy, the exclusion of arson in a fire insurance policy would make sense, but it would not make much sense to exclude all fires, including those originating outside of the insured premises. Not unless the insurer just wants to avoid paying any claims."

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Table 1[37]

Prevalence of certain exclusions of liability in D&O policies in 1984 and 1987

Exclusion	*1984*		*1987*	
	Canada	*U.S.*	*Canada*	*U.S.*
pending and prior litigation	44%	34%	71%	70%
pollution and environmental damage	59%	47%	91%	78%
mergers and acquisitions	—	—	11%	14%
tender offers and rejections	—	—	6%	16%
going private	—	—	3%	2%
public offerings	—	—	8%	4%
securities violations (excl. "short swing")	—	—	22%	26%
securities transactions	—	—	23%	19%
failure to maintain insurance	16%	14%	55%	49%
joint ventures	—	—	11%	12%
general or limited partnerships	—	—	10%	12%
illegal payments or commissions	31%	21%	52%	51%
actions by regulatory agencies	—	—	17%	18%
insured v. insured	—	—	37%	28%
of which = claims by any insured	—	—	33%	23%
= claims by corporation	—	—	1%	2%
= claims by corporation excluding derivative actions	—	—	2%	3%

Accompanying the decrease in the range of risks covered was a move to decrease the period of time within which those risks would be covered. Unlike most liability insurance, which covers risks realized within the policy period regardless of when they are actually reported ("occurrence-based"), D&O insurance has always been provided on a "claims made" basis. That is, the insurer covers insurable risks which are claimed within the policy period, regardless of when the events giving rise to the claim actually occurred.[38] The cancellation of such a policy can lead to a

[37] Data drawn from the 1987 Wyatt Survey, *ibid.*, at pp. 68-9 and 73.

[38] Claims-made policies are used for risks which the industry calls "long-tailed" risks, that is, risks involving a long period of time between the occurrence of the insured event and the claim made. Where this delay leads to uncertainty as to the probable size and number of claims, then occurrence policies become difficult to price, and insurers turn to claims-made policies as a way of reducing the uncertainty associated with the size and number of the claims. Essentially, the long tail of the probability distribution of the risk realization

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gap in coverage for the insured even if a replacement policy is purchased elsewhere, because D&O policies, even though claims-based, typically exclude coverage for events occurring prior to the first policy period with a particular insurer.

To mitigate against this possible gap in coverage, most D&O policies allow the insured the option of purchasing an "extended discovery period" in the event that the insurer cancels or refuses to renew the policy. An insured is then covered for incidents which arise during the policy period, but which are reported after the end of the insurance policy and before the end of the extended discovery period. In both Canada and the United States, extended discovery periods of 12 months were the norm in 1984, while by 1987 discovery periods of 90 days or less were common.[39] According to the Wyatt Co., this represented "a considerable restriction of what is otherwise a very valuable policy right".[40]

In order to attenuate moral hazard problems by insureds, insurance policies of all kinds require that the insured pay a certain amount of the insurable loss itself.[41] D&O policies are no exception, and most policies in the early 1980s required that insureds pay a set amount of any claim (the deductible) and also that insureds pay a percentage of any claim above the deductible amount (the retention).

After years of intense insurer competition in the soft market of the early 1980s, the 5% retention had all but disappeared from Canadian policies by 1984, as it had from Personal Coverage policies in the U.S.[42] This disappearance of the retention continued, in fact, right through the crisis in both countries — likely due to the demand by D&O insurance purchasers that their insurance give full coverage for those risks which it still did cover.

Deductibles, which had also been declining during the early

is chopped off at the end of the policy period. (See the discussion at pp. 182-4 in Anthony J. Falkowski, "Changes in State Regulation of Directors' and Officers' Insurance" in Alan A. Harley, Chairman, *Directors' and Officers' Liability Insurance 1989* (Practising Law Institute), p. 179.

39 1987 Wyatt Survey, *supra*, footnote 24, at p. 71, Table 33.

40 *Ibid.*, at p. 67.

41 This is merely the familiar problem of moral hazard — *i.e.*, the fact that insurance coverage may increase the probability and magnitude of a loss because protected insureds have less of an incentive to take due care in averting the loss. For a basic introduction to the concept of moral hazard (with some applications), see A.M. Polinsky, *An Introduction to Law and Economics* (Boston, Little Brown and Co., 1983), chapter 7.

42 Fifteen percent of U.S. Corporate Reimbursement policies still had a retention in 1984. (Data found in 1987 Wyatt Survey, *supra*, footnote 24, at pp. 87-8, Tables 44 and 45.)

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1980s, encountered a marked increase during the crisis. In Canada, the average Personal Coverage deductible increased from C$4,812 to C$6,456 (34%) between 1984 and 1987, while the Corporate Reimbursement deductible increased from C$42,052 to C$406,833 (867%) during the same period. In the United States, the increases were even larger, with the average deductible for Personal Coverage rising from US$4,989 to US$8,047 (61%), and the average Corporate Reimbursement deductible rising from US$46,511 to US$649,947 (1297%).[43]

Probably the most dramatic symptom of the North American D&O insurance crisis was the sudden and dizzying increase in premiums; when coverage was available at all, it was available at several times its previous cost. Due to the influence on premiums of a host of factors, such as asset size, industry, and financial history on premiums, it is not particularly helpful to compare average premium costs per million dollars of coverage for all survey participants from one year to the next. As a rough indication of the magnitude of premium increases being imposed by the primary insurers, however, the following table provides the average premiums and percentage increases for selected groups of companies with varying asset sizes and policy limits in the United States and Canada.[44]

[43] 1987 Wyatt Survey, *ibid.*, at p. 76 Exhibit 21. The fact that personal deductibles rose less than corporate deductibles is understandable in light of the smaller resources of the individual directors as compared to corporations. Corporations likely agreed to absorb much larger deductibles in an effort to curb skyrocketing premiums by effectively self-insuring for part of the risk. There would have been much stiffer resistance to increased deductibles for personal coverage, however, and corporations may have faced increased difficulty in finding qualified directors had they agreed to trade deductibles for premiums with respect to Personal Coverage.

[44] Statistics derived from the 1987 Wyatt Survey, *supra*, footnote 24, at pp. 96-9, Tables 48 and 49.

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Table 2

Average Annual Premium Costs by Size and Primary Policy Limits: 1984 and 1987

Class of Company	*1984*	*1987*	*Increase*
Canada (C$)			
assets: $25 to $100 million:			
— $5 million policy limit	$ 4,713	$ 31,516	569%
assets: $100 to $400 million:			
— $5 million policy limit	$ 7,209	$ 29,150	304%
— $10 million policy limit	$ 7,107	$ 80,915	1039%
assets: $400 to $1000 million:			
— $10 million policy limit	$18,054	$ 93,575	418%
assets: over $1000 million:			
— $5 million policy limit	$19,308	$ 60,141	211%
— $10 million policy limit	$19,697	$313,361	1491%
— $20 million policy limit	$27,661	$271,635	882%
United States (US$)			
assets: $25 to $50 million:			
— $5 million policy limit	$ 7,276	$ 30,530	320%
assets: $50 to $75 million:			
— $5 million policy limit	$ 5,802	$ 31,301	439%
assets: $75 to $100 million:			
— $10 million policy limit	$ 7,975	$ 43,152	441%
assets: $100 to $150 million:			
— $5 million policy limit	$ 6,004	$ 54,263	804%
— $10 million policy limit	$12,398	$121,154	877%
assets: $250 to $400 million:			
— $10 million policy limit	$11,050	$ 83,391	655%
— $20 million policy limit	$17,240	$163,249	853%
assets: $600 to $1000 million:			
— $5 million policy limit	$14,653	$128,972	780%
— $10 million policy limit	$18,432	$364,574	1878%
— $25 million policy limit	$23,040	$380,109	1549%
assets: $1500 to $2000 million:			
— $10 million policy limit	$13,799	$229,337	1562%
— $15 million policy limit	$15,091	$328,413	2076%

The figures in Table 2 give an indication of the enormous increase in the cost of D&O insurance faced by North American corporations in 1985 and 1986, particularly those with larger asset bases. The straight premium cost alone does not, however, take into account the decrease in the amount of insurance that was actually being supplied due to the increased deductibles and exclu-

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sions and the decreased policy limits and discovery periods mentioned above. In this light, the Wyatt Premium Index was constructed to account for the differential impact of these factors, as well as for asset size.

Taking 1974 as the base year of 100, the Wyatt Premium Index stood at 71.2 in the United States and 58.6 in Canada in 1982. By 1984, the Index had fallen further, to 54.3 in the U.S. and 52.4 in Canada, as insurers pared premiums to the bone. By 1987, however, the U.S. Index stood at 682.4 and the Canadian Index stood at 361.1. It can be seen, therefore, that the combined effect of the increased prices and the more limited insurance available for that price was to make D&O insurance roughly 13 times more expensive for U.S. companies in 1987 than it had been in 1984, as compared to roughly 7 times more expensive for Canadian companies.

The existence of a "crisis" in D&O liability insurance in Canada in the mid-1980s is therefore clearly indicated. The symptoms of the crisis were similar to those of the crisis in the U.S. market, but less severe in nature. Furthermore, the crisis in both markets must be seen in the context of the concurrent crisis in North American liability insurance generally, which again was less severe in Canada than in the United States.

There are indications that the crisis was already easing by 1988, and certainly by 1989, in both Canada and the United States. The 1988 U.S. Wyatt Survey[45] and the 1989 Canadian Wyatt Survey[46] show that the highest reported policy limits had rebounded somewhat, to US$220 million and C$110 million, which were slightly above their 1984 levels. Average policy limits in both countries had stopped their decline, with a 1988 average of $23.6 million in the U.S. and $8.9 million in Canada. Personal Coverage deductibles in Canada increased to C$15,834 from C$6,456 in 1989, while in the U.S. the most common personal deductible dropped to US$5,000. Conversely, the average Canadian Corporate Reimbursement deductible decreased to C$300,000 by 1989, while its U.S counterpart continued to rise, albeit at a slower rate. The Wyatt Premium Index for the U.S. increased only 64 points to 746 in 1988. This weighted index was not reported for

[45] *1988 Wyatt Directors' and Officers' Liability Survey* (the "1988 Wyatt Survey"), the Wyatt Co. (Chicago, 1988).

[46] 1989 Wyatt Canadian Survey, *supra*, footnote 25.

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Canada in 1989, but the Wyatt Co. does report that: "Consistent with a softer insurance market, a majority of participants indicated that as premiums decreased, 1989 policy limits either remained stable or were increased and exclusions were either decreased or remained stable."[47]

Thus, although the D&O market in both countries has not returned to anything like the prices and product available prior to 1984, the situation appears to have stabilized and some new capacity is easing back into the market. Even so, policymakers in the United States have been quick to introduce regulatory changes intended to prevent the return of the severe supply crisis just outlined.[48] These changes have taken the form both of authorizing corporate articles to limit the personal liability of directors for monetary damages, and of statutes prescribing a standard of conduct for which there is no liability.[49] These policy responses may not be appropriate for Canada, however, if the causes of the crisis here were different from those in the U.S.

We now turn, therefore, to examine the principal hypotheses as to the cause of the U.S. crisis in order to evaluate their applicability in the Canadian context.

IV. EXPLANATIONS OF THE CANADIAN D&O INSURANCE CRISIS

Explanations of the crisis in the U.S. market for insurance, extended to explain the D&O crisis, have generally focused on factors endogenous and exogenous to the insurance industry.[50] The former focus on the structure of the insurance industry, while the latter include changes in the nature and intensity of economic

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[47] 1989 Canadian Wyatt Survey, *ibid.*, at p. 15. The *Canadian Directors' and Officers' Liability Survey 1991* (the "1991 Wyatt Canadian Survey"), the Wyatt Co. (Toronto, 1991), confirmed the easing of D&O availability during the 1989-91 period. Average policy limits increased moderately from a low of C$8.9 million in 1989 to C$13.1 million in 1991. Dramatic decreases in personal deductibles were reported, with the average personal deductible falling from C$15,834 in 1989 to C$3,844 in 1991. The average corporate deductible remained fairly constant; however, this average belies substantial increases for firms with assets less than C$1 billion and substantial decreases for larger firms. The average premium per million dollars of coverage fell from C$9,071 in 1989 to C$7,243 in 1991. See the 1991 Wyatt Canadian Survey, at pp. 49-52.

[48] See Falkowski, *supra*, footnote 38, at p. 179.

[49] See Romano (1990), *supra*, footnote 8, at pp. 1160-5.

[50] "We do not have a satisfactory understanding of the cause of the D&O insurance crisis. But one does not have to dig very deep to conclude that any satisfactory explanation will be multicausal." See Romano (1989), *supra*, footnote 8, at p. 32. See also Romano (1988), *supra*, footnote 8.

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activity occurring during the mid-1980s as well as legal developments (both in terms of the enactment and interpretation of laws). These explanations will be examined in the context of the Canadian market for D&O insurance to determine their potential role in the crisis of 1985-86.

1. Endogenous Explanations Based on the Structure of the D&O Market

(1) Industry Collusion

On March 22, 1988, the Attorneys-General of eight U.S. states filed federal antitrust suits against property-casualty insurers and others, alleging the existence of a conspiracy to boycott sales of liability insurance in the United States. Essentially, the claim advanced is that by forming an industry cartel, insurers were able to raise premiums and exclude less profitable lines of coverage. No such formal accusations have been made in Canada. Still, it is worthwhile to examine the structure of the Canadian D&O insurance industry to see if such an explanation is plausible.

As Clarke has noted in the context of analyzing the U.S. insurance market, collusive agreements can be expected to be more effective the fewer the firms in the market, the easier it is to police cheating members, the larger the market share of a few large firms, the greater the barriers to market entry, and the fewer the perfect substitutes that exist for the good.[51] One statistic commonly used to test the degree of concentration in an industry is the Herfindahl-Hirschman Index (the "HHI"). The HHI index is equal to the sum of the squares of the market share of each firm in the market. Thus, the fewer firms there are in the market, and the more unequal their market shares, the higher the index, which ranges between 0 (infinite competition) and 10,000 (monopoly). Romano found that the HHI in the United States was 900 for reinsurers and 1600 for primary insurers based on the number of accounts written, and 1100 for reinsurers and 2500 for primary insurers based on premium volumes. According to the U.S. Department of Justice's merger guidelines, these numbers indicate only moderate concentration in the D&O insurance market in the U.S.

[51] Richard Clarke, Frederick Warren-Boulton, David Smith and Marilyn Simon, "Sources of the Crisis in Liability Insurance: An Economic Analysis" (1988), 5 Yale J. on Reg. 367 at p. 380.

On the other hand, Romano also found that the four- and eight-firm concentration ratios indicated the existence of a few leading firms with roughly equal shares of the market, which could be consistent with a market collusion hypothesis. However, the 1987 Wyatt Survey reported that many firms had exited from the D&O market over the 1984-87 period, and that the market shares of even the leading firms had changed. Significantly, the entry into the market of new players, notably the policyholder-formed companies which sprang up to alleviate the supply shortage in the United States, attests to a highly competitive market in that country.

The Canadian D&O market has fewer participants than the U.S. market,[52] which might make the collusion hypothesis more plausible in this context. However, the 1987 Wyatt Survey also noted significant changes in the market shares of the Canadian industry leaders, as well as the withdrawal or decline of some of the smaller firms. The Wyatt Co. concluded that "a large number of accounts previously handled by the Continental Group, Gestas, Home, Crum & Forster, and others have been picked up by Chubb or the Encon Pool, rather than by [former market leader] AIG".[53]

It is true that new market entrants in the form of policyholder-formed D&O insurers or reinsurers were not as common in Canada as in the U.S. during the crisis. In addition, only one reinsurer (ACE) was operating at the retail level in 1987, with 17.9% of the premium volume, as compared to 11 such insurers in the United States, with 49.8% of the premium volume. This may be due to the higher entry costs relative to the size of the market, and indicates that industry collusion is possible. However, evidence of significant movements in Canadian market shares during the crisis serves to refute this theory. Indeed, with respect to the Canadian non-life insurance industry in general, the Office of the Superintendent of Financial Institutions Canada draws the conclusion that "the property and casualty insurance industry is extremely cyclical and volatile, mostly because prices are set in a marketplace made up of a large number of competitors."[54]

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[52] The 1987 Wyatt Survey lists only nine primary carriers of D&O insurance with a premium market share of 1% or more in Canada in 1987, as compared to 12 in the United States (1987 Wyatt Survey, *supra*, footnote 24, at pp. 111 and 115, Tables 55 and 59).

[53] 1987 Wyatt Survey, *ibid.*, at p. 110.

[54] *Annual Report 1989*, Office of the Superintendent of Financial Institutions Canada (October, 1989), p. 15.

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The collusion theory must also be rejected on theoretical grounds since, as Winter points out, collusion cannot account for the complete withdrawal of some firms from the D&O market: "Firms do not, according to any known theory, establish a cartel to increase profits by completely withdrawing from a subset of segmented markets."[55] In this vein, the 1987 Wyatt Survey reports that the Canadian market saw the decline of the Continental Insurance Group (Harbor and Buffalo Re) as a significant factor in the D&O market, and the complete withdrawal of Gestas, which had had a market share of 12.8% in 1984.

Based on the evidence, therefore, the crisis in Canadian D&O insurance cannot be said to have been the result of collusion by the insurers in an attempt to increase their profits by restricting supply. A more plausible explanation is, in fact, centred on the highly competitive nature of the insurance industry.

(2) Competitive Cycles in the Insurance Industry

The cyclical nature of the insurance industry has long been the subject of observation and commentary, and economists have developed an explanation of the "boom-bust" cycle of premiums and availability that is consistent with the observed competition in the industry. Winter[56] refines this economic theory to explain both the confinement of the crisis to the liability lines of insurance and the suddenness with which the crisis developed. Briefly, he argues that the crisis in liability insurance was brought about by the operation of the insurance cycle in reaction to supply shocks emanating from the United States tort system and the global reinsurance system. These shocks and the reasons for the vulnerability of the Canadian industry to foreign shocks are explained in Part IV, 1(3) below. First, however, Winter's theory of competitive insurance cycles should be investigated more closely.

According to neoclassical economic theory, the law of large numbers means that premiums for any type of insurance should equal the expected value of future claims (probability times magnitude of the claim) under the policy, plus loading costs.[57] So

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[55] Winter (1988), *supra*, footnote 27, at p. 480. See Trebilcock, *supra*, footnote 15, at pp. 936-7.

[56] Winter, *ibid.*; see also Ralph A. Winter, "The Liability Insurance Market", presented at the Conference on the Law and Economics of Liability, Stanford Law School, (May, 1990), at pp. 8-13.

[57] G. Priest, "The Current Insurance Crisis and Modern Tort Law" (1987), 96 Yale L.J. 1521 at p. 1540.

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long as risks are independent, that is, uncorrelated, insurers are risk-neutral because they can diversify away these risks by pooling. If capital markets are efficient then even dependent insurance risks can be hedged by insurer shareholders against the capital markets and efficiently insured by the insurance market. Thus, only risks which are systematically related to macroeconomic factors or the return on the aggregate stock market portfolio are truly non-diversifiable and therefore uninsurable.[58] The traditional insurance market model with perfect capital markets cannot, therefore, explain the sudden withdrawal of capacity from liability lines apparently unconnected with general economic events.

It is tempting to blame the general insurance crisis on the expansion of tortious liability and the escalation of damage awards by the courts in recent years. To invoke burgeoning liability as an explanation for the general insurance crisis, it is necessary, following Knight, to show that the future levels of liability are not merely risky but so uncertain as to be unpredictable.[59] Trebilcock relies on uncertainties in the application of existing legal rules, fuelled by the judiciary's oscillation between compensation and deterrence objectives, to explain the general insurance crisis.[60] In a similar vein, Priest has developed an explanation for the insurance crisis that is rooted in judicial embracement of the Calebresian internalization paradigm, which has caused insurance markets to unravel through a process of adverse selection.[61]

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[58] Winter (1988), *supra*, footnote 27, at p. 468.

[59] F. Knight, *Risk, Uncertainty and Profit* (Boston and New York, Riverside Press, 1921), pp. 197-263. Were these changes predictable, insurers would be able to impound these risks into their premium pricing, generating, at worst, rapid increases in premium levels without any withdrawal of coverage.

[60] Trebilcock, *supra*, footnote 15.

[61] The concept of enterprise liability is developed in G. Calabresi, *The Costs of Accidents: A Legal and Economic Analysis* (New Haven, Conn., Yale University Press, 1970). See also A. Ehrenzweig, *Negligence Without Fault* (Berkeley and Los Angeles, California, University of California Press, 1951). For a history of the theory of enterprise liability, see G. Priest, "The Invention of Enterprise Liability: A Critical History of the Intellectual Foundations of Modern Tort Law" (1985), 14 J. Legal Stud. 461. The link between enterprise liability and the 1980s insurance crisis is developed in Priest, *supra*, footnote 57. According to Priest, the use of tort law to insure third-party claimants against misfortune rather than merely to compensate them for wrongdoing and, hence, to deter such behaviour, entails the widening of risk pools to the point at which low-risk policyholders drop out, the risk pools unravel, and eventually insurers refuse to insure at a price which policyholders are willing to pay (see Part 2., *infra*). For a recent critique of Priest's analysis, see S. Croley and J. Hanson, "What Liability Crisis? An Alternative Explanation for Recent Events in Products Liability" (1991), 8 Yale J. on Reg. 1.

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However, as Winter observes, the legal uncertainty explanation for the insurance crisis cannot explain the increase in insurer profits which accompanied the crisis, nor the suddenness of its onset.[62] To explain these aspects, it is necessary to consider the interaction of the supply shocks caused by, for example, the changing face of tort law and the global reinsurance crisis, with the time lags and constraints acting upon the insurance industry.[63]

Winter's insurance industry explanation for the general insurance crisis draws on the fact that the insurance industry has historically been subject to cycles in product availability. The existence of these cycles can be traced to exogenous shocks that operate upon an industry characterized by rigid production capacity constraints and significant adjustment costs. These constraints are related to statutory capital adequacy standards which require insurance companies to maintain a certain ratio of premiums to equity. Because changes in future levels of insured risk increase the expected value of claims, and therefore premium levels, statutorily prescribed levels of equity will have to increase in order to cover premium increases.

In a world of perfect capital markets, insurance companies should have little difficulty in sourcing new equity. However, Winter notes that raising additional equity capital is not costless. Corporate dividends in both Canada and the United States are subject to a form of double taxation,[64] so equity cannot be costlessly removed once invested. Further, asymmetries of information exist between managers of insurance companies and the capital markets as to the nature of the market opportunities. Because the sale of equity interests in the firm can be interpreted as a sign of management's lack of faith in the future prospects of the company, investors may not believe that an equity call is

[62] Winter (1988), *supra*, footnote 27, at pp. 464-5.

[63] *Ibid.*, at pp. 474-6.

[64] Dividends are paid from after-tax income, and have already been subjected to income tax when they are distributed, yet shareholders must usually pay income tax on the same dividends when they are received. This amounts to "double taxation" of the dividend income. This problem is eliminated in Canada for Canadian corporations which own shares in other Canadian corporations through the allowance of deductions to offset the Canadian dividend income. When dividends are eventually paid to individual shareholders, however, the dividend tax credit fails to completely eliminate the individuals' tax liability and some degree of double taxation of corporate profits persists. (ITA, *supra*, footnote 22, ss. 82, 112, 121).

motivated by increased future insurance risks (as opposed to risks of poor corporate management) and may discount the price they are willing to pay for the shares. Moreover, there are always agency costs involved with any request for investors to give up control of their capital.[65] It will, therefore, generally be more efficient for an insurance company to increase its equity through accumulating retained earnings as opposed to raising fresh equity on the capital markets. Thus, according to Winter,[66] anytime the "capacity ceiling" on insurance volume is hit, a period of high premiums, high profits and even lower volumes will follow until capacity reaches its appropriate level.

Winter uses the insurance cycle model to explain not only capacity reductions, but the suddenness of the onset of the crisis as well. According to Winter,[67] at volumes of insurance below the industry capacity constraint, the supply of insurance will be very elastic. A series of insurer losses occasioned by changing tort law or by unforeseen losses arising from events such as the American asbestos litigation or the Union Carbide disaster in Bhopal will not immediately occasion an increase in premiums. Only when capacity is sufficiently depleted for the premium/equity ratio ceiling to be reached will the supply become inelastic, causing premiums to rise rather suddenly.[68] Furthermore, since the surplus can still earn a normal rate of return in the capital market, insurance availability will be slow to contract in response to an external shock. There will be a tendency for the "soft" markets to be rather protracted, therefore, while the high profits during the crisis serve to generate retained earnings and also attract some equity capital (double taxation of dividends does not discourage equity in insurance more than in any other industry) so that "tight" markets should be relatively short.

The fact that the general insurance crisis was restricted to liability, as opposed to property lines of insurance, can be explained by the fact that liability insurance is subject to greater

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[65] Even insurance subsidiaries of conglomerates face problems in obtaining equity from within the conglomerate group. Other companies within the group may be unable to invest in the insurance company owing to the non-fungible nature of the physical business assets.

[66] Winter (1988), *supra*, footnote 27, at p. 484.

[67] *Ibid.*, at p. 480.

[68] "Crises of rapidly rising premiums tend to follow periods of stable premiums and low returns and result from cumulative losses in the market rather than contemporaneous shocks to the market." Winter, *ibid.*

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uncertainty than other lines. The higher uncertainty associated with liability risks makes the supply more inelastic once capacity constraints are reached. The response to shocks to capacity will therefore be more volatile than for property lines, as capital treats liability lines as "residual" and flows in and out in response to small changes in price. Thus, the "multiproduct nature of the insurance market is critical in explaining the magnitude of the effect of capacity cycles for these lines".[69] This theory has considerable saliency in explaining the withdrawal of coverage in D&O insurance; because specialty lines of insurance like D&O require more expertise to write, and suffer from greater uncertainty than other lines due to the relatively small number of claims and policies, the effect of external shocks on availability is that much more profound.[70]

The 1985-86 crisis in Canadian D&O insurance can thus be seen as the manifestation of a competitive response to capacity shocks impacting on an already highly competitive market. These shocks were initially absorbed, but eventually led to a sudden increase in premiums and profits, and a regeneration of equity capacity. The sudden increase in premiums has been documented. Separate profit figures for the D&O line are not published, but they can be assumed to have followed the increase in profits from all liability lines in 1986 and 1987, as outlined above.

This explanation rests, however, on the vulnerability of the Canadian insurance market to capacity shocks coming from the United States and Europe. If the Canadian insurance market is truly competitive, and the factors causing the capacity shocks are not present in Canada, then one would expect the Canadian industry to generate or attract its own capital and so avoid the crisis.

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[69] *Ibid.*, at p. 487.

[70] There is, in fact, evidence that the industry is currently gearing up for another "hard market" in the liability lines, as a renewed glut of insurance equity is leading to price wars that will culminate in a sudden withdrawal of capacity in the most vulnerable lines. *The Belton Report*, *supra*, footnote 33, at p. 1, warned in January, 1991, that

> Although prices should be rising, surplus capacity is holding increases in check. When increases do occur, they will be selective and undramatic. They will be triggered by a loss ratio which has risen so high that it is causing an erosion of the capital supporting a particular class of business or by an unacceptable [return on equity]. That day is approaching, but the timing of the correction depends very much on the direction taken by the growth rate of premiums and claims over the next two or three quarters.

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Winter blamed the capacity shocks in the United States on changes in tort law and on changes in the global reinsurance market. These issues will now be addressed in turn to determine whether there is any reason to believe that either of these factors could have impacted on the Canadian market through the competitive market mechanisms outlined above.

(3) Global Reinsurance Crisis

As noted earlier, the supply side of the insurance market is composed of several layers: the primary insurer, with whom a policy is written and who usually absorbs claims up to a certain amount, and the reinsurer, who absorbs claims in excess of the primary layer amount. Although seldom observed by consumers, reinsurers are vital to the insurance business. First, since reinsurers actually pay insurers a ceding commission for the business, they increase insurers' access to working capital. Second, the existence of reinsurers greatly increases the capacity of the primary insurers to write business, since, historically, only the retained liability counts against the primary insurers' equity capacity. Third, reinsurance allows primary insurers to diversify their own risks, thereby reducing the premium costs to insureds. Finally, by absorbing the excess in abnormally large claims, reinsurers (who tend to be much larger than the primary insurance companies) provide support and stability for the primary insurance market.

The rapid expansion of the insurance business during the early 1980s was in fact fuelled in large part by a huge increase in reinsurance capacity.[71] For instance, in 1970, there were only 20 licensed reinsurance companies in Canada, compared to 45 in 1985, with a further 12 primary insurers operating reinsurance departments.[72] The profits to be earned by investing premiums at the high interest rates of the early 1980s encouraged existing reinsurers to expand and new entrants to enter the business. Newcomers to the market could get an "instant" premium portfolio by reinsuring a cross-section of another reinsurer's book. If the reinsurers themselves re-reinsured with other reinsurers

[71] John Lock, "Reinsurance as a substitute for capital", *Canadian Insurance/Agent and Broker*, July, 1986, p. 17.

[72] Robert Parizeau, "Reinsurers seek survival in tough times market", *Canadian Underwriter*, April, 1985, p. 58 at p. 59.

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(known as "retrocessionaires"), they would themselves be paid override commissions from the retrocessionaires.

Not surprisingly, not all of the reinsurers acted with the utmost caution in their quest for quick investment profits. Because many reinsurers operate across multiple jurisdictions, they can escape the level of regulatory scrutiny reserved for primary insurers. In a setting of regulatory gaps, some smaller reinsurers underwrote more business than their capital could comfortably allow. Eventually, when these reinsurers failed, primary insurers were left with the responsibility of paying out on the entire amount of the policies they had written — a rather onerous responsibility.

The problems for reinsurers were compounded by the failure of some primary insurers to underwrite insured risks adequately in the first place. Reinsurers found themselves paying out claims for which an adequate premium had never been charged. It may seem unlikely that, in such a sophisticated market, the reinsurers would fall prey to unscrupulous insurers. However, there are many layers in the insurance market, with agency costs and imperfect information flows involved at each level. This asymmetry of information is particularly pronounced in the commercial liability lines where each policy is underwritten separately. Since the reinsurer has no contact with the clients, it must trust the wisdom of the insurer to underwrite the risk prudently. With investment profits beckoning to offset any underwriting losses, and intense competition amongst insurers driving prices ever downward, prudent underwriting standards were not always maintained. The lag between the payment of premiums and the realization of claims meant that it was some time before reinsurers realized the problem. Thus, it seems that the root of the problem was the familiar insurance pitfall of moral hazard: retail insurers had not been required to retain any significant portion of the risks which they were writing and so had not maintained the most prudent pricing and underwriting standards.[73] These problems, combined with the fact that the uncertainty involved in pricing excess policies is inherently much greater than at the primary level, meant that many reinsurers slowly dug themselves into holes from which they could not escape.[74]

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[73] "Reinsurers are no different from insurers. The more they keep for themselves, the more they are careful in their underwriting practices. . . . Many problems developed because insurance companies could reinsure just about anything without retaining a significant interest." *Ibid.*, at p. 58.

[74] "The market has become increasingly undisciplined and some of the most basic

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In this setting, it was the avalanche of asbestos, medical malpractice and product-liability claims in the United States that actually sparked the insurance crisis. These claims frequently exceeded the primary layer of insurance retained by the retail insurers, forcing reinsurers to absorb losses for which they were not adequately prepared, and for which they had not extracted adequate compensation. Given the possibilities of international diversification, one would have thought that reinsurers would not be vulnerable to the explosion of liability in the United States. That is, by reinsuring the risks of non-American companies, the non-systematic risks occasioned by jurisdiction-specific legal changes could be diversified away. However, the fact that many European and Japanese firms were subject to this burgeoning liability by virtue of their exports to the American market, combined with the simultaneous occurrence of severe storm damage in Europe and Japan in 1987,[75] effectively transformed these non-systematic risks into non-diversifiable systematic ones.

To recoup their losses and to restore capacity, the larger reinsurers were forced to increase prices, while reducing the amount of new business they wrote. Some smaller reinsurers failed. The reduction in the capacity at the reinsurance level was only magnified at the level of the primary insurers, who suddenly could not find reinsurance sufficient to allow them to write the same amount of business. For large risks such as those insured in D&O policies, the lack of reinsurance was particularly devastating since the smaller insurance companies could no longer diversify the non-systematic risks.

It is through the mechanism of the reinsurance market that many of the insurance trends extant in the United States were transmitted to Canada. In Canada, this industry is principally populated by foreign-owned firms. The October 1989 Annual Report of the federal Office of the Superintendent of Financial Institutions (OSFI) states that less than 30% of the business written by federally regulated companies, which account for about 85% of the Canadian property and casualty insurance market, is conducted by domestically controlled insurers.[76] Indeed, only

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principles have been forsaken. . . . With the delays involved in international reinsurance accounting, it took a long time before the players realized they were sitting on a time bomb." *Ibid.*, at p. 59.

[75] "Reinsurance Challenge: How to Remain a Top Player", *Canadian Underwriter*, November, 1988, p. 12 at p. 13; and "The Changing World of Reinsurance", *Canadian Underwriter*, November, 1990, p.13 at pp.13-14.

[76] *Supra*, footnote 54, at p. 15.

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about 6.5% of the premiums written by reinsurers operating in the Canadian property-casualty market (excluding companies dealing solely with accident and sickness insurance) in 1985 were written by Canadian-owned companies.[77] As numerous industry commentators have noted, the huge U.S. market is serviced by companies from all nations, and U.S. and other foreign reinsurers alike were under intense pressure to recoup some of the losses sustained on their American policies. Even though Canadian insureds had a risk profile distinct from their American counterparts, these differences were not taken into account by reinsurers.[78]

Trebilcock rejects the proposition that defects in the international reinsurance market account in any appreciable measure for the insurance crisis in Canada.[79] Stated simply, Trebilcock argues that, in the absence of any sustainable entry barriers, any effort by foreign reinsurers operating in the Canadian market to raise premiums above levels appropriate to the Canadian environment would be met with competitive entry. That is, new competitors would flood the market with reinsurance capacity geared to the actual risk of Canadian insureds, thereby thwarting any efforts to make Canadian insureds responsible for American losses.

Trebilcock's reluctance to cede to reinsurance markets a central role in the Canadian insurance crisis neglects, however, the presence of natural entry barriers to reinsurance markets, namely the relatively small size of the Canadian market and the inability of new entrants to make statistically robust projections of future liability on the basis of the scant claims data available in Canada. In order for the law of large numbers to operate to render reinsurers risk-neutral with respect to the policies they reinsure, it

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[77] *Canadian Underwriter*, May Statistical Issue, 1986, at pp. 42 and 128-42. Data on insurance company ownership on file with the authors.

[78] The fact that foreign companies came under intense pressure to raise premiums in an effort to compensate for problems at home is a theme that was frequently sounded by Canadian industry commentators. As Robert Parizeau, *supra*, footnote 72, at p. 60, has noted: "In Canada, the reinsurance market is made up of subsidiaries or branches of foreign companies. Managers in Canada were under strict instructions to make their portfolios profitable and to take whatever steps were necessary to achieve that goal." This assessment was shared by Harold K. Ballantyne in "Plotting a Course in Turbulent Seas", *Canadian Underwriter*, September, 1985, p. 14 at p. 23:

> For example, in reinsurance it appears that Canadian branches and subsidiaries of international corporations are subject to control from elsewhere, and that while lip-service is paid to the apparent difference of this market to others they are subjected to outside pressures and decisions taken which reflect results in foreign markets.

[79] Trebilcock, *supra*, footnote 15, at p. 938.

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seems that a market much larger than that of the Canadian market for D&O liability insurance must be considered.[80] In the absence of statistically robust Canadian data, a natural referent is, of course, the United States. Thus, reinsurers and insurers alike look to the U.S. experience when assessing Canadian risks. They are included with U.S. risks so that the entire North American market can be assessed with the law of large numbers operating intact.

In these terms, the liability insurance crisis facing Canada in the mid-1980s can be traced back to a reinsurance capacity crisis stemming from underpricing in a highly competitive market and dramatic changes in tort liability in the United States. The reinsurance crisis affected Canada both because foreign insurers — however improperly — tend to assume that Canada follows the U.S. lead in all matters including legal liability for torts, and because there is insufficient market size in Canada to support an independent evaluation of reinsurance risks.

The protracted crisis in D&O can in turn be traced to its position as a specialty line of insurance, with a very small market base in Canada, and policy terms that tend to be individualized, all of which mean that this line is particularly uncertain and the first to lose capacity in a crunch. Just as Winter's theory predicted that the capacity constraints would affect the availability of liability insurance more than the less volatile property lines, so within liability insurance it was the more volatile and uncertain lines such as D&O which saw the largest reduction in capacity and the slowest recovery.[81]

The linkage of the Canadian D&O market to that of the United States and to worldwide events in liability reinsurance is obviously

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[80] For instance, the premium volume of the top six Canadian liability insurance companies is about $13 to $14 billion, while one U.S. company alone, State Farm, writes about $20 billion annually. Further, the entire liability reinsurance premium in Canada is unlikely to exceed more than $900 million. Interview with Guy Couture and Mary Holland of Sodarcan Inc., April 30, 1991.

[81] *Canadian Underwriter* magazine reported in March, 1988, that: "Capacity is becoming adequate for most lines of insurance with the notable exception of directors' and officers' cover, which has low capacity and is overpriced" (Stuart Brooks, "Risk managers' rousing theme: Happier Days are Here Again", *Canadian Underwriter*, March, 1988, p. 18). In April, 1988, the magazine reported that: "Rate increases in 1985 and 1986, together with a capacity shrinkage for certain classes, culminated in substantially improved results during 1987. But even as these improved results were being reported, the industry began to witness competitive forces similar to those of the early 1980's. . . There does not appear to be relief in sight for those who require cover for professional liability or directors and officers and the like." See Rex Anthony, Anthony Insurance Inc., "Go-ahead, back-up blues", *Canadian Underwriter*, April, 1988, p. 36 at p. 39.

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not the entire story, however, since the severity of the "crisis" was less pronounced in Canada than in the U.S. Clearly, therefore, the domestic legal and business environment does have some influence on the supply of liability insurance in general and D&O insurance in particular in Canada. It has been suggested by Trebilcock that Canada suffered from the same increase in both the incidence and level of tort liability awards as was manifest in the United States, but to a lesser degree. The possibility that changing legal standards in the D&O context could have influenced the steep rise in premiums and the withdrawal of capacity in Canada will now be examined.

2. Changes in the Exogenous Environment

There is some evidence that changes in the exogenous environment effected the Canadian D&O market. Table 3, below, indicates that the claims exposure of Canadian companies, both in terms of the likelihood and severity of potential claims, increased significantly from 1984 to 1987. The susceptibility of a firm to experiencing at least one claim over the preceding period, as well as the overall frequency of claims per firm during the same years fell markedly after 1987, while average settlement and defence costs fell slightly only after 1989.

Table 3[82]

Trends in Claim Susceptibility, Frequency, Settlements and Defence Costs: 1984-1991

	1984	*1987*	*1989*	*1991*
susceptibility	9.0%	10.5%	5%	6.6%
frequency	0.18	0.38 (+111%)	0.07 (–82)	0.18 (+157)
final settlements	$115,789	$255,432	$371,571	$301,894
paid defence costs	$63,155	$134,120	$344,412	$257,498
total final costs of claim	$178,944	$389,552	$715,983	$559,384

The timing of these increases in the frequency and severity of claims roughly corresponds to that of the symptoms discussed in Part IV, 1(3), above, of the Canadian D&O crisis. The doubling of the frequency and severity of claims between 1984 and 1987,

[82] 1991 Wyatt Canadian Survey, *supra*, footnote 47, at p. 53, Exhibit 17.

however, cannot account entirely for the seven-fold increase in the Wyatt Premium Index (the premiums weighted by losses of coverage) during that period. None the less, the increase in the claims experienced was not insignificant and can be traced to exogenous changes in the legal and business environment.

One of the principal causes identified by Priest and Trebilcock of the liability insurance crisis in the United States was the product liability crisis in the United States. Throughout the 1970s and 1980s, the courts moved to impose liability on corporations for the toxic side-effects of their products, regardless of whether the toxic effects were or could have been foreseen at the time of sale. The well-known asbestos cases and those connected with the Dalkon shield resulted in millions of dollars of liability for insurers who had neither charged nor taken reserves for such risks.[83] In some cases, the fact that the corporate defendant possessed insurance while the plaintiff did not was enough to trigger liability in the defendant on the "deep pocket" theory. There was also a perceptible move towards expanding the notion of fault in negligence cases, a move motivated, it seemed, by the desire to compensate victims who did not have first-party insurance and would otherwise not have been compensated for their misfortune. In effect, tort law came to be used as a means to compensate victims of misfortune — that is, to provide third-party liability insurance — rather than merely to deter wrongdoing and provide an incentive to take appropriate precautions against harming third parties.

According to Trebilcock, the changes in tort law led not to better coverage but to a perverse decrease in coverage as insurers responded to the changes by withdrawing capacity from the liability lines:[84]

> . . . attempts to pursue deterrence objectives and compensation (social

[83] Other lesser known examples include Bristol-Myers' Kantrex and Upjohn's neomycin drugs for deafness and the oral contraceptive Ortho-Novum 2 mg., manufactured by Ortho Pharmaceutical Corp. See, respectively, *Bristol-Myers Co. v. Gonzales*, 561 S.W. 2d 801 (Tex., 1978), and *Brochu v. Ortho Pharmaceutical Corp.*, 642 F. 2d 652 (1st Cir., 1981). But note that the same court which found Johns-Manville Product Corp. liable for the unforeseeable toxic effects of the asbestos it manufactured later seemed to reverse itself on the issue of whether a defendant could be liable for the unforeseen and unforeseeable side-effects of its products. See *Feldman v. Lederle Laboratories*, 97 N.J. 429, 479 A. 2d 374 (1984). See also Rabin, "Indeterminate Risk and Tort Reform: Comment on Calabresi and Klevorick" (1985), 14 J. Legal Stud. 633 at p. 635.

[84] Trebilcock, *supra*, footnote 15, at pp. 929-30.

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> insurance) objectives simultaneously through a single legal instrument — the tort system — entail unresolvable contradictions that have destabilized the system and its associated private insurance arrangements, especially with the increasingly widespread espousal of a social insurance objective for the tort system.

The system was destabilized because the expansion of liability to include risks unforeseeable at the time of manufacture meant that risks were no longer probabilistic — that is, the risks for which insurance was being made to compensate would have been uninsurable when the policy was written. Also, as Priest explains, the switch to third-party from first-party coverage resulted in excessive coverage, including damages for non-pecuniary loss for which no first party would purchase insurance. More importantly, however, the move restricted the degree to which risks could be segregated into narrow risk pools. The result was the unravelling of the risk pools as the low-risk corporations found it cheaper to self-insure than to pay the same premiums as those for whom potential product liability was high. As Priest notes, "the refusal of some insurers to offer coverage at all for day care, municipal, and directors' and officers' liability, among others, is conclusive evidence of the breakdown of the insurance function."[85]

In the case of D&O liability, Romano has argued that an examination of U.S. law relating to D&O liability for negligence shows not a period of radical expansion in liability standards but rather a period of stagnation and possibly reduction in the standard required.[86] Liability for insider trading and other securities transgressions expanded during the 1960s and 1970s, but "the trend of expanding liability was reversed . . . by the mid-1970s with a line of Supreme Court rulings cutting back the reach of the federal securities laws."[87] And although the decision of the Delaware Supreme Court in the celebrated case of *Smith v. Van Gorkom*[88] was viewed by some commentators as marking a significant enlargement of directorial liability,[89] Romano argues that the real

[85] Priest, *supra*, footnote 57, at p. 1578.

[86] Romano (1989), *supra*, footnote 8, at pp. 22-5.

[87] *Ibid.*, at p. 22.

[88] 488 A.2d 858 (Del., 1985). The case involved a decision by the directors of a target company to approve a merger of the firm without having undertaken due consideration of the adequacy of the offered price. The directors in question had been fully briefed on the company's tax problems and had commissioned an independent study on alternative methods of dealing with the problem, but had made the fatal mistake of failing to commission an independent valuation of the company. Instead, they had relied on their collective business experience and the estimates of one of their colleagues at the crucial board meeting.

[89] See, for instance, B. Manning, "Reflections and Practical Tips on Life in the Boardroom

significance of the case lay not in the actual standard of liability applied (gross rather than simple negligence which constituted a reduction in the standard of care), but in the court's willingness to find liability on the facts of the case, which created considerable uncertainty in the business and legal community respecting the way in which the gross negligence standard would be applied by the Delaware courts.[90]

Another factor identified by Romano as contributing to the uncertain liability faced by American directors and officers was the rapid and extensive expansion of financial innovations in the 1980s. With new takeover and financing techniques being devised at a rapid rate, it became extremely difficult to predict how the courts would apply the legal standard for liability in any given situation.[91]

The last factor identified by Romano as a source of uncertainty in American D&O markets was the lawless interpretation of insurance contracts by the courts.[92] Despite relatively clear contractual language indicating the allocation of certain risks to insureds, the American judiciary has consistently refused to read these provisions in their proper light. As a consequence, exclusion clauses and other limitations on coverage were narrowed, thereby increasing the scope (and unpredictability) of insurer liability.

This uncertainty in the D&O market in the United States can be expected to have had some spillover effect on Canada simply because of the importance of trading links between the two

after *Van Gorkom*" (1985), 41 Business Lawyer 1 at p. 1: "[*Van Gorkom*] exploded a bomb. . . . Stated minimally, the court there pierced the business judgment rule and imposed individual liability on independent (even eminent) outside directors. The corporate bar generally views the decision as atrocious. Commentators predict dire consequences as directors come to realize how exposed they have become."

[90] Romano (1989), *supra*, footnote 8, at pp. 24-5.

[91] In this vein, Romano has argued, *ibid.*, at p. 25, that

> Corporate practice in recent years has been characterized by rapid-paced innovation in the structuring of deals, and new claims, such as objections to the latest takeover defensive tactic, are continually being brought against directors. Because litigation in this environment will inevitably raise numerous complex issues involving application of the liability standard, the variance of the standard will increase, making D&O losses more difficult to predict . . . this type of legal uncertainty affects all insureds and thereby creates a dependence across D&O risks, vitiating the applicability of the law of large numbers to D&O policies' pricing. The upshot of the phenomenon is that the increased uncertainty in D&O risk assessment can cause rates to rise even though the apparent core of the standard of conduct has remained the same.

[92] *Ibid.*, at pp. 25-30.

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countries. There are many ways in which the directors of a Canadian company can be exposed to liability in the United States. Among the more common are for the Canadian company to sell goods and services directly to U.S. customers, to establish an American subsidiary, or to trade its shares on a U.S. stock exchange. In fact, the 1989 Canadian Wyatt Survey found that "those participants with U.S. subsidiaries reported claims at more than twice the rate of firms that did not have subsidiaries."[93] Although the Wyatt Canadian Surveys do not report on the claims experience of participants who sell products or services or trade shares in the U.S. without a subsidiary, it is reasonable to assume that they have been exposed to the greater frequency of claims in that country, and to the more stringent standard of conduct imposed by its courts.

Not all Canadian purchasers of D&O insurance trade in or with the United States, however, and it is relevant to our investigation of the Canadian D&O market to determine whether exogenous shifts in the Canadian environment increased the level, and hence the uncertainty, of the liability of directors and officers within Canada. This issue will be canvassed by considering changes in the standards of care and loyalty imposed by corporate and securities law, in the standards of conduct prescribed in non-corporate law statutes such as environmental and employment standards legislation, and in the level and nature of economic activity in Canada during the mid-1980s.

A central theme of this discussion is that, although there has been some accretion in the level of liability imposed on directors from non-corporate and securities sources, by and large, close inspection provides little support for believing that the crisis in Canadian D&O insurance had much to do with indigenous Canadian trends. This underscores the salience of the reinsurance story as the principal cause of the Canadian D&O crisis and also provides an explanation for its lesser severity.

[93] *Supra*, footnote 25, at p. 46. The 1991 Wyatt Canadian Survey, *supra*, footnote 47, at p. 39, reported that Canadian firms with U.S. subsidiaries were by then more than three times as likely to experience one or more D&O claims as those without. Exhibit 26 shows that Canadian respondents without U.S. subsidiaries had a claim susceptibility (percentage of participants with one or more claims over 1979-1988) of just over 3%, while those with a wholly owned subsidiary or an interest in a subsidiary had a claims susceptibility of about 9% and 5% respectively. Similarly, the claims frequency (average number of claims per participant over 1979-1988) for companies without subsidiaries was about 5%, while that of companies with wholly owned and partly owned subsidiaries was about 12.5% and 10.5% respectively.

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(1) Developments in Directors' Corporate and Securities Law Duties

In contrast to the situation obtaining in the United States, where the traditional legal duties of directors to the corporation are principally derived from state corporate law, in Canada these duties are derived from both corporate and securities law sources.[94] The traditional degree of duty and skill required of directors under Anglo-Canadian corporate law was established by Romer J. in 1924 in the seminal case of *City Equitable Fire Insurance Co. (Re)*:[95]

> It has been laid down that so long as a director acts honestly he cannot be made responsible in damages unless guilty of gross or culpable negligence in the business sense.
>
> . . . . .
>
> There are . . . one or two other general propositions that seem to be warranted by the reported cases: (1) a director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. . . . directors are not liable for mere errors in judgment. (2) A director is not bound to give continuous attention to the affairs of his company. . . . (3) In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.

Thus, the traditional English test required that the director behave in an objectively reasonable manner, based on his or her own subjective state of knowledge and skill. Not surprisingly, given the heavy subjective content to the standard, courts have rarely held directors responsible for breaches of the corporate law duty of care.[96]

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[94] R. Daniels and J. MacIntosh, "Toward A Distinctive Canadian Corporate Law Regime" (1991), 29 Osgoode Hall L.J. 863 at pp. 892-900. For a discussion of the impact of this dispersion on the vigour of the Canadian corporate law market, see R. Daniels, "Should Provinces Compete?: The Case for a Competitive Corporate Law Market" (1991) 36 McGill L.J. 130; and R. Romano, "The Genius of American Corporate Law", August 10, 1992, draft manuscript on file with the authors.

[95] [1925] Ch. 407 (C.A.) at pp. 427-9.

[96] The classic statement on this subject is attributable to Joseph W. Bishop, Jr., "Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers" (1968), 77 Yale L.J. 1078 at p. 1099: "the search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." See also M. Trebilcock, "The Liability of Company Directors for Negli-

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Examination of the two Canadian cases decided during the 1980s — *Revelstoke Credit Union v. Miller*[97] and *Grindrod & District Credit Union v. Cumis Insurance Society Inc.*[98] — that dealt with the director's duty of care provides little indication of any departure from traditional judicial deference to board decision making that is not coloured by any hint of conflict of interest. Both of these cases involved actions against directors of credit unions alleging responsibility for the unauthorized conduct of credit managers in making loans to third parties. In *Revelstoke*, the court held that the directors did not breach their statutory duty of care since they had no grounds for suspecting that the manager would engage in wrongful conduct and since they had established internal safeguard systems. In *Grindrod*, the court refused to reverse a lower court finding that the directors did not actually know of the manager's dishonesty and thus did not fail to "well and faithfully" perform the duties of directors.

In addition to the duty of care, directors are also liable for conduct that breaches the corporate law duty of loyalty and the statutory oppression remedy. However, review of the cases interpreting both standards during the 1980s reveals very little departure from pre-existing understandings of the nature of liability under each. For instance, by relying extensively on the earlier judgment of the British Columbia Supreme Court in *Teck*,[99] the Ontario Divisional Court in the 1986 *Olympia & York Enterprises Ltd. v. Hiram Walker Resources Ltd.*[100] decision upheld a fairly lenient standard of review for directors under the duty of loyalty.[101] Similarly, in interpreting the scope of the oppression remedy, the Ontario High Court in the 1987 case of *Brant Investments Ltd. and KeepRite Inc. (Re)*,[102] conferred

gence" (1969), Mod. L. Rev. 499. But, *contra*, see J. Coffee, "Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis" (1984), 52 Geo. Wash. L.Rev. 789.

[97] [1984] 2 W.W.R. 297, 24 B.L.R. 271 (B.C.S.C.).

[98] (1985), 10 C.C.L.I. 39, [1986] I.L.R. 7346 (B.C.C.A.).

[99] *Teck Corp, v. Millar* (1972), 33 D.L.R. (3d) 288, [1973] 2 W.W.R. 385.

[100] (1986), 37 D.L.R. (4th) 193, 59 O.R. (2d) 254.

[101] Following *Teck*, Mr. Justice Montgomery held that directors are not in breach of their fiduciary duties to the company if they act in good faith in what they believe are reasonable and probable grounds to be in the best interests of a new company. Nevertheless, the court allowed the directors to favour a takeover bid which would provide considerably less to shareholders than the alternative offered by another bidder. See L. Grafstein, "Whose Company Is It Anyway?: Recent Developments in Canadian Takeover Law" (1988), 46 U.T. Fac. L.Rev. 522.

[102] (1987), 42 D.L.R. (4th) 15, 60 O.R. (2d) 737, supplementary reasons 43 D.L.R. (4th) 141, 61 O.R. (2d) 469 (H.C.J.), affd 80 D.L.R. (4th) 161, 3 O.R. (3d) 289 (C.A.).

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considerable latitude on outside directors in reviewing the propriety of non-arm's-length transactions.[103] Indeed, the approach of the court contrasts markedly with the much more onerous standards of conduct developed for American directors in comparable circumstances.[104]

Under Canadian provincial securities laws, directors owe various duties to investors and the corporation pursuant to the disclosure obligation.[105] Under s. 130 of the Securities Act,[106] for instance, directors are liable for damages caused to investors by prospectus misrepresentations. Nevertheless, directors are able to insulate themselves from liability by ensuring adequate due diligence.[107] Although the standard of conduct required for directors under the due diligence defence is somewhat amorphous, the leading authority on the degree of care required by directors pursuant to this obligation still continues to be the 1968 American decision in *Escott v. Barchris*.[108] And, while the 1986 decision of the Ontario Securities Commission in *Canadian Tire*,[109] which invoked a broad public interest standard as grounds for enjoining a leveraged buyout transaction — even without any actual contravention of the commission's statute, regulation or

103 The court held, *ibid.*, at p. 36 D.L.R., that the approval of an amalgamation with a subsidiary by the independent directors of a corporation was not a breach of the oppression remedy by reason of the failure of the directors to consider the appropriateness of alternative transactions to the amalgamation — all that was required was for the directors to show some evidence of reasonable benefit to the company from the transaction.

104 See, for instance, *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. Sup. Ct., 1983) (going private transactions subject to review under entire fairness test comprised of fair deal and fair price limbs); and *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261 (Del. Sup. Ct., 1988) (duty on board to enhance the bidding process for shareholders in a company whose control is up for sale).

105 For instance, s. 56(1) of the Ontario Securities Act, R.S.O. 1990, c. S.5, provides that prospectuses filed pursuant to the Act contain "full, true and plain disclosure of all material facts relating to the securities issued or proposed to be distributed".

106 *Ibid.*

107 The due diligence defence requires directors to show that after reasonable investigation they had reasonable grounds for believing that there was no misrepresentation in respect of the non-expertised part of the prospectus and that they had no reasonable grounds for believing that there was a misrepresentation in the expertised part of the prospectus.

108 *Escott v. Barchris Construction Corp.*, 283 F. Supp. 643 (U.S.D.C., S.D.N.Y., 1968). In the absence of Canadian precedent, Canadian textbooks and reporters commonly cite this case.

109 *C.T.C. Dealer Holdings Ltd. v. Ont. (Securities Commission)* (1987), 35 B.C.L.R. 56, 10 O.S.C.B. 857 (O.S.C.), affd 37 D.L.R. (4th) 94, 35 B.L.R. 117 (Div. Ct.), leave to appeal to Ont. C.A. refused (1987), 35 B.L.R. p. xx.

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policies — has been criticized for its impact on business certainty,[110] the fact remains that the public interest jurisdiction is closely associated with the cease-trading power, which does not, in itself, trigger any civil liability for directors.[111]

Could it be argued that the relatively static state of Canadian law in the corporate and securities area was offset by an increase in the level of innovation in underlying economic activity, which created corresponding uncertainty respecting the application of the established legal standard to novel transactions? There is no question that Canada did experience an increase in types of transactions (mergers and acquisitions) during the 1980s that were likely to nurture legal innovation.[112] Indeed, the rate of mergers and acquisitions activity in Canada during the 1980s was comparable to that in the United States during the same period.[113] However, in contrast to the United States, M & A activity in Canada was typically done on a friendly basis, without competitive bidding.[114] In large part, the lack of hostile M & A activity in Canada is attributable to the highly concentrated nature of share ownership in Canada; with concentrated blocks, acquirors can only effect an ownership shift if the high stakes owners in the target are co-operative.[115] Given the more co-operative nature of control transactions in Canada, therefore, it is unlikely that increased M & A activity played much of a role in increasing the vulnerability of directors to civil liability.

Examination, therefore, both of the legal standard of care and of the level of activity occurring under this standard provides little support for the claim that indigenous corporate and securities law

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[110] See, for instance, B. Pukier, "Taking Care of Business: An Inquiry into the Ontario Securities Commission's Public Interest Mandate", draft article on file with the authors.

[111] On the other hand, one could argue that the dramatic expansion of the public interest test in the case sent out a signal of the OSC's more aggressive exercise of its jurisdiction, which would, in turn, affect other parts of the commission's mandate. As well, it could be argued that the more aggressive use of the cease-trading power augurs ill for directors because investors might sue the board for damages suffered as a result of illiquidity.

[112] See, for instance, R. J. Daniels, "Mergers and Acquisitions and the Public Interest: Don't Shoot the Messenger", in L. Waverman, *Corporate Globalization Through Mergers and Acquisitions* (Calgary, University of Calgary Press, 1991), chapter 7.

[113] R.S. Khemani, "Recent Trends in Merger and Acquisition Activity in Canada and Selected Countries" in L. Waverman, *ibid.*, chapter 1, at pp. 12-16. Surprisingly, Khemani finds that, when scaled to differences in GDP, the level of M & A activity in Canada was higher than that in United States during the period 1979 to 1989.

[114] Daniels and MacIntosh, *supra*, footnote 94, at pp. 884-5.

[115] *Ibid.*

duties contributed in any meaningful way to the Canadian D&O insurance crisis.[116]

(2) Developments in Non-Corporate Law Directorial Duties

Apart from the traditional corporate and securities law duties owed by directors to the investors and the corporation as a whole, a wide range of statutes not aimed principally at corporate governance have used directorial liability as a supplemental device to assist in enforcement. The growth of the board's responsibility to non-shareholder interests has been dramatic — by one writer's count, there are now at least 106 federal and Ontario statutes that impose civil liability on directors.[117] The popularity of gatekeeper liability is based on the desirability of deterring wrongful conduct beyond the levels that can be achieved through direct liability of wrongdoers, and on the savings that governments can realize by off-loading some of the on-budget costs of public enforcement of corporate regulations onto private parties.[118]

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[116] One factor which may have sparked fears of a generalized expansion of corporate law duties was the Estey report on the collapse of the Canadian Commercial Bank and the Northland Bank. He recommended that the Bank Act be expanded to provide that directors of a bank owe a duty of care to the bank, its shareholders and the bank's depositors; that the existing procedures for derivative and corporate actions be expanded; and that all persons actually injured through negligent or dishonest actions of a director be able to bring a court action for compensation. See Estey, *Report of the Inquiry into the Collapse of the CCB and the Northland Bank* (1986) as reported in Silber, "Directors' and Officers' Liability Coverage: Directors' Liability and the Scope of Policy Exclusions in Canada, Part II" (1991), 9 C. J. Ins. Law 1 at p. 7. These recommendations were incorporated into the Federal Government's Financial Institution Reform Package, which was adopted in the Spring of 1992. While expanding the range of activities in which each of the "four pillars" can engage, the new legislation requires that the Board of Directors of each financial institution establish a Conduct Review Committee with the duty of ensuring that prohibited non-arm's-length transactions between financial subsidiaries do not occur, that guidelines to ensure that all transactions are arm's length are in place, and to report annually directly to the Office of the Superintendent of Financial Institutions. However, given the distinctive problems faced in the regulation of financial institutions, it is not clear that this model will be transplanted into the general corporate context. For a discussion of the distinctive nature of financial institution regulation, see R.J. Daniels, "Form Over Substance: Bad Policy as a Recipe for Bad Federalism in the Regulation of Canadian Financial Institutions", forthcoming in Osgoode Hall L. J.

[117] D. Palmateer, "Statutory Liabilities and Offences of Directors and Officers in Ontario", draft memorandum dated October 9, 1990, on file with the authors.

[118] Kraakman (1984) and (1986) *supra*, footnote 11. See also R. Howse, J.R.S. Prichard and M.J. Trebilcock, "Smaller or Smarter Government?" (1990), U. T. L.J. 428; R. Howse, "Retrenchment, Reform or Revolution? The Shift To Incentives and the Future of the Regulatory State", forthcoming in Alta. L. Rev.

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Liability under general legislative schemes usually takes the form of an explicit statutory provision detailing board legal responsibility for failing to play an appropriate gatekeeping or monitoring role in the corporation's activities.[119] For instance, amendments to the Environmental Protection Act[120] and the Ontario Water Resources Act[121] in 1986 obligated directors and officers to make continuous, diligent and independent inquiries to ascertain whether the corporation is engaging in activities which may result in the deposit or discharge of a contaminant into the natural environment, or the diminution of water quality. Each director is required to take all reasonable positive steps to prevent such pollution. Further, with the passage of the Goods and Services Tax (GST) legislation in December of 1990, directors became liable along with their corporations for the remittance of the GST. Again, a "due diligence" defence exists, but only if the director ensures that controls to prevent a default are both established and functioning effectively.[122]

The expansion of liability under these non-corporate statutes has introduced an important source of uncertainty into board decision making in Canada. Although most of these provisions allow for a due diligence defence, it is often difficult to predict with any degree of certainty the conduct necessary to satisfy the defence. This is especially so given the omnipresent danger that a court seized of a matter arising under these provisions will be

[119] For instance, under the Ontario Environmental Protection Act, directors face civil liability for failing to "take all reasonable care" in ensuring that their corporations do not unlawfully discharge waste into the environment: Environmental Protection Act, R.S.O. 1990, c. E.19, s. 194(1) (enacted S.O. 1986, c. 68, s. 17; amended S.O. 1988, c. 54, s. 50).

[120] *Ibid.*

[121] R.S.O. 1990, c. 0.40, s. 116 (enacted S.O. 1986, c. 68, s. 42; amended S.O. 1988, c. 54, s. 87).

[122] "Directors are liable for GST", *The Bottom Line*, December, 1990, p. 35. On April 12, 1991, the Ontario government announced an extension of personal liability for unpaid wages and vacation pay in the event of bankruptcy of a corporation to all officers of the bankrupt corporation. The proposed legislation was withdrawn in June, 1991, but the signal to the D&O insurers is that such liability could well be imposed in the future, and that the government expects D&O insurance to cover the risks. "Officers on hook for severance", *Financial Post*, April 12, 1991, p. 1. Most recently, the Occupational Health and Safety Law Amendment Act, 1990, S.O. 1990, c. 7, requires that all directors and officers take reasonable care to ensure compliance with the OHSA and regulations. See Peter W. Strahlendorf, *Personal Liability of Directors and Officers of Corporations in Ontario for Occupational Health and Safety*, November, 1990, paper on file with authors.

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influenced by compensation rather than deterrence objectives, and will accordingly assess the adequacy of the defendant's conduct with some regard to the depth of his or her pocket. For instance, the Tax Court of Canada in *Fraser v. M.N.R.*[123] held that a director of a bankrupt company was liable for employee deductions not remitted to Revenue Canada despite the fact that he was responsible for the operational rather than the financial parts of the business, and despite the fact that he had made inquiries about the deductions with the company's financial officer — who had given him an assurance that the remittances would be forwarded to the government forthwith.

Exacerbating the uncertainty respecting the ambit of the due diligence defence are the difficulties in discerning the degree of liability that is actually triggered by these non-corporate law statutes. For instance, under provincial corporate and employment standards legislation, directors are liable for wages and other sundry benefits owed by the company to employees up to some statutorily prescribed ceiling.[124] These provisions have been subject to conflicting interpretation by the courts in respect of the liability of directors for costly termination pay owed to employees by insolvent corporations.[125]

The statutory expansions of directors' and officers' liability could lead to a withdrawal of insurance supply if, in addition to expanding the need for liability insurance, they increase the uncertainty surrounding the liability standard and the application of that standard. In fact, the appearance of an exclusion for liability for pollution-related offences in the last few years indicates that just such uncertainty has occurred. There is considerable uncertainty of how the courts will apply the legislation and, with potential liability running to millions, if not billions, of dollars, the D&O insurers simply refuse to insure that risk.

123 (1987), 87 D.T.C. 250.

124 See, for instance, s. 119 of the CBCA and s. 131 of the OBCA. Section 119 renders directors jointly and severally liable to employees for all wages and other debts not exceeding six months wages payable to each such employee for services performed for the corporation while they served as directors.

125 In *Schwartz v. Scott* (1985), 35 A.C.W.S. (2d) 406, the Quebec Court of Appeal held that s. 99 of the Canada Corporations Act, R.S.C. 1970, c. 32, permitted employees to recover funds from directors in respect of wrongful dismissal judgments obtained against the corporation, while the Ontario High Court of Justice in *Mills Hughes v. Raynor* (1985), 10 C.C.E.L. 180, determined that CBCA s. 119(1) did not permit employees to recover from directors for such wrongful dismissal judgments.

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(3) Summary

When one considers the proliferation of non-corporate law directorial duties, it may be that there was a greater expansion of Canadian directors' and officers' liability during the "crisis" years of the mid-1980s than there was in the United States. However, there are simply not enough reported cases in Canada on which to form a statistically sound evaluation, and claims data is of only minor assistance.[126] Thus, the lack of sufficient claims experience prevented the industry from forming a conclusion as to how D&O policies would be interpreted by Canadian courts in the early crisis year of 1985.[127]

Therefore, while Romano argues that an "anti-insurance" bias on the part of U.S. courts when interpreting D&O policies led to non-diversifiable risk and uncertainty and undermined the insurance function, the very lack of opportunity to interpret such documents in Canadian courts meant that no independent analysis of the risks of that or any other bias could be formed. D&O insurers have no choice but to apply the U.S. example to Canada, tempered of course by Canadian claims experience and such judgments as are in fact generated by the Canadian courts. With

[126] Indeed, the introduction to the 1989 Wyatt Survey of Canadian corporations contains the following caveat: "The survey results are interesting and confirm some generally held conclusions about D&O liability insurance in Canada. However, care should be taken when drawing conclusions as the data may not be representative of actual circumstances or conditions . . . we do not believe the claims experience reported to be sufficient on which to base conclusions." 1989 Wyatt Canadian Survey, *supra*, footnote 25, at p. 1.

[127] As one participant at the Insurance Law and Practice Conference in Toronto on March 18/19, 1985, concluded: "it is apparent from our discussion of the statutory and other liabilities of directors and officers and our review of the two most common D & O wordings that there has been little opportunity to date for the courts to define the risk being underwritten, or to shed light on the various ambiguities in the policies themselves." John I.S. Nicholl (Ogilvy, Renault) "Directors' and Officers' Insurance", Major Developments in Insurance Law and Practice Conference, March 18/19, 1985, Toronto, at p. 37. This situation did not change during the years of the D&O crisis. In a paper delivered at the 1987 Annual Institute on Continuing Legal Education, Corporate Council Seminar, R. Donaldson stated: "Any study of the nature and extent of the liability of directors of Canadian corporations by necessity must focus on potential legal liabilities rather than case studies. Fortunately, with the exception of statutory liability for wages and tax arrears, there are few recent cases where any of the identified common law or statutory liabilities of directors and officers have actually been asserted in a claim against such persons." Robert A. Donaldson, "Update on the Law of Directors' and Officers' Liability", 1987 Annual Institute on Continuing Legal Education, *Liability of Corporate Officers and Directors — Impact of the Insurance Crisis*, February 5, 1987, p. 1.

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the trends in the United States in 1985-86 towards a stricter application of the negligence and fiduciary standards applicable to directors, towards increased statutory duties of directors, and towards strict interpretations of D&O policies against the insurer, D&O insurers operating in Canada raised the premiums here in anticipation of a similar, albeit more "Canadian" (that is, subdued), judicial trend.

The foregoing analysis of the nature and causes of the most recent crisis in Canadian D&O liability insurance lays to rest any fears that the crisis was the artificial creation of collusion or of foreign insurers seeking to cross-subsidize their losses in foreign markets. Rather, the evidence corresponds with Winter's theory of competitive insurance cycles operating in a climate of restrictions on costless equity infusions. As Winter concludes:[128]

> . . . in general a crisis will be characterized by an increase in premiums that is greater — possibly much greater — than could be "justified" by any increase in expected claims. This increase and the consequent increase in profits is consistent with a competitive market. The market-wide increase in profits does not imply collusion.

The Canadian D&O liability insurance crisis can thus be seen in the context of a crisis in liability insurance generally. After years of surplus supply, investment income underwriting, and cheap and abundant reinsurance, a trend towards higher tort awards and more stringent standards of care in the United States and several severe storms in Europe caused the global reinsurance market to contract — seemingly overnight. The severe contraction of the supply of reinsurance, and the inability of the Canadian capital markets to finance independently the larger risks such as D&O coverage, had the most severe impact on the most uncertain lines. As Winter says, "The most uncertain lines will bear the brunt of shocks to the capacity of the entire market, absorbing and releasing capacity over the cycle."[129]

The small and undeveloped nature of the Canadian D&O market means that the law of large numbers is inoperative and Canadian D&O policies cannot be underwritten as a completely separate market. Thus, the uncertainty generated by the changing application of directors' negligence standards in the United States and the policy of interpreting D&O contracts against the interests

[128] Winter (1988), *supra*, footnote 27, at p. 498.
[129] *Ibid.*

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of the insurer had a profound impact on expected claims in Canada and discouraged a uniquely Canadian expansion in reinsurance supply. This impact was in addition to the direct influence warranted by the trading and corporate links between the two countries. The failure to see the Canadian D&O market separately from that in the U.S. is not the result of investor or consumer myopia but of the statistical requirements of the insurance industry and the relative lack of applicable judicial precedents in Canada.

V. POLICY IMPLICATIONS

1. Insurance Regulation

It follows from Winter's analysis of competitive insurance cycles that premium ceilings and more stringent premium/equity ratios will likely increase, rather than decrease, the amplitude of insurance cycles, and so do more harm than good. The premium increases of the D&O crisis were a competitive response to the threat of large future claims indicated by the claims experience in the United States and to the sudden need for capital replenishment which confronted the industry after years of cut-throat competition. The Canadian regulators seem to have understood the competitive nature of the insurance industry, and have refrained from proposing premium caps. They were, however, active on several other fronts.

The Canadian and British Insurance Companies Act[130] and the Foreign Insurance Companies Act[131]were amended in July, 1987.[132] The Office of the Superintendent of Financial Institutions took heed of the criticisms of the premium/equity ratio as the principal measure of solvency, ignoring as it did the magnitude of the potential liabilities flowing from those premiums. The old capital reserve requirements were replaced, therefore, with a new s. 171 (now s. 516 of the Insurance Company Act), which required

[130] R.S.C. 1985, c. I-12.
[131] R.S.C. 1985, c. I-13.
[132] An act to amend certain Acts relating to financial institutions, R.S.C. 1985, c. 21 (3rd Supp.), ss. 5 to 43. The amendments to these Acts, as well as the controls placed on reinsurance activities discussed below, have been carried over in the new Insurance Companies Act, S.C. 1991, c. 47, which received royal assent on December 13, 1991, came into force June 1, 1992, and the text of which can be found at *Can. Gaz., Part III*, Vol. 14 No. 7, February 19, 1992, p. 1465. This Act repealed and replaced the Canadian and British Insurance Companies Act and the Foreign Insurance Companies Act.

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that capital be maintained at the highest level indicated by any of three different criteria: premiums, liabilities and claims equity.[133] Also, in order that the government be in a better position to anticipate trouble in this volatile industry, quarterly financial statements are now required of all licensed insurance companies (s. 664), and a licensed actuary must report annually on the adequacy of the company's reserves (s. 667).

The more stringent capital requirements are still subject to the criticism levelled by Winter that they are likely to add to the amplitude of insurance cycles by reducing the amount of insurance that can be written when prices rise. It is probably more sensible to tie capital maintenance and reserve requirements to potential liabilities only and to do away with the premium/equity ratio as a guideline. As of Summer 1993, oversupply had again returned to the property-casualty insurance market, and this ratio was not likely to cause any distress in the market in the very near future. However, the industry was predicting the onset of another "hard market" by 1995, or sooner, if there is another shock to capacity such as the liability boom in the United States or a repeat of the reinsurance bubble.[134] The continued use of the premium/equity ratio to gauge solvency could exacerbate the next cycle.

In 1989, the Office of the Superintendent of Financial Institutions took steps to ensure that the kind of reinsurance bubble which had so disrupted liability insurance markets in the mid-1980s would not be repeated. As Robert Hammond, then Deputy Superintendent of Financial Institutions, commented, the regulations which came into effect on January 1, 1990, aimed to implement the "lessons learned from the [insurance company] failures in the early 1980's".[135] One of these lessons was that

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133 See the Asset (Property and Casualty Companies) Regulations, SOR/92-524, *Can. Gaz. Part II*, Vol. 126, No. 20, p. 3650, for the detailed calculation of the capital reserve requirement. These calculations are essentially the same as those contained in the former s. 171, but have been moved into the Regulations for ease of amendment.

134 The Belton Report, *supra*, footnote 33, at p. 10: "If my 'crash and burn' scenario unfolds . . . it will be late 1995."

135 Telephone conversation, Friday, June 7, 1991. The reinsurance controls referred to were contained in the Reinsurance (Canadian Insurance Companies) Regulations: SOR/89-573, *Can. Gaz. Part II*, Vol. 123, No. 26, p. 4877; the Reinsurance (British Insurance Companies) Regulations SOR/89-574, *Can. Gaz. Part II*, Vol. 126, No. 26, p. 4887; and the Reinsurance (Foreign Insurance Companies) Regulations: SOR/89-575, *Can. Gaz. Part II*, Vol. 126, No. 26, p. 4894. The same limits apply to all companies based on their Canadian policies.

The Reinsurance Regulations have been renewed under the Insurance Companies

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insurance companies, like consumers, must retain a portion of their liabilities as an incentive to engage in sound underwriting practices. Without retentions by retail insurance companies to guard against their own moral hazard, they sometimes write poor-quality business. This moral hazard culminated in undue risks being passed off on reinsurance companies who, removed from the scene, were not in a position to assess the risk adequately for themselves. To guard against this, retail insurers are now required to retain at least 25% of any risk that they insure.

Another lesson learned was that unlicensed (and sometimes largely unregulated) offshore reinsurers cannot always be trusted to pay claims that exceed their assets invested in Canada. The previous rules had stipulated that the premium ceded by a Canadian insurer to the offshore reinsurer had to be held in trust by the Canadian insurer as a deposit against claims. To try to ensure that the claims could be paid, these premiums could not be credited as a reduction in the Canadian insurer's liabilities. But the whole point of insurance is that claims may sometimes exceed the premium, and this rule was not found to be stringent enough to guard against "rogue" unlicensed reinsurers defaulting on their policies. The Canadian liability market is so small, however, and risks such as D&O policies are so large that the offshore market cannot be cut off completely. Since 1990, therefore, no more than 25% of a risk can be ceded to unlicensed reinsurers. Further, the Canadian insurer cannot allow reinsurance to reduce its capital requirements below 50% of what they would be without the reinsurance.[136] Since the Canadian insurer still has the primary responsibility to the policyholder, this will ensure that the insurer has reserves sufficient to cover the claim in case the reinsurer reneges, and that a maximum of 25% of a risk can be held by unlicensed reinsurers.

With respect to the Canadian D&O market in particular, there has been some easing of the supply since the crisis, but not, as outlined above, as much as in some other lines. This is not

Act by the Reinsurance (Canadian Companies) Regulations SOR/92-298, *Can. Gaz. Part II*, Vol. 126, No. 12, p. 2183; and the Reinsurance (Foreign Companies) Regulations SOR/92-302, *Can. Gaz. Part II*, Vol. 126, No. 12, p. 2198.

[136] The "reinsurance ratio" mechanism of the former s. 172 of the old Canadian and British Insurance Companies Act enforced this limit. The same mechanism is now contained in the Assets (Property and Casualty Companies) Regulations, *supra*, footnote 133, s. 3(1).

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surprising, given the continued uncertainty surrounding the move to increasing statutory duties for directors and officers on both sides of the border, as well as the uncertainty surrounding the eventual aftermath of the savings and loan debacle in the United States, and similar recession-driven failures in Canada.

The reinsurance regulations should help to ensure that the Canadian liability insurance industry is not as vulnerable to global reinsurance cycles as before, and improved monitoring systems by the government regulators should help to improve performance generally. "Made in Canada" D&O policies, exclusions, limits and premiums, however, will simply have to await the day when there is sufficient Canadian claims experience for underwriters to assess Canadian risks separately.

2. Corporate Governance

Although the policy recommendations developed above may temper wild oscillations in the level of insurance capacity, the status of the Canadian D&O market as a highly specialized, residual liability market will make it difficult to eradicate completely any vestiges of cyclicality in insurance availability. This cyclicality has profound implications for the quality of Canadian corporate governance. As directors become increasingly aware of the risks that are posed to their personal wealth from burgeoning legal liability, their concern with the availability of durable and cost-effective D&O insurance coverage can be expected to increase correspondingly. In this respect, any suggestion that directors will not be able to secure insurance coverage for the expected duration of their service will impact adversely on their decision to serve — making it difficult for Canadian corporations to create boards composed of dynamic, successful business leaders.[137]

But perhaps the greater challenge posed by cyclical insurance availability to the integrity of the Canadian corporate governance model is that prospective board members will agree to serve, but

[137] The Board of Directors Fifth Annual Study in Canada (1991) (Korn/Ferry International) reported, at p. 8, that 67% of surveyed CEOs believe that there is a problem attracting and retaining qualified new directors. The fear of liability for unpaid wages upon insolvency as illustrated by the resignations of directors from troubled Westar Mining Ltd. and Canadian Air Lines International Ltd. is an example of this phenomenon. See R. Daniels and E. Morgan, "Directors face grab-bag of liabilities", *Financial Post*, August 12, 1992, p. 10.

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then insist as a condition of appointment that the companies on whose boards they serve credibly commit to running the corporation in a way that minimizes the prospect of any future legal entanglements by, for instance, reducing the riskiness of the corporation's investment set. In other words, board members would guard against future liability through excessive risk reduction. Doing so, however, may well require violation of the positive net present value rule[138] — the core decision rule for corporate investment activity which states that all projects whose expected benefits exceed their risk adjusted costs be adopted — which would, in turn, imperil the wealth creation function of the corporation.

An alternative but equally objectionable option would be for individuals to accept nominations to corporate boards, but then insist that the boards systematically contract out the risks of board decision making to outside professional advisers. Essentially, by retaining experts to advise the board on discrete matters, the board can claim reliance on this outside advice, and thus transfer some, if not all, of the responsibility of negligent or illegal action to these advisers. Although this delegation alternative has received some modest encouragement from both judicial and regulatory sources,[139] its normative desirability is not uncontroversial. Quite simply, by effecting risk control through risk-shifting strategies, there is a danger that professional advice — which should do no more than provide a foundation upon which directors can make fully informed, rational decisions — will determine rather than merely inform board decisions. The escalation of the professional adviser's role follows quite naturally from the depreciated sense of responsibility of board members once professional advisers are integrated into the decision-making process. And while this role may be applauded in the context of conflict of interest transactions, it is less suitable for the kinds of decisions that must be made in the day-to-day management and oversight of the business and affairs of the corporation. This is especially so given the infirmities of the partnership form (the predominant organizational form for professional advisers in Canada) in relation to risk bearing.[140]

[138] See, generally, S. Ross and R. Westerfield, *Corporate Finance*, (St. Louis, Times Mirror/Mosby College Publishing, 1988), chapter 3.

[139] See *Smith v. Van Gorkom*, *supra*, footnote 88, and OSC Policy 9.1, *supra*, footnote 4.

[140] For a discussion of the defects of the partnership form in permitting law firms to achieve

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In light of the adverse effects of intermittent insurance availability on the quality of corporate governance, Canadian legislatures will be forced to consider more closely their addiction to directorial liability as a gatekeeping device. One suggestion in this direction would be to mimic the lead of Delaware and other American states by permitting shareholders to contract out of liability for the corporate law duty of care.[141] Nevertheless, given the relatively few times that courts in Canada, as elsewhere, have invoked the duty of care as a basis for directorial liability, the actual impact of such a measure on corporate governance would be small indeed. A far more effective legislative strategy would be to initiate an immediate and comprehensive review of the plethora of non-corporate law legislation that imposes liability on directors to determine whether in a setting of periodic insurance scarcity the benefits of liability (in terms of deterrence of corporate wrongdoing) exceed the costs occasioned (in terms of lower quality boards and much more conservative business decision making). If the government fails to undertake this task, it risks throwing out the board with the legislative bathwater.

certain scale economies, see R. Daniels, "Growing Pains: the Why and How of Law Firm Expansion" (1993), 43 U.T.L.J. 147.

141 See, *e.g.*, DEL CODE ANN. tit. 8, ss. 102(b)(7) (Supp. 1986). For a discussion of director exculpation statutes, see J. Hanks, Jr., "Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification" (1988), 43 Business Lawyer 1207; J. Weiss, "The Effect of Director Liability Statutes on Corporate Law and Policy" [Spring 1989] J. Corporation L. 637; and "Note", "Evaluating the New Director Exculpation Statutes" (1988), 73 Cor. L. Rev. 786.

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