

What Went Wrong With Directors' and Officers' Liability Insurance?

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I. INTRODUCTION

Corporate boards are widely perceived as having experienced a severe liability insurance crisis. After several years of expanding coverage and falling prices, starting in late 1984 the market for directors' and officers' (D&O) liability insurance changed dramatically: premiums skyrocketed, deductibles increased, and coverage was reduced.¹ There are reports of directors resigning because their firms had lost insurance coverage and of individuals declining in-

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1. The only data source on directors' and officers' liability insurance is the biannual survey of business organizations published by the Wyatt Company. Its 1985 survey reported for the first quarter of 1985 a premium increase in 93% of D&O policy renewals, for an average premium increase of approximately 190%, and an increase in the corporate deductible in 61% of renewals, for an average deductible increase of about 296%. The Wyatt Co., 1985 Wyatt Directors and Officers Liability Insurance Survey 5 (1985). Of the renewals, 17% experienced coverage reductions and 23% obtained an increase in coverage, with a net reduction in policy limits of 3.5%. In addition, excess capacity levels had even larger premium increases over 1984 levels. *Id.*

vitations to serve on boards in increasing numbers.² In accord with the reported anecdotes is a reversal of a two-decade trend in board composition, as the proportion of outside directors, individuals not employed by the corporation, decreased.³ Management's perception of an insurance problem is further evident in the shift in reasons firms provide for not carrying D&O insurance. In 1984, the most frequently stated reason for not purchasing such insurance was that there was no need for it, whereas in 1987 the main reason was affordability.⁴

The turbulent conditions in the D&O insurance market persisted until mid-1986, when the rate of cost escalation and capacity reduction declined. While many corporations reported having difficulty in securing D&O insurance coverage in 1986, only a small number failed to resolve the problem.⁵ The increased capacity in D&O insurance appears to be due, in part, to the emergence of new institutions, policyholder-formed insurers. In 1986, new policyholder-formed insurers accounted for approximately half of all premiums in the excess D&O insurance market and over one-quarter of the premiums in the primary market.⁶

This article attempts to explain what went wrong in the D&O insurance market. As will be evident, the conclusions are at times tentative, and there are a number of important loose ends. This is because data are quite limited, for D&O liability insurance is not a separate line item. In addition, although there is a superb literature on the tort liability crisis,⁷ little serious attention has been directed to D&O insurance in particular. Further, the analyses of the tort literature are not always applicable in the D&O context. These difficulties are compounded by the fact that the economics of crucial aspects of the insurance market, such as the working of the insurance

2. *E.g.*, Lewin, *Director Insurance Drying Up*, N.Y. Times, Mar. 7, 1986, at D1, col. 2; Baum, *The Job Nobody Wants*, Bus. Wk., Sept. 8, 1986, at 56; Bennett, *Losing Ground? Survey Firms Report Fewer Women Directors*, Wall St. J., July 17, 1987, at 21, col. 4.

3. Baum, *supra* note 2, at 57.

4. The Wyatt Co., 1987 Wyatt Directors and Officers Liability Insurance Survey 55 (1987); The Wyatt Co., 1984 Wyatt Directors and Officers and Fiduciary Liability Survey, Comprehensive Report (1984).

5. 1987 Wyatt Survey, *supra* note 4, at 161.

6. *See id.* at 105-08.

7. *E.g.*, Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521 (1987); Trebilcock, *The Social Insurance-Deterrence Dilemma of Modern North American Tort Law: A Canadian Perspective on the Liability Insurance Crisis*, 24 SAN DIEGO L. REV. 929 (1987).

cycle and the drying up of reinsurance in the recent crisis, are only dimly understood.

The article begins with a sketch of the changing patterns in liability claims against directors⁸ and in D&O liability insurance policy provisions, in order to convey some understanding of the dimensions of the problem. It then examines three institutional factors that became of increasing importance in the 1980s and caused or contributed to the crisis: (1) the relationship between general economic conditions and the risk of directors' liability, (2) the D&O insurance market structure, and (3) the features of the legal system that generate uncertainty in the market for D&O insurance. The policy recommendation is prosaic though important: courts ought to refrain from rewriting D&O insurance contracts. Court decisions in this area have not only often been lawless, but they have also had perverse effects. For although much of what has been termed a "crisis" is simply the ordinary operation of market forces, judicial decisions have unwittingly created impediments to agreement by the parties to a D&O liability insurance contract.

II. THE EXTENT OF THE CRISIS

A. *Trends in Claims Against Directors*

Directors and officers of for-profit corporations face two types of claimants: shareholders who sue either on behalf of the corporation, referred to as a derivative suit, or in their own right; and third parties, such as the corporation's employees, creditors, suppliers, and customers, or government agencies. Directors and officers are liable to shareholders for breaches of their fiduciary duty. This duty has two components: the duty of care, which guards against negligent decisions, and the duty of loyalty, which prohibits certain self-interested transactions. By contrast, in the third party litigation context, the corporation is frequently also a defendant, and there is no conflict between the firm, or its shareholders, and the individual defendants.

Given this difference in defense posture, state indemnification statutes typically differentiate between third party actions and share-

8. The article will refer to "directors" rather than "directors and officers," largely for convenience, but also because the impact of the insurance crisis has been more severe for directors, given that they bear, for the most part, the same risk as officers yet receive far less compensation.

holder derivative suits: in the former category amounts paid in settlements or judgments are reimbursable, while in the latter category indemnification is limited to expenses.⁹ From the shareholder's perspective, there are two standard reasons for directors' indemnification: (1) to ensure that the ablest individuals are employed as directors, since the compensation of a director is small relative to the liability risk; and (2) to ensure that directors take the desired level of risk, as they might otherwise be too cautious for fear of the potential liability for a decision that proves harmful with hindsight.¹⁰ The difference in indemnification treatment provides a powerful incentive for managers to have their firms purchase D&O insurance because the same state corporation codes that impose limits on direct indemnification permit corporations to purchase liability insurance for their directors and officers, which compensates them whether or not they can be indemnified for the loss.¹¹ There are two other potential situations in which insurance is desirable. First, the firm may be unable (as in the case of an insolvent corporation) to provide indemnity. Second, the firm may be unwilling (as in the case of a corporation that has experienced a change in control) to indemnify its directors and officers. The availability of insurance need not lead to an increased level of misconduct: in a competitive insurance market, even if insurers cannot monitor insureds perfectly, they can adjust insurance contract terms and offer partial insurance to mitigate the moral hazard of insurance inducing suboptimal levels of care by insureds.¹²

D&O insurance was introduced in the aftermath of the stock market crash and the enactment of the federal securities laws in the 1930s, in order to protect directors against liability from shareholder suits, when statutory indemnification rights were less express or expansive than under current law. While shareholder claims constitute the largest category of claims against directors, they comprise less than 40% of all claims according to the Wyatt Company Survey (Wyatt Survey), the principal source of information concerning D&O

9. *E.g.*, DEL. CODE ANN. tit. 8, § 145(a) & (b) (1987). In the wake of the recent insurance crisis, some states have done away with the statutory distinction. *E.g.*, MO. ANN. STAT. § 351.355.2 (Vernon 1988).

10. *See* Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L.J. 895, 898-900.

11. *E.g.*, DEL. CODE ANN. tit. 8, § 145(g) (1987).

12. *See generally* Shavell, *On Liability and Insurance*, 13 BELL J. ECON. 120 (1982).

claims and insurance.¹³ The second largest category of claimants, employees, has been increasing over time. This category represented 26% of all 1986 claims, compared to a historic average of 16%. A further recent change is that the proportion of claims filed by customers has almost doubled, with an offsetting decline in the percentage of claims by prior owners of acquired companies. It is possible that the explosion in regulation in areas outside of shareholder-manager relations is having a significant spillover, in the form of the increasing number of nonshareholder claims, upon an insurance policy conceived to address different problems. But it is also possible that these claims do not involve rights under new legal rules and come up under conventional legal doctrines such as fraud.¹⁴

The Wyatt Survey groups claims filed against directors and officers into a large number of categories, such as misleading representations, breaches of employment contracts and duties to minority shareholders, civil rights violations, fraud and antitrust violations. A substantial number of the claims are not, however, classified because they constitute unique types of allegations. Therefore, in the 1987 Wyatt Survey, while there are seventeen separate categories of allegations against directors of nonbank corporations, 17.1% of the allegations still could not be classified.¹⁵ In addition, when claims are grouped according to the circumstances surrounding the allegations, such as impaired employee relationship, acquisition of another company, entering into a contract and going private, the Wyatt Survey could not classify 16.7% of the allegations, despite twenty-seven specified categories of circumstances.¹⁶ For both types of claim classification, type of allegation and circumstances surrounding an allegation, the number and proportion of claims not susceptible

13. 1987 Wyatt Survey, *supra* note 4, at 28. The range from the 1974-1987 surveys is 35-42%, with an average close to 39%. Because the surveys include some corporations that have no shareholders, such as mutual companies, the percentage of shareholder claims for companies with shareholders is understated. The figures on shareholder claims can be adjusted to eliminate from the base claims filed against nonpublic corporations, which include mutuals. The range of the proportion of shareholder claims so adjusted is 41-50% and the average is 45%. But the adjusted figures overstate the proportion of shareholder claims because the corporations in the largest group of nonpublic corporations, closely-held firms, have shareholders, and thus some of the claims excluded from the base may have been brought by shareholders.

14. The Wyatt Surveys do not cross-tabulate information concerning the content of claims with the identity of the claimants.

15. 1987 Wyatt Survey, *supra* note 4, at 31.

16. *Id.* at 36. The percentages for banks are even higher.

to classification increased from 1984 to 1987.¹⁷ The large number of unclassified claims is most likely a testament to creative lawyering. If, however, unclassifiable claims are viewed as an index of unexpected claims because they are unique claims, then their increasing number over the past few years suggests a source of the insurance crisis—increased difficulty in assessing D&O liability risks and therefore difficulty in the pricing of policies, which at a minimum, would raise premiums.¹⁸

In all likelihood, however, the most important impetus for the recent ratchet in D&O insurance premiums is the sheer increase in the number of claims filed against directors. According to one account, the number of suits filed against directors in 1985 increased fourfold over 1984.¹⁹ From 1974 to 1984, the number of companies reporting in the Wyatt Survey that they had experienced a liability claim against a director more than doubled, from 7% to 18% of those surveyed.²⁰

The Wyatt Survey charts the increase in the number of claims by two measures, "claim susceptibility," which is defined as "the probability of a corporation having one or more claims against it in the nine-year experience period" consisting of the nine years preceding the year of the survey, and "claim frequency," which is defined as "the total number of claims per (participating firm) during (that) nine-year interval."²¹ These measures are specially tracked for the largest firms in the survey, those listed in Fortune magazine's top 1000 firms. As the following data indicate, while claim suscep-

17. The 1984 percentages of nonclassifiable claims were 13.9% (nature of allegation) and 12.7% (circumstances surrounding allegations). *Id.* at 31, 36. In earlier surveys, the percentage of unclassified claims was occasionally higher than the 1987 percentage. Because those surveys also had fewer specified categories of claims, it is probable that what were then novel, and hence unique claims, have now become common enough to form additional separate claim classes.

18. Any relation between unclassified claims and the insurance crisis depends on what precisely D&O actuaries consider: in particular, the significance of the claims and whether they occur randomly across firms.

19. Andrews, *Keeping Directors Aboard*, *Venture*, June 1986, at 36, 37.

20. *See* 1984 Wyatt Survey, *supra* note 4, at 22; The Wyatt Co., Wyatt Directors and Officers Liability Survey, at 7.

21. 1987 Wyatt Survey, *supra* note 4, at 11. The figures are adjusted for selection bias among the respondents based upon the first survey year's results. Firms are apparently reluctant to report large claims, and poorly performing firms, which are frequently litigation targets, respond to the survey with less frequency than profitable firms. *Id.*

tibility for this group has steadily increased, claim frequency has increased even more dramatically.²²

<u>Year</u>	<u>Claim Susceptibility</u>	<u>Claim Frequency</u>
1978	20.6%	.306
1980	26.2%	.437
1982	27.4%	.473
1984	32.7%	.633
1986	40.7%	.908

This means that, on the basis of the 1986 data which are derived from claims that were filed in 1977-1985, the probability of a Fortune 1000 company's directors' being sued during the past nine years has been slightly more than 40%. Furthermore, for every ten Fortune 1000 corporations, slightly more than nine claims against directors have been filed over those nine years. The Wyatt Survey goes on to project that one in five Fortune 1000 firms will experience a D&O claim in 1987.²³ Because of inherent problems in the survey data from which D&O claim information is derived, estimating the rate of increase in claim frequency is difficult; the best guess based on the 1986 data is an annual increase for all firms in the range of 10% to 25%.²⁴

Of equal or greater concern to insurers as the increase in claims, is the escalation in claim costs. While less than half the claims against directors are closed with a payment made to the claimant, the number of claims closing with a payment in excess of \$1 million has increased. This has led the Wyatt Survey to conclude that settlement payments are rising over time, while the number of claims closed with no payment has remained fairly constant.²⁵ An additional factor bearing on the cost spiral may be the increasing use of the civil remedies provision of RICO, the federal Racketeer Influenced Corrupt Organizations Act, against directors for fraud. RICO permits plaintiffs to recover treble damages as well as attorneys' fees.²⁶

22. *Id.* at 12. The same trend appears in the earlier Wyatt Surveys, which are not fully comparable as they were based on six-year periods. *See* The Wyatt Co., 1976 Wyatt Directors and Officers Liability and Fiduciary Liability Survey, Complete Report 12 (1976) (comparable data for 1974, 1975, and 1976 surveys).

23. 1987 Wyatt Survey, *supra* note 4, at 12.

24. *Id.* at 13. Besides the selection problems mentioned earlier, *supra* note 17, it is possible that respondents are less likely to remember older claims.

25. 1987 Wyatt Survey, *supra* note 4, at 15-16.

26. Ichel, *Directors' and Officers' Insurance Coverage: An Overview and Current*

The average cost of paid claims in the Wyatt Surveys, excluding legal fees, was \$1,988,200 in 1986, up from \$1,306,000 in 1984 and \$877,361 in 1980.²⁷ The increase is still striking when the figures are deflated to 1967 dollars: average claim costs went up more than 50%.²⁸ As insurers project future losses from present claims, an increase in payouts automatically raises the expected value of future claims, which in turn raises the price of insurance.

Even when there is no payout to a claimant, D&O insurance pays for directors' and officers' legal defense. While the data are sketchy, so that all figures are really best guesstimates, these expenditures have clearly risen. Average defense costs in 1986 were estimated at \$592,000, up from \$461,000 in 1984, \$318,255 in 1980 and \$181,508 in 1974.²⁹ Again, adjusting for inflation mitigates, but does not eliminate, the increase: when these figures are deflated to 1967 dollars, there is still a sizeable 35% rise.³⁰ Because legal fees have outpaced inflation, a comprehensive explanation of the insurance

Problems, reprinted in DIRECTORS' AND OFFICERS' LIABILITY INSURANCE AND SELF INSURANCE 29, 73 (1986). The actual impact on settlement and litigation expenses of adding RICO charges is, unfortunately, unknown.

27. 1987 Wyatt Survey, *supra* note 4, at 19; 1984 Wyatt Survey, *supra* note 4, at 31; The Wyatt Co., 1980 Wyatt Directors and Officers Liability and Fiduciary Liability Survey, Report on U.S. Corporations 27 (1980). Average total claim costs of all claims, including those with no payment and excluding defense costs, increased from \$340,018 in 1980, to \$583,000 in 1984, to \$880,800 in 1986.

28. The Wyatt Survey does not adjust its figures for the effect of inflation. The deflated costs, using the Consumer Price Index (CPI), which takes 1967 as the base year, as reported in the Annual Report of the Council of Economic Advisers to the President (1987), are \$617,070 in 1986, up from \$437,668 in 1984 and \$403,570 in 1980. I used the CPI for the year prior to the stated year, because that is the final year of claims contained in each survey. That is, 1986 costs were deflated by the 1985 CPI. Even these adjustments are inaccurate and overstate the increase because each Wyatt Survey year's costs contain costs paid on claims over a nine-year interval. The figures cannot be further disaggregated to adjust or weight the deflator because surveyed firms are not asked to indicate the year of the payments. Average total claim costs including claims closed with no payment but excluding defense costs, when similarly adjusted for inflation, increased by 75% from 1980 to 1986.

29. 1987 Wyatt Survey, *supra* note 4, at 15. These estimates include the costs of open claims. The average cost of all closed claims, however, is less; for example, for 1986 it is \$338,000. *Id.* at 14.

30. The deflated figures are \$183,737 in 1986, up from \$154,491 in 1984, \$146,391 in 1980 and \$136,370 in 1974. The increase during the 1980s was therefore 26%. See 1987 Annual Report, *supra* note 28. Because the Wyatt figures average claim costs over nine-year intervals, even these deflated figures may overstate the increase.

crisis will require a more complete understanding of the market for legal services.³¹

The upward trend in liability costs is magnified for the largest category of claims, shareholder suits. Although 74% of shareholder claims, an above average proportion for claims against directors, are settled without payment to the claimant, the percentage of shareholder claims with awards over \$500,000, \$1,000,000, and \$5,000,000 is greater than that of other claimants.³² In addition, the costs of defending shareholder suits have not only increased over time,³³ but they also are consistently above the average defense costs of claims against directors.³⁴ While employee suits have become more prevalent, the damages sought and received in such cases, as well as the costs of defending them, are considerably below average. Hence, where personal liability is involved, the single greatest fear of boards is still a shareholder suit.

B. Trends in D&O Policy Forms

D&O policies consist of two parts, a "Company Reimbursement" portion, that reimburses the corporation for legally valid indemnification payments made to directors and officers for covered losses, and a "Directors and Officers Liability" part, that provides personal coverage, reimbursing the individual directors and officers for unindemnified payments. Because most claims come under the corporate reimbursement portion, as claims have increased, corporate reimbursement deductibles have risen over time while personal coverage deductibles have not.³⁵ Corporate deductibles surged upwards recently, for an average increase of 1,326% from 1984 to 1987.³⁶ Personal coverage deductibles, after declining steadily for a decade,

31. See Trebilcock, *supra* note 7, at 941 (excellent discussion of why it is unlikely that an increase in the number of attorneys is a source of the increase in the number of tort claims).

32. 1987 Wyatt Survey, *supra* note 4, at 29. The damages alleged by shareholder claimants are also, on average, higher than those of other claimants.

33. For example, average legal fees per claim with shareholder claimants increased from \$397,060 in the nine-year period covered by the 1984 Wyatt Survey to \$513,409 in the nine-year period covered by the 1987 Wyatt Survey. *Id.* at 30; 1984 Wyatt Survey, *supra* note 4, at 55. Adjusted for inflation, the increase over the two surveys is 20%.

34. 1987 Wyatt Survey, *supra* note 4, at 30 (\$513,409 compared to average legal fees per claim of \$281,684).

35. *Id.* at 76.

36. *Id.* at 75.

have also begun to drift upward, increasing an average of 44% from 1984 to 1987, although the deductible amount is still lower than it was in the 1970s.³⁷ It might appear that individual insureds should favor this trend in deductibles because, unlike the corporate deductible, the personal deductible comes directly from their pockets. This is so because firms do not—and in some cases, given mandatory indemnification statutes, cannot—reduce the amount paid in indemnification by the amount of the corporate deductible. But this ostensible benefit may be more apparent than real. Organizations have many options with which to affect their members' behavior. Just as organizations can increase an individual's income, in visible and less visible ways, to cover the cost of paying the personal deductible, they can also reduce an individual's income to compensate the entity for having paid the corporate deductible.³⁸

Concurrent with the rise in policy deductibles, premiums have gone up, reversing a downward trend of several years. Over 80% of firms renewing policies from mid-1985 through 1986 experienced a premium increase, and over half reported an increase in excess of 200%.³⁹ Of course, the effective rate of premium increase is far greater than this, because new policies have higher deductibles and provide less coverage. Taking 1974 as a premium index base year equaling 100%, the Wyatt Survey computes an index that incorporates deductible levels as well as other factors, such as policy limit and corporate asset size, in determining the premium. Based on this calculation, the average premium index for 1987 was 682.4%, in contrast to a 1984 average of 54.3%.⁴⁰

Coverage has also been restricted by adding exclusions and revising coverage extension provisions. While there have always been exclusions in D&O policies, such as exclusions for losses caused by dishonesty or personal profit, which mitigate obvious moral hazard concerns, the proportion of policies with exclusions, as well as the number of exclusions per policy, have sharply increased. In particular, traditional exclusions, such as exclusions for losses due to pollution, pending and prior litigation, and failure to maintain insurance, were reported as included in D&O policies in 1987 at a

37. *Id.* at 75-76.

38. See generally Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CALIF. L. REV. 1345 (1982) (discussing choice between enterprise and agent liability).

39. 1987 Wyatt Survey, *supra* note 4, at 89.

40. *Id.* at 90-91.

rate approximately double their reported inclusion in policies in effect in 1984.⁴¹ In addition, the newer exclusions for losses due to litigation by an insured against another insured, mergers and acquisitions, tender offer resistance, actions by regulatory agencies, and securities transactions appeared in more than 10% of D&O policies in 1986.⁴² While some of the exclusions, such as the pollution exclusion, are relatively innocuous as they prevent D&O policies from being used as umbrella or substitute general liability policies, others, such as the acquisitions and takeover resistance exclusions, undercut the very rationale for acquiring D&O insurance as they eliminate from coverage shareholder claims that have been a traditional impetus for purchasing insurance.

A further method of restricting coverage, besides the addition of specific exclusions, is reducing the policy's duration. There are two key provisions involving coverage duration in the standard D&O policy: insurer cancellation and extended discovery or extended reporting period clauses. Cancellation provisions, which give the insurer the right to cancel the policy after a specified advance notice period, have not been used in a serious way to limit coverage in the recent crisis. This is reflected in the fact that the percentage of new policies with shorter cancellation notice periods—primarily a period of less than 45 days—is imperceptibly higher than the proportion in the past.⁴³ Rather, significant reductions in coverage have occurred with regard to extended discovery provisions.

Extended discovery provisions extend the period of coverage during which the insured can report claims to the insurer concerning wrongful acts committed during the original policy period, for payment of an additional premium. These provisions can be crucial for the insured because D&O policies are written on a claims-made basis, in contrast to the occurrence basis of general liability policies.⁴⁴ As these provisions often come into play when the insurer has exercised its cancellation right, they protect the insured against a potential gap in coverage that could not arise under an occurrence policy—a

41. *Id.* at 68.

42. *Id.* at 68-69, 73-74.

43. *Id.* at 67, 70.

44. A claims-made policy covers losses for claims that are filed against the insured during the policy period, whereas occurrence insurance covers losses arising out of acts occurring during the policy period even if the policy has expired when the claim is brought. Extended discovery period provisions, thus, move a claims-made policy in the direction of an occurrence policy.

wrongful act occurring during the policy period with no claim having been filed before the policy is terminated.

During the recent crisis, the number of policies with shorter extended discovery periods has been increasing. For instance, 41.2% of new policies had a one-year extended discovery period compared to 56.5% of old policies, while 41.1% of new policies had a 90-day period compared to 29.9% of old policies.⁴⁵ This particular revision is a significant loss of protection for insureds because insurers frequently cancel policies when a claim appears likely. For instance, one-third of directors who submitted D&O insurance claims reported that the insurer tried to cancel the policy or narrow its coverage.⁴⁶ Cancellation under these circumstances creates severe problems for an insured, as a new policy application asks whether the insured knows of any past acts that could produce a claim and then will typically exclude losses from any acts so disclosed.⁴⁷

The final important change in D&O policies during the current crisis is a sharp reduction in policy limits. From early 1985 to mid-1986, an increasing number of companies found their D&O policies renewable only at substantially lower levels of coverage, despite premium and deductible increases. The Wyatt Survey reported an average decrease in policy limits of 50% in the first quarter of 1986.⁴⁸

45. 1987 Wyatt Survey, *supra* note 4, at 71.

46. Scheibla, *A Plague of Lawyers*, Barron's, Nov. 17, 1986, at 38. For examples of particular D&O policy cancellations or attempts to narrow coverage as claims became likely, see Fletcher, *AIG Unit disputes coverage for Seafirst D&O settlement*, Bus. Ins., July 14, 1986, at 2; Taravella, *Insurer sues to void D&O cover of firm facing shareholder suit*, Bus. Ins., Apr. 22, 1985, at 2; Victor, *D&O Canceled and Unocal Sues*, Legal Times, July 29, 1985, at 1.

47. Although in the early 1980s competition for accounts led new entrants to adopt a continuity policy that did not require a new disclosure statement with a switching firm's application, it is inconceivable that the issuer of a new policy in today's circumstances will insure the anticipated loss or not raise charges accordingly. Rundle, *Coverage continuity beckons D&O buyer*, Bus. Ins., Dec. 29, 1980, at 1. For example, Unocal Corp., whose insurance was cancelled when it became a takeover target, was able to replace its cancelled policies but at a substantial cost: (1) payment of a forty-fold increase in the premium; (2) payment of a \$13,000,000 loss reserve to the new insurers (the unused portion to be returned to Unocal); and (3) a promise to indemnify fully the new excess insurer for any claims it paid out under the policy. Third Amended Complaint for Unocal Corp., *Unocal Corp. v. Harbor Insurance Co.*, No. C-550-393 (Cal. Super. Ct. July 2, 1986), reprinted in *DIRECTORS' AND OFFICERS' LIABILITY INSURANCE 1987*, at 319, 324 (1987). When it cancelled the policy, the primary insurer simultaneously offered Unocal a new policy which would not cover losses arising from one of the anticipated events, board resistance to a takeover, for a thirty-fold increase in the premium. *Id.*

48. 1987 Wyatt Survey, *supra* note 4, at 57.

Virtually all insurers remaining in the market cut back their capacity from 1984 to 1986.⁴⁹ By the end of 1986, however, the situation improved somewhat, as newly organized policyholder-formed insurance groups offered increased limits for their members. As a result, there was a net reduction in policy limits of only 10% in the last quarter of 1986 and, on average, the limits were higher than pre-1984 levels.⁵⁰

III. CAUSES OF THE CRISIS

A. Business Conditions and D&O Liability Risks

Business conditions can contribute to the insurance crisis by altering the underlying risk of loss. In particular, the economic environment can encourage transactions or create situations that breed litigation. Conditions in the 1980s were conducive to three major categories of events that have a high correlation with shareholder suits, and hence may partially explain the increase in the number of claims filed against directors: acquisitions, initial public offerings, and bankruptcies.

(1) Merger and acquisition activity appears to occur in waves that crest with buoyant stock prices.⁵¹ The 1980s witnessed one of the largest waves of acquisitions yet, as new financing techniques left no firm too big for a takeover, and revised antitrust merger guidelines adjusted the market share definition, which expanded the number of permissible corporate marriages. A view shared by the bar and the press is that this merger boom is a primary cause of the D&O insurance crisis.⁵² This is because acquisition activities frequently spawn lawsuits against directors by shareholders objecting

49. *Id.* at 167-74; Brown, *Statutory Format of D&O Coverage—Dual Policy Structure and Relationship to Corporate Indemnification*, *THE CRISIS IN DIRECTORS' AND OFFICERS' LIABILITY INSURANCE* 77, 79 (1986).

50. 1987 Wyatt Survey, *supra* note 4, at 57. The higher policy limits were more adversely affected; while in 1984, two respondents indicated limits of over \$215 million, in 1987, the highest reported limit was \$141 million. *Id.* at 59.

51. *E.g.*, R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 722 (2d ed. 1984).

52. *E.g.*, Maher, *MGIC Indemnity Expanding D&O Horizons*, *Nat'l Underwriter* (Life ed.), Nov. 28, 1981, at 2, 17; Lerach & Weiss, *Securities Class Actions and Derivative Litigations Involving Public Companies: A Plaintiff's Perspective on the Supposed Crisis in Directors' and Officers' Liability Insurance*, *THE CRISIS IN DIRECTORS' AND OFFICERS' LIABILITY INSURANCE* 208 (1986).

to the terms of the deal, the disclosure surrounding the deal, or defensive tactics used to thwart the deal. The behavior of insurers lends some support to the contention; applications for insurance inquire into past and future acquisition activity and often carve out exclusions for losses due to acquisitions. Exclusions for resistance to takeovers have been increasingly demanded on renewals, and policies of insureds that become targets have been cancelled. In addition, the leading judicial decisions in corporate law during the 1980s have involved acquisition battles.⁵³

(2) The strong stock market of the 1980s prompted a flurry of public offerings, particularly in the high technology industry. Lawsuits follow if the price of a new issue drops, as investors try to recoup their losses with the aid of the federal securities laws. One commentator attributes the substantial increase in shareholder litigation in 1985 over 1984 to souring public offerings.⁵⁴ Like an increase in merger and acquisition activity, an increase in the pace of initial public offerings can alter the distribution of losses and, therefore, can have some impact on D&O insurance rates.

(3) The final important environmental condition spurring litigation in the 1980s is more immediately related to economic performance. Over the past several years, there has been a rash of business failures, primarily among oil companies and banks, especially banks with a high proportion of energy loans in their portfolio. The increasing number of bankruptcies is of concern to D&O insurers because directors and officers of bankrupt firms are often sued by bankruptcy trustees and shareholders in an attempt to locate cash. Moreover, the Federal Deposit Insurance Company has been suing bank directors to tap the failed institutions' D&O insurance. The litigation-prone condition of an insolvent entity explains why the most desirable risk is said to be a company "in sound financial condition with a good earnings record."⁵⁵ Insurance applications

53. For example, over half of the cases in the most recent supplements to corporate law casebooks involve acquisition transactions. *E.g.*, W. CARY & M. EISENBERG, *CORPORATIONS, CASES AND MATERIALS* (5th ed. Supp. 1987); L. SOLOMON, D. SCHWARTZ & J. BAUMAN, *CORPORATIONS LAW AND POLICY MATERIALS AND PROBLEMS* (Supp. 1986). Because the Wyatt Survey only began classifying claims by circumstances in 1980, those data cannot be used to trace whether claims involving acquisitions, public offerings, or bankruptcies have increased in the 1980s.

54. Andrews, *supra* note 19, at 37 (discussing how high-tech companies enjoyed a boom of hot issues but then suffered through a bust and several lawsuits).

55. Hinsey, Delancey, Stahl & Kramer, *What Existing D&O Policies Cover*, 27 *Bus. Law.* 147, 155 (1972) (comments of Vincent Stahl).

require the submission of financial statements; rates are correlated with profitability, as companies with prior losses pay substantially higher premiums.⁵⁶ Although the entire market has been affected, banks have experienced particular difficulty in obtaining D&O insurance during the recent crisis.⁵⁷

By changing the distribution of D&O liability risk, business conditions in the 1980s can explain some aspects of the D&O insurance crisis, especially the large premium increases. However, they do not provide a complete explanation because they do not explain capacity constraints and the exit of insurers from the market. This is because product withdrawal suggests that risks are perceived to be uninsurable. Losses from a rising number of bankruptcies, acquisitions, or public offerings are, however, within the realm of the predictable and can be handled by rate adjustments. Moreover, since some of the environmental factors increasing the number of lawsuits have an important industry-specific component, it is puzzling that the crisis has been felt so widely across the market. However, to the extent that all firms are affected by these factors, the increased liability risks will not be independent. A dependency in insureds' losses disrupts insurance markets because the law of large numbers will no longer apply for pricing risks, so that premiums will be greater than expected losses.⁵⁸

B. Market Structure Considerations

One explanation for rising premiums and capacity restrictions that has been offered in the literature on the general liability insurance crisis is collusion among insurers. Conspiracy theories have been especially popular because the insurance industry is exempt from antitrust laws. Although in the early 1960s Lloyd's of London provided the only market for D&O insurance, the line is more competitive now. Nevertheless, D&O insurance is still a highly specialized product offered by a limited number of companies in comparison to

56. E.g., 1980 Wyatt Survey, *supra* note 27, at 63-64.

57. Jennings, *D&O Market Dries Up for Bankers*, Nat'l Underwriter (property & casualty insurance ed.), Aug. 15, 1986, at 4; Schares, *Banking: Directors Resigning Over Lost Insurance*, San Francisco Chronicle, Sept. 9, 1985, at 23, col. 8.

58. *But cf.* R. Winter, "Crises" in *Competitive Insurance Markets*, Hoover Inst. of Stan. U. Working Papers in Econ., No. E-86-74, at 4 (Dec. 1986) (arguing dependent risks, that is, nondiversifiability in the insurance market, should not matter in a stock market economy because insurers could diversify those risks in the capital market).

other insurance lines. The most recent Wyatt Survey identified less than fifty providers, and their capacity and activity in the market vary greatly. Tallies of the major active D&O insurers range between six and eighteen.⁵⁹

Some sense of the concentration in the D&O insurance industry, hence the potential for collusion, can be derived from the Wyatt Survey data on market shares. I computed several estimates of the primary concentration measures (the Herfindahl-Hirschman index⁶⁰ and four- and eight-firm concentration ratios) by using two computations of market share (number of policies written and premium dollar volume) and two separate markets (primary and excess insurance). The industry's Herfindahl-Hirschman index is generally quite low, ranging from 900 for excess insurance by number of accounts to 1600 for primary insurance by number of accounts, 1100 for excess insurance by premium volume and 2500 for primary insurance by premium volume. Under the Justice Department's revised merger guidelines such a market is on average in the classification of moderately concentrated.⁶¹ This suggests that collusion is unlikely. However, the four-firm concentration ratios are high, ranging between 52% for excess insurance by number of accounts, 70% for primary insurance by number of accounts, 59% for excess insurance by premium volume, and 85% for primary insurance by premium volume.⁶² These estimates are not inconsistent: the market

59. Brown, *supra* note 49, at 79 (nine principal companies); Goldwasser, *Directors and Officers Liability Insurance: An Overview*, in *DIRECTORS' AND OFFICERS' LIABILITY INSURANCE AND SELF INSURANCE* 11, 15 (1986) (only six companies offering coverage on general basis in U.S.); Middleton, *A Broker's View of the Directors' and Officers' Market and Placing Risks*, in *DIRECTORS' AND OFFICERS' LIABILITY INSURANCE AND SELF INSURANCE* 429, 437-41 (1986) (listing 18 companies).

60. See F. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 56-59 (2d ed. 1980) (discussion of the measure).

61. Department of Justice, Antitrust Division Merger Guidelines, 47 Fed. Reg. 28,493 (1982), *reprinted in* 71 CALIF. L. REV. 649, 655-57 (1983) (market with index under 1000 is unconcentrated, but between 1000 and 1800 is moderately concentrated).

62. Under the 1968 merger guidelines which looked at market concentration ratios, four-firm ratios of 75% were frequently a cut-off point under the most stringent scrutiny, and hence a challenge to mergers. As noted in the new merger guidelines, a market with a Herfindahl-Hirschman index in the moderately concentrated range corresponds to a market with a four-firm concentration ratio of between 50% and 70%. *Id.* The eight-firm concentration ratios are 86% for primary insurance by number of accounts, 75% for excess insurance by number of accounts, 93% for primary insurance by premium volume and 81% for excess insurance by premium volume.

contains several firms with infinitesimal market shares and a few firms with large, but relatively equal, shares.

Of at least equal importance to share data in assessing competitiveness is the stability of market shares. While concentration ratios are a static measure of market structure, turnover among top firms suggests dynamic competition that concentration ratios may obscure.⁶³ There have been dramatic shifts in D&O insurance market shares in recent years. Eight insurers that were ranked in the top ten by number of accounts between 1975-1984 had left the market by 1985.⁶⁴ Chubb Group, which is currently the second largest insurer by number of accounts and third largest by premium volume, was not present in the D&O market in 1980, and two of the newly formed policyholder insurers are among the top four firms measured by premium volume and the top eight firms measured by number of accounts. In addition, in 1987 two major commercial insurers began writing D&O insurance. Despite the high concentration ratios, when the relatively low Herfindahl-Hirschman index and the fluidity in entrance, exit and market shares are considered together, the resulting picture is most consistent with competition.

The data on mobility in market position and concentration measures for D&O insurance do not indicate the degree of competitiveness of the reinsurance market, although reinsurance is a critical factor for D&O rates because most D&O insurance is re-insured. Reinsurers are the traditional source for insurers not only to spread risk but also to reduce reserve requirements attributable to new business from the required maintenance of a specified premium-to-surplus ratio.⁶⁵ In fact, American competition in D&O insurance with the London market was initiated in the 1970s with the aid of aggressive European reinsurers: reinsurance enabled American

63. SCHERER, *supra* note 60, at 73-74.

64. 1987 Wyatt Survey, *supra* note 4, at 106.

65. J. ATHEARN & S. PRITCHETT, *RISK AND INSURANCE* 57-58 (5th ed. 1984). Insurance companies are required to maintain a specified premium-to-surplus ratio. This ratio affects the amount of new business that can be written because it requires an increase in reserves to correspond to additional premiums. *E.g.*, Loomis, *Naked Came the Insurance Buyer*, *Fortune*, June 10, 1985, at 68. Issuing a new policy adds more to liabilities than assets because all the expenses are incurred immediately while the revenues are spread out as earned. In addition, the reserve requirement does not make allowance for that practice. Consequently, there is a short-run drain of surplus which raises the premium-to-surplus ratio and impairs the capital of the growing firm.

companies with no D&O claim experience to enter the field and offer substantial limits, for only modest exposure.⁶⁶

This linkage of D&O insurance with the reinsurance market contributed to the D&O crisis. In the mid-1980s, as reinsurers absorbed substantial losses, the worldwide reinsurance market tightened. Because D&O reinsurance is facultative, whereby each policy is separately and specially negotiated with a reinsurer, it is particularly susceptible to changes in the reinsurance market since the ceding insurer cannot bind coverage until the reinsurance is arranged.⁶⁷ Delay in this costly negotiation process, therefore, disadvantages the ceding company, while the reinsurer can use this as leverage for limiting which policies it must accept to retain the business. On their 1985 renewals, American insurers could no longer obtain inexpensive reinsurance. As a direct consequence, at the same time that they were forced to retain more units of risk, they reduced their D&O capacity.

The apparent capacity constraint produced by a reduced availability of reinsurance is one of the more puzzling aspects of the D&O insurance crisis. Conventionally, markets are expected to adjust by changes in a product's price and not its withdrawal. That is, it would be reasonable to expect that 1984 D&O policies, with their higher limits, would be available but more expensive in 1986. Yet in D&O, as well as other professional liability insurance, desired terms of coverage—and for some firms any coverage—became unavailable, at apparently any price.

Given that the input for insurance is wealth and not the physical capital of a factory which could have productive capacity limits, a capacity constraint story seems intuitively implausible. For such a story to be compelling there must be a barrier preventing the entry of new insurers or reinsurers. Some attribute the capacity problem to regulation, and in particular, the required premium-to-surplus ratio. Under this scenario, insurers do not write all the business demanded and drop the riskier lines, such as D&O, in order to avoid the required increase in reserves to match the increase in premiums. But the absence of data on the frequency of firms pushing up against that constraint⁶⁸ and the shifting market shares and turn-

66. See, e.g., Middleton, *supra* note 59, at 431.

67. Webb, *Reinsurance as a Social Tool*, ISSUES IN INSURANCE 207, 211 (J. Long, 2d ed. 1981).

68. See Priest, *supra* note 7, at 1531.

over in the D&O insurance market suggest that there is no such barrier.

Although it is possible that entry into the D&O reinsurance market is particularly expensive, it is difficult to imagine what aspect of the business would create such a bar, especially since reinsurers are subject to far less regulation than insurers. In markets where a firm's reputation is important, the cost of developing a reputation creates a barrier to new entrants. While it might appear that insureds would be concerned about their insurer's solvency so that reputation would matter, the turnover in D&O market shares suggests that reputation is not crucial for this market, and there is no powerful reason for concluding that the reinsurance market is any different. Indeed, regulation and private rating services reduce entry costs and make reputations less necessary, in general, for the insurance market. Furthermore, the purchasers of reinsurance—insurers—are presumably more informed about the product they are purchasing than the buyers of insurance, which further limits the importance of reputation. Given the fruitlessness of this line of analysis, it is possible that we are operating under a false impression that there was a capacity constraint and that, instead, firms were simply unwilling to pay the higher premiums necessary to induce insurers to supply coverage.

A market structure explanation of the D&O insurance crisis that is more plausible than a collusion thesis and is in keeping with the evidence of easy entry of firms is that the crisis was simply the peak of a competitive cycle. Insurance cycles have been charted for many lines, in many countries, and have been thought by some to be the cause of the general liability insurance crisis.⁶⁹ According to this thesis, the D&O cycle started in the late 1970s when prices were high. This induced new entrants to appear on the scene in the 1980s. As they competed for business, prices dropped. At the same time, interest rates were rising so insurers, the theory goes, were willing to price policies below cost (the expected loss) to obtain more premium

69. See generally N. Doherty & H. Kang, *Price Instability for a Financial Intermediary: Interest Rates and Insurance Price Cycles*, Center for Research on Risk and Insurance, Wharton School, Univ. of Penn. Working Paper No. 87-1; J. Cummins & J. Outreville, *An International Analysis of Underwriting Cycles in Property-Liability Insurance*, Center for Research on Risk and Insurance, Wharton School, Univ. of Penn. Working Paper No. 86-7. See also Priest, *supra* note 7, at 1529-32 (discussing Cuomo Commission's report and the general use of cycle theories to explain tort liability crisis).

dollars to invest at the higher rates. In 1984, interest rates declined, and low-premium D&O policies became unprofitable. As a result, some insurers left the market; those remaining raised their prices. Hence we have the characteristics defining the crisis—rising premiums and shrinking capacity—and a full cycle defined from peak to peak.⁷⁰ Lured by higher prices, new entrants arrived in late 1986, and the rate of price increase slowed, presaging the cycle phase of lower prices.

Cycle explanations typically treat the period of low premiums, such as 1982-1984 for D&O insurance, as involving a deliberate underpricing of risks, and the period of higher prices as a realignment in accord with cost. A cycle explanation also typically assumes that losses are unaffected when interest rates change: as the insurance premium equals the discounted value of the expected losses, when interest rates rise, the premium is lowered, if the expected loss remains constant. If a significant part of the rise in interest rates is caused by inflation, then it would follow that losses will increase as well, and premiums would not decline. But as long as the increase in expected payout is not identical to the increase in invested earnings, an inverse relationship between interest rates and premiums will hold.

Still, casual empiricism suggests that a cycle explanation cannot explain the full magnitude of D&O premium increases during the recent crisis. Real interest rates have been at historic highs throughout the 1980s, including 1984-1985, the years the crisis began, and while the real rate was lower in 1985 than in 1984, it was also lower in 1983 than in 1982.⁷¹ Moreover, payments on D&O claims increased throughout the 1980s, and they increased faster than did inflation. Both of these facts are inconsistent with a cycle explanation of D&O insurance price shifts. In addition, the incentive created by high interest rates for insurers to lower premiums and to increase accounts written is more powerful for writers of occurrence, rather than claims-made, policies. This is because the time between receipt of the premium and payment of a claim is substantially shorter under a claims-made than an occurrence policy, and the shorter interval reduces the investment income that will be earned on the premium before a claim is paid. In all likelihood, interest rate changes have

70. See Priest, *supra* note 7, at 1529-30.

71. R. IBBOTSON & G. BRINSON, INVESTMENT MARKETS: GAINING THE PERFORMANCE ADVANTAGE 130-32 (1987).

had some effect on D&O insurance prices since there is still a gap between receipts and payouts under claims-made policies.⁷² But, given the high real interest rate throughout the 1980s, it is improbable that the receipt-payout gap for D&O insurance could be responsible for the entire reported increase in premiums.

C. Legal Considerations

1. Substantive Corporate Law Doctrine

The most persuasive explanation of the crisis in general liability insurance emphasizes changes in tort doctrines of liability and damage recovery.⁷³ Such an explanation is not directly applicable to D&O insurance, for the substantive doctrine concerning the largest and most expensive category of D&O claims, shareholder claims, has not undergone radical expansion or even major change since the 1970s.

Firms began to purchase D&O insurance on a widespread basis toward the end of the 1960s. The best available data are that in 1965 less than 10% of corporations carried D&O insurance, whereas by 1971, 70-80% of major corporations purchased it.⁷⁴ In addition, the amount of insurance written went from an insignificant figure in 1963 to over \$1 billion in 1968.⁷⁵ At the time of the boom in insurance coverage, director liability rules were in flux. In 1968, two important decisions held directors and officers liable for violating federal securities laws.⁷⁶ These decisions were thought to herald a new era of D&O liability, where even defendants who had not personally profited from the transactions could be held liable.⁷⁷

72. According to one account, the average time to settle a D&O claim is 6.6 years. Scheibla, *supra* note 46, at 38. The average claim age in the Wyatt Surveys ranged from 4 to 5 years.

73. Priest, *supra* note 7, at 1523. See also U.S. Dep't 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 60-75 (1986).

74. Diehlmann, Stahl & Wallace, *Insurance*, reprinted in PROTECTING THE CORPORATE OFFICER AND DIRECTOR FROM LIABILITY 89, 193-94 (2d ed. 1971); *A Shield Against Stockholder Suits*, Bus. Wk., July 2, 1966, at 56.

75. *The Law: Trouble for the Top*, Forbes, Sept. 1, 1968, at 23.

76. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); Escott v. Barchris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

77. See, e.g., Memorandum of Machinery and Allied Products Institute, Directors' and Officers' Liability Insurance . . . Some Management Considerations at 5-6 (1969); *The Law: Trouble for the Top*, *supra* note 75, at 22-23, 27, 29, 32;

The projections by commentators concerning the sweep of *Texas Gulf Sulphur* proved to be accurate: in succeeding years, D&O liability was expanded under the federal securities laws, largely through suits extending the coverage of rule 10b-5 under section 10(b) of the Securities Exchange Act of 1934. *Barchris*, on the other hand, remained more an "instructive cautionary tale"⁷⁸ than a progenitor of increased liability under section 11 of the Securities Act of 1933. In addition, the Federal Rules of Civil Procedure for class actions were liberalized in 1966, and courts extended that approach by interpreting the rules sympathetically to plaintiffs in securities cases, further facilitating claims against directors.⁷⁹ While D&O premiums rose with the increasing liability risk,⁸⁰ the increase was not as steep as that of the 1980s, and the market was apparently not perceived to be in a state of crisis.

The trend of expanding liability was reversed, however, by the mid-1970s with a line of Supreme Court rulings cutting back the reach of the federal securities laws.⁸¹ In addition, federal courts became less accommodating to class action and derivative suits.⁸² This contraction in the scope of D&O liability under the securities laws has shown few signs of abatement in the 1980s.⁸³

Johnston, *Directors' and Officers' and Related Forms of Liability Insurance*, reprinted in 5 SECURITIES LAW TECHNIQUES: TRANSACTIONS, LITIGATION 122-1, -5 (1988) (growth of demand for D&O insurance due to litigation explosion beginning in 1960s with expansion of class action remedies, liberalization of class action rules, increased SEC enforcement, and proliferation of damage actions after *Texas Gulf Sulphur* decision). A second important and concurrent development that also led to the increase in insured firms was the heightened competition caused by the entrance of American companies into the previously London-dominated market. Stahl, *supra* note 55, at 156.

78. The phrase is Robert Clark's. R. CLARK, CORPORATE LAW 746 (1986).

79. Lerach & Weiss, *supra* note 52, at 145, 171.

80. Knepper, *Defense Memo, Liability Insurance for Corporate Directors and Officers*, 13 FOR THE DEFENSE 5, 6 (Jan. 1972); Diehlmann, Stahl & Wallace, *supra* note 74, at 124-26.

81. *Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977) (claims alleging breach of fiduciary duty or unfairness not actionable under federal securities laws); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (scienter requirement for liability for damages under rule 10b-5); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975) (standing restricted to actual purchasers or sellers).

82. For example, courts read the federal procedural rules more restrictively against plaintiffs, as in the adoption of a strict fraud pleading requirement. Lerach & Weiss, *supra* note 52, at 171-76.

83. *E.g.*, *Schreiber v. Burlington N., Inc.*, 472 U.S. 1 (1985) (scienter required for 14(e) violation, which involves takeover litigation); Lerach & Weiss, *supra* note 52, at 177-83 (detailing decisions chilling derivative and class actions in federal courts in the 1980s).

State fiduciary doctrines have also experienced little change during the past two decades. If there has been any doctrinal movement at the state level, it has also been to contract the scope of liability. For example, at the turn of the century, self-interested transactions were voidable at will by shareholders, regardless of the terms. But by 1910, self-interested transactions were generally valid unless a court found them unfair. Statutes enacted in virtually all the states since the 1960s prescribe procedures, such as the informed approval of a disinterested board, that can preclude a fairness review.⁸⁴ In addition, the business judgment rule, which gives directors who are informed and act in good faith the benefit of the doubt for their decisions, has been steadfastly applied in duty of care cases.⁸⁵ Further, in a recent innovation, special litigation committees, which are appointed by the board, have been permitted to terminate derivative suits.⁸⁶

The one important case arguably expanding directors' liability for negligence over the past two decades, *Smith v. Van Gorkom*,⁸⁷ in which the Delaware Supreme Court found directors grossly negligent in accepting a bid for their firm, was decided in 1985 after the insurance crisis was well under way. The business judgment rule was not rejected in *Van Gorkom* but was held inoperative because the directors were found to have not properly informed themselves con-

84. CLARK, *supra* note 78, at 160.

85. Delaware courts have recently modified the burden of proof of the business judgment rule for cases involving management's use of defensive tactics to thwart hostile takeovers. To be able to maintain the presumption of good faith against the plaintiff, the defending board must first show that its actions were reasonable in relation to the threat posed by the bidder. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985). This nuance of difference has proved easy for boards to satisfy. The only major case in which a board has failed to meet the burden involved approval of a lockup favoring the incumbent management's competing bid, a transaction in the self-interest of board members besides the defendants, and of associates of the defendants. *See Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986). This crucial factor, a self-interested transaction approved or permitted by independent directors, has been present in all of the very rare cases in which directors have ever been held liable under the ordinary operation of the business judgment rule and the duty of care. *See, e.g., Phillips, Principles of Corporate Governance: A Critique of Part IV*, 52 GEO. WASH. L. REV. 653, 692-98 (1984).

86. *Burks v. Lasker*, 441 U.S. 471 (1979); *Auerbach v. Bennett*, 47 N.Y. 2d 619, 393 N.E.2d 994, 419 N.Y.S. 2d 920 (N.Y. 1979). Delaware allows greater judicial review of the decision of such committees than other states. *See Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

87. 488 A.2d 858 (Del. 1985).

cerning the firm's value. The court further indicated that if specific procedures had been followed, such as obtaining an investment banker's fairness opinion, there would have been no liability.⁸⁸ Given such a procedural safe harbor, which is not wildly in conflict with standard business practice, the opinion is not a scandalous harbinger of increased exposure. Quite to the contrary, the decision arguably lowered the standard of conduct by defining breaches of the duty of care in terms of "gross" rather than "ordinary" negligence.⁸⁹

Changing the liability standard is not, however, the sole method by which a legal system can produce uncertainty and thereby disrupt insurance markets by making loss prediction difficult. The application of a liability standard can also be a source of uncertainty. When there is uncertainty over the standard—that is, when there is a changing standard—settled law that did not previously create a liability might now do so. When there is uncertainty over how a standard is applied, the problem is just as severe for affected parties as in the case of a changing standard because it is equally difficult to predict what a court will do. Moreover, an environment of extensive transactional innovation can produce serious doctrinal uncertainty even though the relevant liability standard has not changed, for the outcomes of the many cases of first impression generated by the novel transactions will be particularly difficult to predict when the application of a standard is in flux.

The *Van Gorkom* decision illustrates how uncertainty in the legal system can take different forms. There was a strong, critical reaction to the decision by boards, commentators and the Delaware legislature.⁹⁰ Yet, as discussed earlier, it is quite plausible to maintain that the decision did not alter any substantive liability rule. In fact, the focus of debate among commentators concerned how the law had been *applied*, and not the location of the standard of care: did the facts evidence gross negligence by the board or ordinary negligence that in the past was found to constitute nonnegligent behavior? The

88. *Id.* at 881.

89. *Id.* at 889.

90. *E.g.*, Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 *BUS. LAW.* 1437, 1453-55 (1985); Schatz, *Focus on Corporate Boards: Directors Feel the Legal Heat*, *N.Y. Times*, Dec. 15, 1985, at F12, col. 3 (*Van Gorkom* a "topic of fervent discussion among directors"); Note, *1986 Ohio Corporation Amendments: Expanding the Scope of Director Immunity*, 56 *U. CIN. L. REV.* 663, 667-68 (1987) (Delaware statute permitting shareholders to eliminate directors' liability for monetary damages for negligence was a legislative reaction to *Van Gorkom*).

reaction to *Van Gorkom* suggests the decision created uncertainty concerning how the liability standard would be applied. The effect on litigants is the same as that of an uncertain standard, difficulty in predicting case outcomes. 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. An increase in uncertainty should not be of moment to insurers, who, unlike insureds, are risk neutral and concerned with an increase in the expected value of a loss rather than an increase in its variability. However, 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 this 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.

2. Insurance Contract Construction

The problem confronting D&O insurers in assessing the risks of unanticipated, novel lawsuits is exacerbated by court rulings on insurance contracts which are all too often, to be blunt, lawless. In their reading of D&O insurance contracts, courts frequently rewrite the allocation of risk against the insurer. Insurers have had, for example, to pay defense costs as incurred, even though the action may not be covered by the policy, the insured refuses to respect the insurer's reservation of rights, and the policy explicitly gives the insurer the option to make defense advances.⁹¹ Insurers have not been permitted to litigate the applicability of the dishonesty exclusion when the underlying action has been settled without an adjudication of guilt.⁹² They have also not been permitted to exercise their cancellation rights when the insured is bankrupt.⁹³ Related transactions

91. *Okada v. MGIC Indemnity Corp.*, 795 F.2d 1450 (9th Cir. 1986); *Pepsico, Inc. v. Continental Casualty Co.*, 640 F. Supp. 656 (S.D.N.Y. 1986).

92. *Pepsico, Inc. v. Continental Casualty Co.*, 640 F. Supp. 656 (S.D.N.Y. 1986).

93. *Minoco Group v. First State Underwriters Agency*, 799 F.2d 517 (9th Cir. 1986).

have been found to constitute "separate loss occurrences," increasing the liability of the insurer,⁹⁴ and knowing misrepresentations in financial statements have been held not to void policies because the documents were not explicitly incorporated by reference in the policy application's cognizance warranty.⁹⁵ In addition, insurers have been held liable for losses arising from suits involving an outside directorship—an insured individual serving on the board of a company different from the insured corporation—when the policy was silent on the issue.⁹⁶ The two notable decisions favorable to insurers have permitted the voiding of a policy as to all insureds when there has been a material misrepresentation in the application process.⁹⁷

Courts have also construed D&O policies as placing the risk of all new perils on insurers. The recent spate of cases in which banks have directly sued officers and directors for negligently approving what with hindsight were bad loans, in order to recover upon the D&O insurance policy, illustrates this tendency.⁹⁸ Such claims could not have been anticipated by insurers because a corporation suing its employees for negligence was theretofore unthinkable. Yet in *National Union Fire Insurance Co. v. Seafirst Corp.*,⁹⁹ the court cavalierly rejected the insurer's contention that its D&O policy was not intended to cover such a claim by citing the policy language that the insurer would pay losses suffered as a result of "any" claims against directors.

The corporate strategy followed in the bank cases, when successful, converts what is priced as third-party insurance into first-party insurance, because the corporation can trigger a payment to itself by suing its employees. A corporation suing its own employees has access to far more records and information than the typical shareholder-plaintiff, making a defense more difficult.¹⁰⁰ The action

94. *Okada v. MGIC Indemnity Corp.*, 795 F.2d 1450 (9th Cir. 1986); *North River Ins. Co. v. Huff*, 628 F. Supp. 1129 (D. Kan. 1985).

95. *Federal Ins. Co. v. Oak Indus.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,519 (S.D. Cal. Feb. 3, 1986); *National Union Fire Ins. Co. v. Continental Ill. Corp.*, 673 F. Supp. 267 (N.D. Ill. 1986).

96. *Continental Copper & Steel Indus. v. Johnson*, 491 F. Supp. 360 (S.D.N.Y. 1980), *aff'd*, 641 F.2d 59 (2d Cir. 1981).

97. *Shapiro v. American Home Assurance Co.*, 584 F. Supp. 1245 (D. Mass. 1984); *Bird v. Penn Central Co.*, 341 F. Supp. 291 (E.D. Pa. 1972).

98. *E.g.*, *Complaint in Bank of Am. v. Powers*, No. C 536-776 (Cal. Super. Ct. filed Mar. 1, 1985), *reprinted in DIRECTORS' AND OFFICERS' LIABILITY INSURANCE AND SELF INSURANCE* 115, 116 (1986).

99. No. C85-396R (W.D. Wash. Mar. 19, 1986), *reprinted in DIRECTORS' AND OFFICERS' LIABILITY INSURANCE* 1987, at 307 (1987).

100. *See Labich, Showdown Over Insuring Corporate Officers*, *Fortune*, Dec. 9, 1985, at 70.

shifts the cumulative probability distribution of losses to the right; the probability of a loss—that is, of the plaintiff's success—is higher than before at every point. Moreover, the liability on such claims has been substantial: Chase Manhattan settled a \$175 million claim for \$32.5 million covered by insurance; Bank of America settled a \$95 million claim for an \$8.2 million payment from insurers; and Seafirst Corporation entered into a \$110 million settlement with its directors and officers limiting recovery to its \$70 million remaining policy limits.¹⁰¹ The inevitable consequence of such litigation is higher insurance premiums.

This judicial approach to D&O insurance contracts also magnifies moral hazard and adverse selection problems. Liability arising out of novel D&O litigation is being borne by the insurer although the insured is often better informed about such risks and some of these risks are within the insured's control. This situation may be one of the reasons for the rise in policyholder-formed insurers: the adverse selection and moral hazard problems created by the information asymmetry between insured and insurer will obviously be remedied if the insured becomes the insurer. It is plausible, in this context, to anticipate that policyholder-formed insurance groups could screen members more effectively than commercial insurers.

The *Seafirst* decision may simply be an example of special judicial solicitude for banks and their customers, an inclination that has been exhibited in corporate law decisions on directors' liability for negligence.¹⁰² Insurance companies have not, however, viewed the de-

101. *Id.* (Chase Manhattan settlement); *BankAmerica's Settlements*, N.Y. Times, Jan. 5, 1988, at D4, col. 5. See also *National Union Fire Ins. v. Seafirst Corp.*, 662 F. Supp. 36 (W.D. Wash. 1986) (the primary insurer paid \$15 million in addition to paying \$5 million in defense costs, while the excess insurer is contesting paying its \$55 million share). Bank of America settled related shareholder litigation with payments from its D&O insurers totaling \$60.4 million. Waldman, *BankAmerica Settles Suits Tied to Losses, Posts Gain on Sale of Bank-Firm Stake*, Wall St. J., Jan. 5, 1988, at 12, col. 2.

102. See Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1095-96 (1968). Of course, given the existence of federal deposit insurance, current concerns for bank depositors are superfluous, except to the extent that any recovery reduces the costs of operating the insurance system and therefore reduces the depositor's costs. In support of applying a higher standard of conduct to bank directors, it should be noted that shareholders in financial corporations may have need for greater protection than shareholders in manufacturing firms, because the liquidity, and hence redeployability, of the corporate assets may make misappropriation of assets by management easier to undertake, yet far harder to detect.

cision as a ruling limited to banks. Many new D&O policies, of both nonfinancial and financial corporations, include an exclusion for lawsuits brought by one insured against another insured, as insurers seek to limit their exposure under *Seafirst*.¹⁰³ This reaction by insurers exemplifies George Priest's thesis that insurers use exclusions to control adverse selection problems produced by court decisions expanding liability, and that the decisions, which are intended to compensate victims more fully, tend to have the opposite effect.¹⁰⁴ This is because the solution D&O insurers implemented to eliminate the exposure of *Seafirst* is not precisely tailored to the problem and has thus resulted in a decrease in available insurance. The typical wording of the new insured exclusion is broad, applying as well to what are ordinarily considered to be legitimately insurable losses, such as derivative suits and suits brought by a terminated officer who feels wronged by the board.¹⁰⁵ The failure of a policy to cover derivative suits particularly limits its value because indemnification is generally not permitted for payments in those suits. This means that not only will recoveries by future plaintiffs be smaller but there will also be fewer of them because they are typically paid only out of insurance proceeds.¹⁰⁶

Decisions such as *Seafirst* further contribute to the insurance crisis by placing insurers in a dilemma. Insurers may not be able

103. In 1987, 41% of bank, financial and leasing company D&O policies contained such a provision, which is substantially higher than the survey average of 29%, but several other industries were not far behind the banks: publishing and communications, 38%; petroleum, 38%; construction and real estate, 38%; utilities 34%. 1987 Wyatt Survey, *supra* note 4, at 73.

104. Priest, *supra* note 7, at 1574-75. The source of the judicial problem in D&O liability, however, is not a change in substantive doctrine as in Priest's context of general tort liability, but rather it is a matter of insurance contract construction.

105. 1987 Wyatt Survey, *supra* note 4, at 69. A small number of policies (3%) attempt to remedy this problem by excepting derivative suits from the exclusion. *Id.* at 39. There is, however, no easy solution to the drafting quagmire. If the corporation does not take direct action against directors and officers, a shareholder can bring a derivative suit and the corporation need not vigorously oppose its prosecution. *Cf.* National Union Ins. v. Seafirst Corp., 662 F. Supp. 36 (W.D. Wash. 1986) (insurer challenging bank's "collusive" settlement of derivative suit).

106. Settlements may even expressly limit the plaintiffs' recovery to amounts equal to the corporation's D&O policies' limits, and some even provide for payment only to the extent the company recovers on its policies. There are numerous incentives for plaintiffs, as well as defendants, to settle and make the insurer pay. *See* Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5 (1985) (thorough discussion of the strong incentives to settle in derivative litigation).

to delimit their exposure by writing more detailed policies that specify what risks are covered because courts typically construe exclusions narrowly just as they construe coverage provisions broadly. The judicial provision of a safety net for insureds is a well intentioned, but misguided use of the insurance law maxim that ambiguity in a contract is construed against the drafter.¹⁰⁷ This rule of construction is sensible when the contract is a standard form and the party who drafted it has superior and cheaper access to information. However, these concerns are not present in the D&O context where the purchasing corporations employ professional brokers to negotiate particularized policies, and the contracting parties are both sophisticated enterprises.¹⁰⁸ It is ironic that the behavioral effect of the decisions is not necessarily an expansion of coverage, as the courts intend, but rather, a contraction, for they leave negotiators with fewer bargaining points with which to facilitate the crafting of mutually acceptable contracts.

Although creative judicial interpretation of insurance contracts is not a new phenomenon,¹⁰⁹ until the mid-1980s there were very few cases involving D&O policies, since insurers rarely litigated D&O contract disputes. While the new litigiousness may be a function of new players in the market for D&O insurance, it is also possible that the increased litigation is connected to the insurance crisis: that is, the insurance contract litigation may be contributing to the crisis. When courts rewrite an insurance contract, the price insurers received will not have been commensurate with the risk they actually bore. Higher premiums are necessary on new policies, with terms identical to older, cheaper policies, to compensate the insurer for the court-added risk. To the extent that the losses are within the insured's control, as in the *Seafirst* case, or are correlated across insureds because of general economic factors affecting all businesses, the new risks

107. Ostrager & Ichel, *Rules of Construction Affecting Business Insurance Policies*, reprinted in *DIRECTORS' AND OFFICERS' LIABILITY INSURANCE AND SELF INSURANCE* 359 (1986). This doctrine is typically used in the opinions discussed throughout the text as favoring insureds. See *supra* text accompanying notes 92-97 & 99-100.

108. There have been a few exceptions to the doctrine's use to support the claims of the insured in the business insurance context, but the cases typically involve provisions specially drafted by the insured, so the doctrine could straightforwardly be applied in the insurer's favor. Ostrager & Ichel, *The Role of Bargaining Power Evidence in the Construction of the Business Insurance Policy: An Update*, 18 *FORUM* 577, 580-81 (1983).

109. E.g., Horvitz, *Handling Defense Appeals in Light of Expanding Concepts of Liability*, 16 *FOR THE DEFENSE* 105 (Sept. 1975).

being placed on insurers may be so difficult to assess as to be uninsurable, which could lead insurers to withdraw from the market.¹¹⁰

3. State Efforts at Easing the Crisis

By 1987, approximately the same time as the insurance market had begun to stabilize, thirty-five states, including those with the greatest number of corporations listed on the New York Stock Exchange, had modified their corporation codes to reduce the financial exposure of directors and officers for shareholder claims. Statutes limiting liability have taken three general approaches. The most popular approach, adopted by thirty states, is to permit shareholder-approved charter amendments eliminating or limiting directors' liability for monetary damages for negligence.¹¹¹ The second most popular strategy, chosen by four states, is to raise the culpability standard for directors' liability for damages to require willful misconduct or recklessness, thereby eliminating liability for negligence.¹¹²

110. See Winter, *supra* note 58 (formal model of capacity constraints in the context of increasing legal uncertainty (that is, dependent risk) and an imperfect capital market).

111. The Delaware statute, the model for the other 29 states, was intended to ease the insurance crisis by permitting firms to eliminate liability for acts that were typically covered by D&O insurance. S. 533 Synopsis, 133rd Gen. Assembly, at 2 (1986). The states with this type of statute are: ARIZ. REV. STAT. ANN. §§ 10-004.A.17, 10-054.A.9 (Supp. 1988); ARK. CODE ANN. § 4-27-202.B.3 (Supp. 1989); CAL. CORP. CODE § 204(a)(10) (West Supp. 1989); COLO. REV. STAT. § 7-3-101(1)(u) (Supp. 1988); DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988); GA. CODE ANN. § 14-2-171(b)(3)(A) (Supp. 1988); IDAHO CODE § 30-1-54(2) (Supp. 1988); IOWA CODE ANN. § 496A.49.13 (West Supp. 1988); KAN. STAT. ANN. § 17-6002(b)(8) (Supp. 1987); LA. REV. STAT. ANN. § 12:24-C(4) (West Supp. 1989); MD. CORPS. & ASS'NS CODE ANN. § 2-104(8) (Supp. 1988); MASS. GEN. LAWS ANN. ch. 156B, § 13(b)(11/2) (Supp. 1988); MICH. STAT. ANN. § 21.200(209)(c) (Callaghan Supp. 1988); MINN. STAT. ANN. § 302A.251(4) (West Supp. 1989); MONT. CODE ANN. § 35-1-202(2)(a)(v) (Supp. 1987); Act of March 18, 1987, ch. 28, 1987 Nev. Stat. 80; N.J. STAT. ANN. § 14A:2-7(3) (West Supp. 1988); N.M. STAT. ANN. § 53-12-2-E (Supp. 1988); N.Y. BUS. CORP. LAW § 402(b) (McKinney Supp. 1989); N.C. GEN. STAT. § 55-7(11) (Supp. 1987); OKLA. STAT. ANN. tit. 18, § 1006(B)(7) (West Supp. 1989); ORE. REV. STAT. ANN. § 60.047(2)(c) (1988); 42 PA. CONS. STAT. ANN. § 8364(a) (Purdon 1988); R.I. GEN. LAWS § 7-1.1-48(a)(6) (Supp. 1988); Act effective June 21, 1987, No. 282, 1987 S.D. Laws 13; TENN. CODE ANN. § 48-12-102(b)(3) (1988); TEX. REV. CIV. STAT. ANN. art. 1302-7.06 (Vernon Supp. 1989); UTAH CODE ANN. § 16-10-49.1 (Supp. 1989); WASH. REV. CODE ANN. § 23A.12.020 (Supp. 1988); WYO. STAT. ANN. § 17-1-202(c) (1987).

112. FLA. STAT. ANN. § 607.1645 (1987); IND. CODE ANN. § 23-1-35-1(e) (Burns 1988); OHIO REV. CODE ANN. § 1701.59D (Page Supp. 1987); WIS. STAT. ANN. § 180.307(1) (West Supp. 1988).

The third approach, promoted by the American Law Institute and adopted by one state, is to set a statutory limit to directors' and officers' monetary liability for negligence and to permit shareholders to specify a damages limit in the corporate charter or bylaws.¹¹³

In addition to the strategy of reducing liability, several states have expanded directors' and officers' indemnification. This has been achieved by eliminating the traditional distinction between third party and derivative suits;¹¹⁴ expressly permitting corporations to provide greater indemnification rights to their directors and officers by contract;¹¹⁵ altering the procedural presumption concerning requests for indemnification so as to favor the individual director or officer;¹¹⁶ and expressly authorizing advance payments of litigation expenses.¹¹⁷ Another corporation law innovation, sometimes enacted at the same time as limited liability statutes, is a provision permitting directors to consider nonshareholder interests.¹¹⁸ These provisions are primarily directed at aiding management's ability to oppose corporate takeovers without liability to shareholders for loss of the bid premium. By increasing the insulation of the board's decisions, they serve to limit liability.

Insurers did not respond to the enactment of these statutes by reducing 1987 policy rates, although many firms acted immediately

113. VA. CODE ANN. § 13.1-692.1 (Supp. 1988). The statutory limit is the greater of \$100,000 or the individual's cash compensation from the corporation received over the 12 months preceding the act or omission for which liability was imposed. The American Law Institute's proposal would limit liability to an amount "not disproportionate" to the individual's compensation for services during the year of the violation. American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, T.D. No.7, part VII, ch. 1, § 7.17 (Apr. 10, 1987).

114. *E.g.*, MO. ANN. STAT. § 351.355(2) (Vernon Supp. 1989).

115. *E.g.*, *id.* § 351.355(7).

116. *E.g.*, MD. CORPS. & ASS'NS CODE ANN. § 2-418(b)(1) (Supp. 1988).

117. *E.g.*, DEL. CODE ANN. tit. 8, § 145(e) (Supp. 1988).

118. Eight states have such provisions, although not all were passed in response to the insurance crisis: ILL. ANN. STAT. ch. 32, para. 8.85 (Smith-Hurd Supp. 1988) (effective Aug. 23, 1985); IND. CODE ANN. § 23-1-35-1(d) (Burns 1989) (effective Apr. 1, 1986); MO. ANN. STAT. § 351.347.1 (Vernon Supp. 1989) (applies to board's exercise of business judgment concerning acquisitions only) (effective May 6, 1986); N.M. STAT. ANN. § 53-11-35.D (Supp. 1988) (effective Apr. 9, 1987); N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1989) (effective July 23, 1987); OHIO REV. CODE ANN. § 1701.59(E) (Page Supp. 1987) (effective Apr. 1, 1985); 42 PA. CONS. STAT. ANN. § 8363(b) (Purdon 1988) (effective Jan. 28, 1987); WIS. STAT. ANN. § 180.305 (West Supp. 1988) (effective June 12, 1987).

to amend their charters.¹¹⁹ For a number of reasons, it is problematic whether the many firms opting into the limited liability statutes will ever see lower premiums. First, a large number of claims, such as those alleging violations of federal securities laws or breaches of the duty of loyalty, cannot be eliminated under the statutes. Second, the statutes permit directors, but not officers, to be exempted from liability. Finally, plaintiffs will, in all likelihood, be able to redraft their complaints to continue to bring lawsuits; for example, instead of alleging negligence they will allege reckless behavior.¹²⁰ Of course, the key actor is the judiciary, for plaintiffs' strategies can succeed only if courts are willing to characterize negligent behavior as intentional misconduct to avoid the liability limitations. Accordingly, although the recent legislative reforms have the potential for easing the insurance crisis by reducing the number of claims in one of the more costly claim categories, the effect of the statutes on insurance may well be minimal.

IV. CONCLUSION

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. This article has sought to identify some of those causal factors. In the 1980s, unexpected and undesired exposure was increasingly placed on insurers by economic conditions increasing the number of bankruptcies, acquisitions and public offerings, which shifted the underlying D&O liability risk, and by judicial decisions altering the contractual allocation of that risk. These factors aggravated the difficulty of loss prediction in the D&O line, thereby decreasing its profitability. At the same time, interest rates were falling and worldwide reinsurance markets were contracting, which further restricted D&O insurers' flexibility. One of the few clear policy recommendations in this murky area is for courts to enforce D&O insurance contracts. The judicial reallocation of risk in D&O insurance contracts is the most controllable factor in the confluence of factors that are

119. In a random sample of 100 Delaware corporations, I found that 90 had adopted charter amendments eliminating directors' liability under DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988), within one year of its enactment.

120. One commentator suggests that the lack of opposition to the new statutes by the plaintiffs' bar is evidence that the statutes will not substantially inhibit future claims (or at least evidence of the bar's belief that there will be no effect). Smith, *D&O Liability Crisis: Good News, Bad News*, N.Y.L.J., Oct. 29, 1987, at 6.

likely to have produced the insurance crisis that staggered the D&O consumer in the mid-1980s.

