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D&O ALTERNATIVE RISK FINANCING

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I. INTRODUCTION

Since the insurance crisis of the mid-1980s, companies of all sizes have given increased attention to the appropriateness of alternative methods to finance director and officer ("D&O") liability risks. D&O risk financing alternatives create unique legal issues not applicable to financing alternatives in respect to other types of risks. Before adopting a D&O funding alternative that either replaces or supplements traditional D&O insurance coverage, a corporation must carefully analyze those unique issues and identify the advantages and, more importantly, the limitations to that funding alternative.

A corporation's ability to financially protect its directors and officers is largely governed by the corporation law of the state in which the corporation is incorporated. All states have now enacted statutes permitting or requiring corporations to indemnify their directors and officers and authorizing corporations to purchase D&O insurance. These statutes define the conditions and limitations to D&O indemnification and permit the purchase of D&O insurance which may provide coverage for matters that are otherwise not indemnifiable under the statute.

If directors and officers rely only upon corporate indemnification as the sole source of financial protection, three types of coverage "gaps" will generally exist, thus subjecting the personal assets of the D&Os to risk:

1. Public Policy Limitation. State indemnification statutes contain various limitations on the scope of indemnification protection that a corporation may grant to its directors and officers. For example, most state statutes prohibit indemnification of judgments, and in many instances settlements, in cases brought against a director or officer by or on behalf of the corporation, including shareholder derivative lawsuits. Such a provision reflects a public policy of preserving the integrity of suits by or on behalf of the corporation by assuring that such suits are not circular in result or self-defeating. In addition, most indemnification statutes permit indemnification only if the individual is found to have acted in good faith and in the reasonable belief that his conduct was in or not opposed to the best interests of the corporation. Such a limitation is intended to discourage bad faith conduct by eliminating a source of financial protection to D&Os for such conduct.

In addition to state statutory limitations, other public policy limitations may exist in respect of indemnification for violation of various federal statutes. For example, the SEC[1] and some courts[2] have ruled that it is against public policy for a corporation to indemnify D&Os for violation of the registration and perhaps anti-fraud provisions of the federal securities laws because such indemnification would dilute the deterrent effect of those statutes. Similar public

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[1] 17 C.F.R. §§229.510 and 229.512(i).

[2] See, e.g., Globus v. Law Research Service, Inc., 418 F.2d 1276 (2d Cir. 1969), cert. denied 397 U.S. 913 (1970); Baker, Watts & Co. v. Miles & Stockbridge, 876 F.2d 1101 (4th Cir. 1989); Odette v. Shearson, Hammill & Co., 394 F. Supp. 946 (S.D.N.Y. 1975); First Golden Bankcorporation v. Weiszman, 942 F.2d 726 (10th Cir. 1991); Eichenholtz v. Brennan, 52 F.3d 478 (3d Cir. 1995); Ades v. Deloitte & Touche, 1993 WL 362364 (S.D.N.Y. 1993).

policy limitations may restrict indemnification under other federal statutes that either expressly prohibit such indemnification[3] or otherwise impose personal liability for deterrent purposes.[4]

Finally, common law public policy may prohibit indemnification for particularly egregious wrongdoing, including situations where the director or officer intended to commit the wrongdoing or inflict the resulting injury or damage.

2. Change in Circumstances. The mandatory indemnification provision set forth in the corporation's by-laws or articles of incorporation may be changed to limit or eliminate indemnification for certain directors or officers. This may occur, for example, when hostility develops between controlling management and dissident or former D&Os, or in the aftermath of a takeover or other change in control of the corporation. Similarly, the corporation's board of directors may become antagonistic towards the director or officer seeking indemnification. This antagonism can be significant because state statutes typically require an affirmative determination by the board of directors, independent counsel for the corporation, shareholders or a court that the applicable standards of conduct were satisfied by the director or officer before indemnification is permitted. If any of these unforeseen changes in circumstances occur, the director or officer seeking indemnification will face, at best, a difficult, time-consuming and expensive battle to enforce his/her indemnification rights and may lose the indemnification protection entirely.

3. Financial Inability to Fund. The corporation may be financially unable to fund the indemnification, either because it is insolvent or because of cash flow constraints. D&O litigation can be extremely expensive to defend and can result in a multi-million dollar settlement or judgment. The 2000 Tillinghast D&O Liability Survey concluded that the average reported defense costs per case by U.S. business corporations for reported closed D&O claims was $492,000 and that the average reported payment to claimants was $3.23 million. The average reported payment to claimants in shareholder claims was $9.62 million. Even if a corporation is financially solvent, the payment of such large amounts on behalf of the defendant D&Os could impair the corporation's other business activities, thus forcing the corporation to abandon the defendant director and officer in lieu of jeopardizing the corporation's continuing existence.

Traditional D&O liability insurance policies can fill most of the above-listed gaps in protection. State indemnification statutes[5] and the SEC[6] expressly recognize the ability of corporations to purchase and maintain D&O insurance which can provide coverage for non-indemnifiable claims. Because the D&O insurance policy is a contract, it cannot be changed

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[3] See, e.g., Foreign Corrupt Practices Act of 1977, 15 U.S.C. §78ff(c)(4) and §78dd-2(b)(4).

[4] See, e.g., Sequa Corporation v. Gelmin, 851 F. Supp. 106 (S.D.N.Y. 1993) (indemnification for RICO liability prohibited as against public policy); First American Corp. v. Al-Nahyan, 948 F. Supp. 1107 (D.C. 1996) (indemnification for RICO claim not allowed); Stamford Bd. of Ed. v. Stamford Ed. Ass'n, 697 F.2d 70 (2d Cir. 1982) (court refused to enforce indemnity clause in Title VII sex discrimination case because indemnity would undermine public policy goals of deterring sex discrimination).

[5] See, e.g., Section 145(f), Delaware General Corporation Law.

[6] 17 C.F.R. §230.461(c).

unilaterally and funding under the policy is not subject to the approval of current management of the corporation. Finally, the insurance policy is collectable (assuming the insurer is solvent) regardless of the financial health of the corporation.

Thus, in order to be a viable supplement or alternative to traditional D&O insurance, any alternative D&O risk financing should address one or more of these three gaps in coverage. If an alternative successfully addresses all three gaps, the alternative may be an adequate substitute for D&O insurance. If the alternative satisfies only some but not all of the gaps, the alternative may be an advantageous supplement to D&O insurance and statutory indemnification, but is not a complete substitute for traditional insurance coverage.

At a minimum, many risk financing arrangements can protect against a gap in indemnity coverage created by a change in circumstances. The following discussion analyzes the degree to which an alternative can satisfy the gaps in coverage created by the public policy limitations and financial ability to fund. The degree to which various sample alternatives satisfy some or all of the three gaps in coverage is then analyzed. Finally, the ability of shareholders to challenge the appropriateness of the risk financing arrangement is addressed.

II. AVOIDING PUBLIC POLICY LIMITATIONS

As explained above, public policy limitations on indemnification are derived from limitations imposed by common law, state indemnification statutes and federal statutes or public policy. The public policy limitations under the state indemnification statutes and in the federal statutory context can be avoided if the risk financing arrangement is considered "insurance." However, no alternative, whether or not considered insurance, can provide protection against claims for particularly egregious conduct for which indemnification or other third party protection is prohibited by common law public policy.

Although the various state indemnification statutes and the SEC expressly permit corporations to purchase and maintain "insurance" to provide protection against non-indemnifiable claims, neither those statutes nor the SEC attempt to define what is considered "insurance" for this purpose. Most definitions of insurance in other contexts are vague and difficult to apply to specific arrangements. For example, the term "insurance" is defined in Couch on Insurance, 2d, ' 1:2 as follows:

> In a general sense, "insurance" is a contract to pay a sum of money upon the happening of a particular event or contingency, or indemnity for loss in respect of a specific subject by specified perils....The primary requisite essential to a contract of insurance is the assumption of a risk of loss and the undertaking to indemnify the insured against such loss.

The largest body of authority today seeking to classify various risk financing arrangements as insurance exists in the tax arena, where corporations seek to obtain a tax deduction for premiums paid to various types of plans. Because those cases attempt to determine whether a particular risk financing program is "insurance," the analysis applied in those cases may be applicable in determining what arrangements constitute "insurance" under state corporation statutes.

At least in the tax context, the U.S. Supreme Court defined "insurance" as follows:

> Historically and commonly insurance involves risk shifting and risk distributing.[7]

The Court ruled that both risk shifting and risk distributing are essential elements of insurance. These two elements have been defined in subsequent cases as follows:

> Risk shifting emphasizes the individual aspect of insurance: the effecting of a contract between the insurer and the insured each of whom gamble on the time the later will die. Risk distribution, on the other hand, emphasizes the broader, social aspect of insurance as a method of dispelling the danger of a potential loss by spreading its costs throughout a group. By diffusing the risk through a mass of separate risk shifting contracts, the insurer casts his lot with the law of averages.[8]

This two-prong definition of insurance has been adopted by authorities in the non-tax area as well.[9]

III. INSULATION OF FUNDS FROM CREDITORS

If a goal of the risk financing arrangement is to assure a source of funding, it is essential that the arrangement be structured to insulate funds from potential claimants who may seek to apply the funds for purposes other than protecting the directors and officers. The primary concern in determining whether the funding device is protected against claims by corporate creditors or a bankruptcy trustee arises under the fraudulent conveyance statutes, as adopted by the various states and as contained in the federal bankruptcy law. Under these statutes, a creditor or the bankruptcy trustee may recoup on behalf of the corporation assets transferred by the debtor corporation if (i) the debtor made the transfer without receiving a "reasonable" equivalent value or "fair consideration;" and (ii) the debtor was insolvent at the time or became insolvent as a result of the transfer. It is admittedly difficult to identify the "reasonably

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[7] Helvering v. LeGierse, 312 U.S. 531, 539 (1941).

[8] Commissioner v. Treeanowan, 183 F.2d 288, 291 (2d Cir. 1950) cert. denied 340 U.S. 853 (1950) (emphasis added). See also, Gulf Oil v. Commissioner, 89 T.C. 1010, 1035 (1987), aff'd in part and rev'd. in part on other grounds 914 F.2d 396 (3rd Cir. 1990); Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989).

[9] See, e.g., Utah Federal Directors and Embalmers Association v. Memorial Gardens of the Valley, Inc., 17 Utah 2d 227, 408 P.2d 190 (1965) (insurance involves the spreading of a risk by a group and not merely the repayment of an accumulative trust fund); Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205 (1979) (the primary elements of an insurance contract are the spreading and underwriting of a policyholder's risk): Couch on Insurance 2d §1:3 ("It is characteristic of insurance that a number of risks are accepted, some of which will involve losses, and that such losses are spread over all of the risks so as to enable the insurer to accept each risk at a slight fraction of the possible liability upon it."); State v. Continental Cas. Co., 879 P.2d 1111 (Idaho 1994) (the essence of insurance is risk shifting, therefore, self-insurance is not insurance).

equivalent value" or "fair consideration" received by a corporation when it funds a D&O liability risk financing arrangement. Arguably, the corporation receives value through the directors' and officers' agreement to continue their service for the corporation. Although state indemnification statutes and D&O liability limitation laws are expressly designed to attract competent corporate managers, the adequacy of such "consideration" for purposes of the fraudulent conveyance analysis is not entirely free from doubt.[10] The reasonableness of the amount transferred to the funding arrangement will likely be considered in relationship to the number of beneficiaries covered, the type and amount of claims anticipated and the assets and liabilities of the corporation at the time of the transfer.

A conveyance by a debtor is also deemed fraudulent, and therefore recoverable by a creditor or trustee on behalf of the debtor, if the transfer is made with actual intent to hinder, delay or defraud any creditor of the debtor. In determining the actual intent of the transfer, the Uniform Fraudulent Transfer Act identifies several important factors, including whether the transfer obligation was to an insider, whether the debtor retained possession or control of the property transferred after the transfer, whether the debtor was sued or threatened with a suit prior to the making of the transfer and whether the transfer occurred shortly before or shortly after a substantial debt was incurred.[11] These factors highlight the importance of establishing the alternative funding arrangement as early as possible and before substantial claims are made or are reasonably foreseeable, and before the company incurs financial hardship.

Carefully considered and structured risk financing arrangements that are irrevocable, funded at a reasonable level by a solvent corporation and treated by the corporation as an arms-length transaction should generally withstand later attack by creditors or a bankruptcy trustee.

An additional concern particularly applicable to a subsidiary captive insurance company is the risk that if the parent corporation becomes subject to a bankruptcy proceeding, the bankruptcy court may order an equitable consolidation of the parent and captive subsidiary, thereby sweeping the captive subsidiary's assets into the bankruptcy proceeding of the parent corporation.[12] In effect, this remedy allows third party creditors to assert claims against a common fund. The primary situations where this consolidation occurs involves the subsidiary being a "mere instrumentality" of the parent or the subsidiary and parent being hopelessly interrelated and thus separating the two entities is very expensive or difficult. Financial and operational independence of the captive from its parent should help reduce this risk.

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[10] See, e.g., U.S. v. Glen Eagles Investment Co., 956 F. Supp. 556 (M.D. Pa. 1983), aff'd in part and vacated in part sub nom.; U.S. v. Tabor Court Realty Corp., 803 F.2d 1288 (3rd Cir. 1986), cert. denied, McClellan Realty Co. v. U.S., 483 U.S. 1005 (1987) (in the context of a leveraged buyout which resulted in insolvency, new management did not constitute "sufficiently valuable consideration" so as to insulate loans entered into by the corporation in the LBO from a fraudulent conveyance claim).

[11] Uniform Fraudulent Transfer Act, §5.7(A) U.L.A. (1985).

[12] See, e.g., In re Auto-Train Corp., Inc., 810 F.2d 270 (D.C. Cir. 1987) (consolidation overturned); In re Continental Vending Machine Corp., 517 F.2d 997, 1000-02 (2d. Cir. 1975), cert. denied, 424 U.S. 913 (1976) (consolidation approved); Chemical Bank New York Trust Company v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966) (consolidation approved).

In addition, if the risk financing arrangement also transacts business with unaffiliated persons, the prudence of those third party transactions must be continually monitored in order to assure the ongoing economic solvency of the funding arrangement.

IV. SAMPLE RISK FINANCING ALTERNATIVES

A. Captive Insurance Company

Corporations have used in other contexts wholly-owned captive insurance companies as a risk management device for many years. These subsidiary insurance companies generally are capitalized by the parent corporation, are managed professionally and provide insurance through policies similar to but broader than traditional insurance policies. In addition to providing coverage that may not be available otherwise, a captive insurance subsidiary offers a number of advantages. For instance, a captive may be more efficient and the long-term insurance costs to the parent corporation may be reduced. Also, use of a captive can eliminate the parent corporation's need to pay acquisition costs and commissions in the traditional commercial insurance market.

By adequately funding the captive insurer, the insured D&Os may realize some protection against the insolvency or financial inability of the parent corporation to fund its indemnification obligations. Such protection is not certain, though. In addition to the concerns in the insolvency and bankruptcy contexts, as discussed above, corporations forming a wholly-owned insurer should take strong precaution to assure that the subsidiary is formed and operated as a separate entity so that its corporate veil may not be pierced by creditors of the parent corporation. Among other things, the separate corporate identities of the two corporations should be scrupulously maintained; the captive should be adequately capitalized to provide appropriate reserves and operating expenses without periodic infusion of capital; the captive should be independently managed; and the captive should be operated on an arms-length, commercially reasonable basis.

Although a captive insurer may provide substantial protection against the "financial inability to fund" and the "change in circumstance" gaps in coverage, there is substantial uncertainty whether such an arrangement would constitute insurance and therefore could provide financial protection against nonindemnifiable claims. As explained in a leading corporate law treatise:

> [A] court may view any "insurance" by a subsidiary not as insurance but rather as a "cover" for indemnifying the parent's directors and officers, particularly if the insurer - subsidiary reimburses its parent's directors on a dollar for dollar basis.[13]

[13] R. Balotti & J. Finkelstein, The Delaware Law of Corporations and Business Organizations §4.17, at 200.4 - 200.6 (1988).

Similarly, tax authority, to the extent applicable, generally have ruled that a traditional wholly-owned captive insurance company does not provide "insurance" to or on behalf of its parent corporation since no risk is either transferred or distributed. These authorities do not recognize a transfer of risk from the parent corporation to the subsidiary insurer because both corporations are members of the same "economic family." This rationale has been explained as follows:

> Although use of a wholly-owned insurance affiliate served legitimate purposes, [the parent company], in substance, by deducting the premiums on its tax returns, achieved indirectly that which it could not do directly…. Insurance through a wholly-owned insurance affiliate is essentially the same as setting up reserve accounts. The risk of loss remains with the parent and is reflected on the balance sheet and income statements of the parent.[14]

There is a greater chance that a captive insurer provides "insurance" and thus can cover nonindemnifiable D&O claims, if the subsidiary insurer extends coverage to a sister corporation rather than to its parent corporation. For example, a federal appellate court[15] held for tax purposes that a brother-sister insurance transaction can constitute insurance under certain circumstances. The court reasoned that risks and loss assumed by the insurer would not appear on the insured's balance sheet as it would in a parent-subsidiary relationship. The court further identified several key factors to consider in determining whether coverage constitutes insurance, including whether the transaction was at arms-length and reasonable premiums were charged; whether the captive qualified for regulatory purposes as an insurance company; and whether side agreements existed relating to indemnification of the insurer for losses incurred.

A captive insurer has the greatest chance of creating "insurance" if it insures not only the risks of its affiliates, but also the risks of other unrelated persons or entities.[16] The Seventh Circuit ruled that premiums paid by Sears, Roebuck & Co. to its Allstate Insurance Company subsidiary in return for insurance coverage constituted "insurance" for tax purposes since 99.75% of Allstate's premiums came from third-parties and that the policies issued and premiums charged by Allstate to Sears were comparable to policies issued to unrelated insureds.[17] In finding such an arrangement created risk-transfer and risk-distribution, the court stated:

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[14] Mobile Oil Corp. v. U.S., 56 A.F.T.R.2d 85-5636 (Cl. Ct., 1985) (emphasis added). See also, Stearns-Roger Corp. v. U.S., 774 F.2d 414 (10th Cir. 1985); Beech Aircraft Corp. v. U.S., 797 F.2d 920 (10th Cir. 1986); Humana v. Commissioner, 881 F.2d 247 (6th Cir. 1989); Gulf Oil Corporation v. Commissioner, 89 T.C. 1010 (1987), aff'd in part and rev'd. in part on other grounds 914 F.2d 396 (3rd Cir. 1990); Kurth Orbun Company, Inc. 1987 P-H-TC Memo ¶87,518.

[15] Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989). See also, Malone, Hyde Inc., T.C. Memo 1993-585 (1993); HCA v. Comm., T.C. Memo 1997-482, 1997 WL 663283 (1997).

[16] Ocean Drilling & Exploration Co. v. U.S., 988 F.2d 1135 (Fed. Cir. 1993).

[17] Sears, Roebuck & Co. v. Comm., 972 F.2d 858 (7th Cir. 1992).

> Allstate puts Sears's risks in a larger pool, performing one of the standard insurance functions in a way that a captive insurer does not. Moreover, Allstate furnishes Sears with the same hedging and administration services it furnishes to all other customers. It establishes reserves, pays state taxes, participates in state risk-sharing pools (for insolvent insurers), and so on, just as it would if Sears were an unrelated company. States recognize the transaction as "real" insurance for purposes of mandatory insurance laws (several of the policies were purchased to comply with such laws for Sear's auto fleet, and for worker's compensation in Texas). From Allstate's perspective this is real insurance in every way. It must maintain the reserves required by state law (not to mention prudent management). Sears cannot withdraw those reserves on whim, and events that affect their size for good or ill therefore do not translate directly to Sear's balance sheet.

A U.S. Tax Court opinion[18] similarly ruled as follows:

> When the aggregate premiums paid by the captive's affiliated group is insufficient in a substantial amount to pay the aggregate anticipated losses of the entire group, the affiliated and unrelated entities, the premiums paid by the affiliated group should be deductible as insurance premiums and should no longer be characterized as payments to a reserve from which to pay losses.

In a footnote, the court suggested what amount of premiums from unrelated sources is necessary to create "insurance:"

> If at least 50% [of a captive's premiums] are unrelated, we cannot believe that sufficient risk transfer would not be present.

Other decisions have recognized sufficient risk distribution and risk shifting where the subsidiary insurer's unrelated business constituted 30%[19], 44%[20], and 52%.[21] The Tax Court in a series of three cases[22] established a three-step analysis to determine if insurance existed in cases where the subsidiary insurer issued coverage to parties unrelated to the parent and the parent's affiliates. The Tax Court analysis involves the following factors:

1. Presence of insurance risk;
2. Risk shifting and risk distributing;

[18] Gulf Oil Corporation v. Commissioner, 89 T.C. 1010 (1987), aff'd in part and rev'd. in part on other grounds 914 F.2d 396 (3rd Cir. 1990).

[19] The Harper Group v. Comm., 96 T.C. 45, 1991 WL 61250, aff'd 979 F.2d 1341 (9th Cir. 1992).

[20] Ocean Drilling & Exploration Co. v. U.S., 988 F.2d 1135 (Fed. Ct. 1993).

[21] AMERCO v. Comm., 96 T.C. 18, 1991 WL 4981, aff'd 979 F.2d 162 (9th Cir. 1992).

[22] AMERCO v. Commissioner, 96 T.C. 18 (1991), aff'd 979 F.2d 162 (9th Cir. 1992); The Harper Group v. Commissioner, 96 T.C. 45 (1991), aff'd 979 F.2d 1341 (9th Cir. 1992); Sears Roebuck & Co. v. Commissioner, supra.

3. Commonly accepted notions of insurance.

With respect to the "presence of insurance risk," the Tax Court stated:

> Basic to any insurance transaction must be risk. An insured faces some hazard; an insurer accepts a premium and agrees to perform some act if or when the loss event occurs. If no risk exists, then insurance cannot be present. "Insurance risk" is required; investment risk is insufficient. If parties structure an apparent insurance transaction so as to effectively eliminate the effect of insurance risk therein, insurance cannot be present.[23]

With regard to "risk shifting and risk distributing," the Tax Court relied upon the following definition: "'Risk shifting' means one party shifts his risk of loss to another, and 'risk distributing' means that the party assuming the risk distributes his potential liability, in part, among others."[24]

With respect to the third requirement of "commonly accepted notions of insurance," the Tax Court did not generally discuss how to apply the requirement but addressed the requirement by applying the facts of each case to determine if insurance existed in a "commonly understood manner." For instance, in one case, the Court determined that insurance existed in the "commonly accepted" sense based upon the following factors: the subsidiary insurer was organized and operated as an insurance company and was regulated by Hong Kong insurance law, the insurer's capitalization was adequate, premiums were negotiated at arm's length, and the policies issued by the insurer were valid and binding.[25] In all three of these cases, the Tax Court held that the premiums received by the subsidiary were for "insurance."

Similarly, a federal district court ruled that "insurance" is created for tax purposes where the stock of the captive insurer was owned by the shareholders of several affiliated corporations but in different proportions than their stockholdings in the insured corporations.[26] In finding at least some risk sharing in the arrangement (albeit only a modicum), the Court noted that the captive extended coverage not only to the affiliated companies but also to some of their distributors which had no ownership relationship to the captive.[27]

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[23] AMERCO, supra, at 38-39.

[24] The Harper Group, supra, at 58-59 (1991) (quoting from Beech Aircraft, supra, 797 F.2d at 922).

[25] The Harper Group, supra.

[26] Crawford Fitting Company v. U.S., 606 F. Supp. 136 (N.D. Ohio 1985).

[27] But see, Rev. Rul. 88-72, 1988-2 C.B. 31 (disallowing tax deduction for insurance premiums paid to wholly-owned captive insurer, notwithstanding the captive's acceptance of insurance risks from unrelated parties; despite a "risk distribution" there is still no risk shifting between the parent and subsidiary); Pariseau v. Commissioner, ¶85,124 P-H Memo TC (1985) (a sole proprietor did not provide "insurance" to companies wholly-owned by the proprietor because no risk-shifting or risk distribution occurred even though coverage was extended to three companies owned by the brother of the sole proprietor).

In response to the perceived D&O insurance crisis of the mid-1980s, several states amended their indemnification statutes to specifically authorize corporations to purchase and maintain coverage from an insurer owned by the corporation.[28] For example, New Jersey allows corporations to purchase D&O coverage through "an insurer owned by or otherwise affiliated with the corporation, whether or not such insured does business with other insureds."[29] These statutes permit the captive to cover loss from nonindemnifiable state law claims, although the captive may not be permitted to cover nonindemnifiable federal claims. Even as to state claims, the applicable state statutes should be examined closely to determine if the intended coverage for nonindemnifiable claims is in fact permitted. For example, some of these statutes permit corporations to purchase "insurance" from captive or affiliated insurers. Under those statutes, risk shifting and risk distribution may be required, in which case the statutes may permit only the use of captives with substantial unaffiliated business or group insurers in which the corporation owns a fractional interest, not wholly-owned captive subsidiaries, to cover nonindemnifiable claims.

B. Group Insurance

To avoid many of the problems associated with a wholly-owned captive insurer, some corporations have formed a group captive in which several companies own and are insured by the captive insurer. Because risk is transferred to the separately owned insurer and is spread among the various participants, such arrangements will likely be considered "insurance" (assuming an adequate number of companies participate in the group) and thus protection for nonindemnifiable claims should be permissible.[30]

The advantages of a group captive include the ability to develop insurance policies meeting the needs of the group members; the retention of investment income in the captive; long-term underwriting cost reductions; favorable tax consequences; the ability to provide various types of insurance to the group members; and lack of dependence upon the continuing existence and financial health of one corporation.

To distribute risk broadly, it may be preferable to participate in a group arrangement which covers more than one industry. However, industries such as banking, utilities, oil and gas, drugs and chemicals may find admission into general group captives difficult. As a result, both general group captives and group captives specializing in a single industry have been formed in recent years.

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[28] See, Ariz. Rev. Stat. Ann. §10-005(G); Cal. Corp. Code §317(i); Col. Rev. Stat. §7-3-101.5(9); Hawaii Rev. Stat. §415-5(h); La. Rev. Stat. Ann. §12:83(F)(1); Md. Corps. & Assn's Code Ann. §2-418(k); Nev. Rev. Stat. §78.752; N.J. Rev. Stat. §14A:3-5(9); N.M. Stat. Ann. §53-11-4.1(J); Ohio Rev. Code Ann. §1701.13(E)(7); Tex. Corps. & Ass'ns Code Ann. §2.02-1(R).

[29] N.J. Rev. Stat. §14A:3-5(9).

[30] See, e.g., Rev. Rul. 78-338, 1978-2 C.B. 107 [31 insureds participated in pooling arrangement]; Rev. Rul 80-102, 1980-1 C.B. 41 [5,000 insureds participated]; Rev. Rul. 83-172, 1983-2 C.B. 107 [40 insureds participated]; U.S. v. Weber Paper Co., 320 F.2d 199 (8th Cir. 1963) [reciprocal, interinsurance plan pursuant to which members paid yearly premiums into fund for loss protection was "insurance" even though the member was entitled upon withdrawal from the plan to as much as 99% of its premium payments if no losses had been paid out of the fund].

In spite of the advantages provided by these group arrangements, membership in these associations generally will not be available to high risk or financially unstable corporations. Additionally, the group captive must satisfy the stringent insurance and underwriting regulatory requirements relating to capitalization and other matters, as well as applicable federal and state securities laws if it is a stock captive. To be a viable alternative to the traditional D&O insurance market, these group insurers must be well organized and operate with the purpose of long-term survival. Their capitalization, underwriting criteria, and claims handling should be reasonable and tailored to the statutory requirements. Its members must be loyal to the captive and not abandon the facility during favorable cycles in the traditional insurance market.

C. Fronting/Finite Risk Arrangements

A fronting insurance arrangement is an agreement between a corporation and a traditional insurance company pursuant to which the insurance company issues a standard or perhaps enhanced D&O insurance policy in exchange for the corporation agreeing to fund all (or at least a substantial portion of all) loss under that insurance policy. The insurance company receives a fee for its services in providing a "fronting" policy, but assumes no or very little risk of loss.

Depending upon how it is structured, such an arrangement can provide assurance to the insured D&Os that funding will be available and can protect against changes in circumstances which would jeopardize the availability of statutory indemnification. Despite these benefits, a true fronting policy may not be capable of covering nonindemnifiable claims because arguably no risk is transferred. Tax authority consistently has concluded various types of front arrangements do not constitute "insurance[31]," although it is at least arguable that some arrangements may under certain circumstances actually transfer risk.

One form of fronting arrangement consists of the corporation paying to the insurer upon inception of the policy an amount equal to or approaching the policy limit of liability. The insurer retains that "premium" in a special account and funds any loss under the policy from that account. Such an arrangement does not effectively transfer risk and is not likely to be considered "insurance." Alternatively, the parties may agree that the insurer will charge to the corporation a retrospective premium, which is payable by the corporation after loss is paid under the policy and is based upon the amount of loss paid. Depending upon the percentage of total loss recouped by the insurer and the likely ability of the insurer to collect the retrospective premium, such an arrangement may or may not constitute a transfer of risk. At

[31] Gulf Oil Corp. v. Commissioner, 914 F.2d 396 (3rd Cir. 1990); Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir.) cert. denied, 454 U.S. 965 (1981); Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987); Steere Tank Lines, Inc. v. U.S., 577 F.2d 279 (5th Cir. 1978), cert. denied, 440 U.S. 946 (1979); Malone & Hyde Inc., TC Memo 1989-604 (1989); Rev. Rul. 77-316, 1977-2 C.B. 53. See also, Bail Bonds by Marvin Nelson, Inc., 1986 P-H TC Memo ¶86,023, 1986 WL 21439 (1986), aff'd. 820 F.2d 1543 (1987). But see, HCA v. Comm., T.C. Memo 1997-482, 1997 WL 663283 (1997).

least one state's corporation statute prohibits the use of retrospective rated D&O insurance policies.[32] However, Arizona expressly authorizes retrospective rated D&O policies.[33]

These two types of fronting arrangements have recently been combined by some corporations into a so-called finite risk program. Although the exact terms and structure of such a program vary, generally an unrelated insurer affords a defined amount of coverage over an extended period of time in exchange for which the insureds agree to pay to the insurer, for example, between 50 to 70% of covered loss. If no loss is incurred during the coverage period, up to 90 to 95% of the premium and investment income is returned by the insurer to the insured. Depending upon the exact terms of such a program, it is at least arguable that sufficient risk has been transferred to the insurer such that the program may constitute "insurance." A finite risk program pursuant to which the insureds fund only 20%, for example, of the covered loss would likely create sufficient risk transfer to constitute insurance, whereas a finite risk program pursuant to which the insureds fund 90%, for example, would likely not constitute insurance. Between those two ends of the spectrum, there is obviously no clearly defined point at which the program converts from a risk shifting insurance arrangement to a noninsurance arrangement. Although a program which funds 50 to 70% of loss may arguably be considered insurance, such a conclusion is largely speculative given the current lack of significant judicial precedent. However, insureds can receive some guidance through the captive insurance company cases, which have held that insurance exists even if at least 50% and perhaps as little as 30% of a risk is transferred to unrelated parties.

Yet another alternative involves the insurance company reinsuring the risk through the corporation's wholly-owned captive insurer. Although tax authority has differed as to whether there is transfer of risk in such an arrangement,[34] the insurer has arguably assumed risk to the extent the reinsurance is unavailable for whatever reason.

D. Trust Fund

Another method for securing financial protection to D&Os is the irrevocable trust. The corporation establishing the trust typically enters into a trust agreement with a bank or other third party as trustee and transfers a sum of money to the trustee to be held in trust pursuant to the provisions of the agreement. The trust agreement may provide that the corporation will keep the value of the trust assets at a given level at all times, or it may provide for a single contribution or annual contributions. The trust agreement typically reads substantially similar to a D&O insurance policy, with the covered directors and officers being the designated beneficiaries.

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[32] See, e.g., N.Y. Bus. Corp. Law §726(c).

[33] Ariz. Rev. Stat. Ann. §10-005(G).

[34] IRS Tech. Adv. Memo. 8637003; Malone & Hyde, Inc. v. Comm., 62 F.3d 835 (6th Cir. 1995) (no transfer of risk); United Parcel Service of America, Inc. v. Commissioner, 2001 U.S. App. LEXIS 13926 (11th Cir. June 20, 2001) (insurance arrangement had "real economic effect" and a business purpose, so was respected for tax purposes); Kidde Industries, Inc. v. U.S., 81 AFTR 2d 98-326 (Ct. Fed. Cl. 1997) (sufficient risk transfer).

In order to protect against change in circumstances with the corporation, not only the trustee but also any claims manager or other trust administrator should be independent persons who are likely to remain sympathetic or at least not hostile to the interests of the D&O beneficiaries.

A trust arrangement, if structured properly, may also assure the availability of funds for the benefit of directors and officers. To insulate trust funds from creditors of the sponsoring corporation, the trust should be irrevocable and perhaps should provide for ultimate payment of any remaining assets upon termination of the trust to a charity or other independent third party. Also, the corporation should not be allowed to amend the trust agreement. Otherwise, subsequent owners of the corporation or a bankruptcy trustee may be able to terminate the trust or substantially dilute the protection it affords.[35]

Even though a trust arrangement can provide significant benefits to covered directors and officers,[36] it is doubtful such an arrangement is "insurance" because no risk transfer or distribution typically occurs. Accordingly, it is doubtful such an arrangement can provide coverage for nonindemnifiable claims. A Tax Court case ruled that a trust created by a medical professional corporation to provide medical malpractice protection for its employees did not shift any risk of loss and therefore was not "insurance."[37] Among other things, the court noted that the trust was not licensed as an insurance company, the corporation retained the power to amend the terms of the trust and the corporation was obligated to contribute funds in addition to its premium in the event that the trust funds became inadequate to pay claims.

A few state have amended their indemnification statutes to expressly permit the use of trust funds for protecting directors and officers. For example, Louisiana, Maryland, Nevada, New Mexico, Ohio, Pennsylvania and Texas now authorize the use of trust funds to provide protection against nonindemnifiable state claims, although it is doubtful even in those states that trust funds can provide protection against nonindemnifiable federal claims.

E. Miscellaneous Other Alternatives

Depending upon the financial condition of the corporation and the applicable state indemnification law, several other alternative D&O risk financing alternatives may be available. For example, a corporation may enter into indemnification contracts with its directors and officers and secure coverage afforded by those contracts with a letter of credit ("LOC"), surety bond or other similar arrangement. By creating contractual rights to indemnification, the corporation protects its directors and officers against unilateral amendments by the

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[35] Askanase v. Living Well, Inc., 45 F.3d 103 (5th Cir. 1995) (bankruptcy trustee had "nearly unlimited power of amendment" under terms of trust and therefore was allowed to terminate the trust and thereafter sue former directors and officers); Gibson v. RTC, 750 F. Supp. 1565 (S.D. Fla. 1990), aff'd 51 F.3d 1016 (11th Cir. 1995).

[36] Security America Corp. v. Walsh, Case, Coale, Brown & Burke, 1985 WL 225 (N.D. Ill. Jan. 11, 1985) (irrevocable and unamendable trust established in the face of an imminent change of control upheld as permissible method to provide for advancement of defense costs to the outgoing directors).

[37] Anesthesia Service Medical Group, Inc. v. Commissioner, 85 T.C. 1031 (1986), aff'd, 825 F.2d 241 (9th Cir. 1987).

corporation to the indemnification protection and against other unforeseen changes in circumstances. By securing the indemnification obligation with the credit and assets of an independent third party, the indemnified D&Os are insulated from the financial insolvency of the corporation.

However, use of an irrevocable letter of credit or surety bond has numerous disadvantages. For example, an LOC imposes a standby fee and interest on any payments made under the LOC. The LOC will normally be available only for a limited term and is renewable at the discretion of the bank and will require the use of corporate assets as security. If the term of the LOC or surety bond expires when the corporation is financially insolvent or distressed (i.e. exactly when the D&O protection is most needed), it is likely the instrument will not be renewed. Further, such an arrangement clearly does not constitute "insurance" and thus would not cover non-indemnifiable claims.

Recent legislation in Arizona, Louisiana, Maryland, Nevada, Ohio, New Mexico and Texas, for example, expressly authorize corporations to maintain "self-insurance" for the benefit of its directors and officers and to provide coverage through such self-insurance for nonindemnifiable state claims. The statutes do not define what is "self-insurance." Presumably, separate funding is not required, although it would be desirable if the corporation's financial condition is potentially in doubt. Because this statutory authorization is contained in the state indemnification statute, it is doubtful that such a self-insurance plan would circumvent the restriction against indemnification for violations of the federal securities laws and other federal statutes. Absent specific statutory authorization, self-insurance clearly could not be used to fund nonindemnifiable claims since no risk transfer or distribution occurs.[38]

V. FIDUCIARY DUTIES IN IMPLEMENTING RISK FINANCING ALTERNATIVE

Historically, there was considerable doubt whether a corporation could financially protect its directors and officers from personal liability. Some early authority indicated that corporate expenditures for purposes of D&O indemnification and insurance were prohibited because such payments were not considered to be for the direct benefit of the corporation itself.[39] Other courts recognized that indemnification and reimbursement were permissible and consistent with public policy because such protection encouraged sound corporate management, a prerequisite to responsible corporate activity.[40] These early decisions resulted in the enactment in all states of statutes permitting or requiring indemnification and authorizing corporations to purchase D&O insurance.

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[38] See, e.g., American States Ins. Co. v. Utah Transit Authority, 699 P.2d 1210 (Utah 1985); American Nurses Association v. Passaic General Hospital, 192 N.J. Super. 486, 471 A.2d 66 (1984), aff'd. in part and rev'd in part on other grounds 484 A.2d 670 (1984).

[39] See, e.g., New York Drydock v. McCollum, 173 Misc. 106, 16 N.Y.S.2d 844 (S.Ct. 1939); Bailey v. Bush Terminal Co., 293 N.Y. 735, 56 N.E.2d 739 (1944), aff'd. 267 App. Div. 889, 48 N.Y.S.2d 324 (1st Dept. 1944), aff'd 46 N.Y.S.2d 877 (S.Ct. 1943).

[40] See, e.g., In re: E.C. Warner Co., 232 Minn. 207, 45 N.W.2d 388 (1950). Cf. Solimine v. Hollander, 129 N.J. Eq. 264, 19 A.2d 344 (1941).

Notwithstanding this statutory authorization, directors and officers who consider the adoption of a D&O liability risk financing alternative should consider the appropriateness of such arrangement from the standpoint of the corporation and its shareholders. For example, if the formation of a funding arrangement causes the corporation to be undercapitalized or otherwise adversely affects the corporation's business operations, a potential claim for breach of fiduciary duty may arise against the approving directors and/or officers. Because the beneficiaries of the arrangement are the persons approving the arrangement, courts may require the directors and officers to establish the intrinsic fairness of the arrangement to the corporation and its shareholders. Accordingly, the corporation should fully document the justifications for the funding arrangement and the reasonableness of the amount funded in light of the financial condition of the corporation. Where appropriate, shareholder approval of the arrangement, after full disclosure of all material information, could be obtained to further insulate the approving directors and officers from claims of self-dealing, waste of corporate assets, and the like.

In one case challenging the appropriateness of an irrevocable indemnification trust fund, the corporation had established two irrevocable trusts and funded each with $100,000 for the purpose of paying defense costs in certain lawsuits against directors of the corporation. New management of the company challenged the creation and use of the trust, alleging that the trust prohibited the company from reviewing on a continuing basis the appropriateness of funding the defense costs of the former directors. Because the former directors ostensibly accepted their positions and served as directors based in part upon the existence of the trust and because the trust did not provide protection beyond that authorized by the applicable state indemnification statute, the court upheld the trusts and refused the corporation's request to return the funds to the corporation.[41] However, the court was "troubled" by several aspects of the trust, including the fact that one-third of the company's assets were used to fund the trust, the law firm defending the former directors were the trustees, and current management was unable to stop the advancement of litigation expenses.

In addition to adequately justifying the reasonableness of the arrangement, management should also confirm that the funding does not directly or indirectly violate any loan covenants or other agreements of the corporation which limit or require prior approval of payments to or on behalf of the directors and officers. Regulated companies may also need regulatory approval for the funding.

VI. CONCLUSIONS

Several risk financing alternatives can provide meaningful and valuable protection which is either not afforded by the traditional D&O insurance market (e.g. coverage for or arising out of pollution incidents), or if traditional D&O coverage is unavailable, greater than that afforded by statutory indemnification. However, it is questionable whether any D&O liability risk

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[41] Security American Corp. v. Walsh, Case, Coale, Brown & Burke, 1985 WL 225 (N.D. Ill. Jan. 11, 1985). See, also, Creel v. Birmingham Trust National Bank, 383 F. Supp. 871 (N.D. Ala. 1974), aff'd 510 F.2d 1363 (5th Cir. 1975).

financing alternative that does not transfer and distribute risk is a complete substitute for traditional D&O insurance coverage (assuming coverage for nonindemnifiable federal claims is desired).

When evaluating various alternatives, companies should identify the goals sought to be accomplished by the risk financing arrangement and then determine the extent to which those goals are satisfied by various alternative arrangements. Any arrangement that provides some degree of protection beyond that otherwise existing is worthy of consideration.

Statutes enacted over the last 10 years in many states expand the degree of protection available under some alternatives and should be carefully considered when evaluating a corporation's optimum D&O liability risk management program.

Unlike most other areas of corporate risk management, alternative risk financing arrangements in the D&O context create complex issues involving, among other matters, corporate indemnity law, insurance law, bankruptcy law, D&O liability law and tax law. Expert analysis of these various issues is an essential ingredient to any D&O liability risk financing plan if the maximum protection and benefits from that arrangement are to be attained. Unfortunately, much of the analysis and planning in this area must be in unchartered waters. Because of the enormous adverse consequences to the covered directors and officers if the risk financing plan does not successfully accomplish its intended goals, a conservative approach to this topic appears most prudent.

About the Author:

Dan A. Bailey is the Chair of the Firm's Directors & Officers Liability Practice Group and represents and consults with directors and officers, corporations, insurance companies, and law firms across the country. In addition to advising Boards and drafting most of the D&O insurance policies in the market, he has represented clients or served as an expert witness in many of the largest D&O claims for more than 30 years. He is co-author of Liability of Corporate Officers and Directors, a leading treatise on the topic, has published dozens of articles and speaks at more than 20 seminars a year on the subject.

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