"CAPTIVATING" D&O INSURANCE: RECTIFYING MORAL HAZARD THROUGH CAPTIVE INSURANCE

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INTRODUCTION

Most states define statutorily and in great detail the obligation of a business, whether it be a corporation, LLC, or partnership, to indemnify its directors, officers, or other members for costs incurred during corporate activities, including expenses to defend themselves in litigation.[1] Though the risk of liability is remote, the potential damages and litigation expenses can be substantial; thus, directors and officers cannot ignore their exposure to liability arising out of their position in

1. STEPHEN M. BAINBRIDGE, BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, LLCS, AND CORPORATIONS 468 (LEG, Inc. 11th ed. 2021).

a company.[2] This Note explores the measures protecting directors and officers from liability, the downfalls of those measures, and a potential solution to the hazards arising out of those protections.

Indemnification, advancement, and director and officer ("D&O") insurance are each seen as necessary to some extent for companies to attract talented officers and directors.[3] Without those protections, directors' and officers' personal assets become "fair game" in the event of a suit in which they are personally named a defendant because of their position.[4] In fact, many directors and officers will not accept positions at a company that does not provide D&O insurance.[5] D&O insurance provides indemnification and advancement for expenses incurred by a company's officers and directors when the company otherwise cannot or will not provide such indemnification or advancement.[6] The policy also reimburses the company when it does indemnify or advance fees to its directors and officers.[7] Thus, the policy is seen as a necessity for the company and for its directors and officers. The provision of insurance is not without issue, however.

Though largely seen as beneficial to any company, D&O insurance creates a moral hazard problem and a market for lemons.[8] The provision of D&O insurance lessens the accountability that directors and officers face for their actions, making them less incentivized to avoid risk and do good work. This situation is described as a moral hazard, in which the insured is more inclined to take unreasonable risks, given that the potential costs associated with that risk will not be incurred by the risk taker, but rather by the insurance provider.[9] D&O insurance also creates a market for lemons, in which "bad" directors are likely to seek companies with high policy coverage.[10] Thus, although the company provides insurance to attract "good" directors and officers, a company providing high levels of coverage under its D&O policy may actually find itself with "bad" directors and officers who are less risk averse because they feel protected from personal liability.

State legislatures and the insurance market have both attempted to address the "morally hazardous market for lemons" created by D&O

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2. *Id.*

3. *See infra* Part I.

4. *Directors & Officers Insurance*, EMBROKER, https://www.embroker.com/coverage/directors-officers-insurance/ [https://perma.cc/YR7S-6BXQ] (last visited Feb. 10, 2024).

5. *See infra* Part II.

6. *See infra* Part I.

7. *See infra* Part I.

8. *See infra* Part III.

9. CFI Team, *Moral Hazard*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/economics/moral-hazard/ [https://perma.cc/J42Q-2Y54] (last visited Feb. 10, 2024).

10. George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 492 (1970).

insurance, though each falls short of providing adequate protection.[11] Statutes disallow indemnification and advancement for certain behaviors, including bad faith actions by the director or officer.[12] However, despite statutes limiting when a company may provide indemnification or advancement, the statutes also anticipate the use of insurance to provide such indemnification and advancement on behalf of the company.[13] Thus, although some effort is made by state legislatures to limit the consequences of indemnification and advancement, the side effects of indemnification and advancement live on through D&O insurance. The insurance market, no stranger to moral hazard and the market for lemons, also attempts to solve those problems through policy exemptions and high deductibles.[14] Like statutory exemptions, policy exemptions also fall short of solving the morally hazardous market for lemons problem, given that policy carve-outs create exceptions to the exemptions in many areas,[15] notably often allowing coverage for derivative litigation, which would otherwise be disallowed by statute.[16] High deductibles also fall short of rectifying the situation, given that the deductibles are often paid by the company, not the director or officer themselves, and are not required for certain types of coverage.[17]

This Note proposes that captive insurance provides a potential solution to the moral hazard and market for lemons problems caused by the provision of indemnification, advancement, and D&O insurance.[18] Captive insurance companies are owned either wholly or in part by the entity which it insures.[19] Put another way, the insured becomes an owner of its insurance company. Because the entity has incentives to

11. *See infra* Part IV.

12. Paul J. Lockwood & Arthur Bookout, *Legal and Practical Limits on Indemnification and Advancement in Delaware Corporate Entities*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 2, 2018), https://corpgov.law.harvard.edu/2018/07/02/legal-and-practical-limits-on-indemnification-and-advancement-in-delaware-corporate-entities/ [https://perma.cc/AHN6-FBW4].

13. *See id.*

14. *See infra* Part IV.

15. *Carve Back*, INS. TRAINING CTR., https://insurancetrainingcenter.com/glossary/carve-back/ [https://perma.cc/D9QB-4DQM] (last visited Feb. 10, 2024).

16. Geoffrey B. Fehling & Yaniel Abreu, *Maximizing Executive Protection Under D&O Policies: Common Disputes and Lessons Learned from Recent Case Law*, THOMSON REUTERS WESTLAW TODAY (Mar. 30, 2021), https://www.huntonak.com/images/content/7/5/v2/75113/maximizing-executive-protection-under-d-o-policies-common-disput.pdf [https://perma.cc/DW6G-HBPA].

17. Lynda A. Bennett, *Your D&O Coverage: Do You Have What You Need ... and Expect?*, DIRS. & BDS., June 2015, https://www.lowenstein.com/media/3191/directorsboardsmagazine.pdf [https://perma.cc/AW2V-AMQX].

18. *See infra* Section VI.D.

19. Michael Mead & Joe McDonald, *Captives 101: What Are They, and Why Do You Want One?*, IRMI (July 1, 2021), https://www.irmi.com/articles/expert-commentary/captives-101-what-are-they-and-why-do-i-want-one [https://perma.cc/Z4JH-QP38].

keep the captive performing well, directors and officers are re-incentivized to do good work while still being protected by an insurance policy. Admittedly, captive insurance may not be a viable option for all companies, given the costs associated with producing insurance rather than procuring it from the market.[20] Nonetheless, captives lower informational asymmetry between the insured agent and the principal insurance provider and lower the risk of adverse selection. Further, group captives may be used by companies that may not be able to afford a wholly-owned captive insurance company.[21] Despite hesitancy around captives due to cost and perceived "circularity,"[22] Delaware seemingly anticipates the use of captives to provide D&O insurance by amending subsection 145(g) of the Delaware General Corporation Law to define insurance as including captive insurance.[23]

This Note proceeds as follows. Part I will discuss the various mechanisms available to provide protection from litigation expenses for directors and officers: indemnification, advancement, and D&O insurance. Part II will discuss the policy reasons for providing D&O insurance. Part III will discuss the moral hazard and market for lemons problems associated with the provision of D&O insurance. Part IV will discuss attempted solutions to those problems, as well as the ways that those solutions fall short. Part V will discuss the Delaware General Corporation Law relating to the matter and provide a brief explanation of key departures from the Model Business Corporation Act. Part VI will explore captive insurance, counterarguments regarding the permissibility of using captive D&O insurance, and how captive insurance may potentially solve the morally hazardous market for lemons. A brief conclusion follows.

I. CORPORATE PROTECTIONS FOR DIRECTORS AND OFFICERS FROM LITIGATION-RELATED LIABILITY

Directors and officers are exposed to frequent litigation arising out of their role in the company which they serve. Litigation is costly, not to mention settlements and judgments that may need to be paid. Directors and officers often find themselves needing to cover the costs associated with litigation and look for resources to avoid paying the

20. *See infra* Section VI.B.

21. INS. INFO. INST., GROUP CAPTIVES: AN OPPORTUNITY TO LOWER COST OF RISK 1 (2023), https://www.iii.org/sites/default/files/docs/pdf/2023_triple-i_captive_resources_brief.pdf [https://perma.cc/E6R8-8CN4].

22. MARSH CAPTIVE SOLS., MARSH & MCLENNAN COS., ARE CAPTIVES AN OPTION FOR D&O LIABILITY INSURANCE? 2 (2020).

23. Priya Cherian Huskins & Evan Hessel, *D&O Game Changer: Delaware Approves Using Captives for D&O Insurance*, ABA BUS. L. SECTION (Feb. 8, 2022), https://businesslawtoday.org/2022/02/do-game-changer-delaware-approves-using-captives-for-do-insurance/ [https://perma.cc/Q9MA-LVFA].

associated and resulting expenses. Directors and officers may be protected from personal liability arising out of their positions through several mechanisms: indemnification, advancement, and D&O insurance.

A. Indemnification

The International Risk Management Institution, Inc. ("IRMI") defines indemnification as "compensation to a party for a loss or damage that has already occurred or to guarantee through a contractual clause to repay another party for loss or damage that might occur in the future."[24] Indemnification by a corporation to its directors and officers can be made mandatory by statute in some circumstances, with room to expand directors' and officers' right to indemnification under a company's founding documents and bylaws.[25] The right to indemnification is largely contingent on the outcome of litigation, with directors and officers unable to be indemnified if they are found liable—thus, a director or officer must prevail on the merits before he is entitled to indemnification.[26]

B. Advancement

The IRMI defines advancement of defense costs provisions as a provision in "directors and officers (D&O) liability policies . . . obligat[ing] the insurer to pay defense [and indemnity] costs as incurred" and notes that "[s]uch provisions eliminate the need for insured directors and officers or the corporate organization to pay such costs prior to receiving reimbursement from the insurer."[27] Advancement provides corporate officials with immediate relief from personal expenses caused by litigation.[28] Advancement does not require evaluation of a case on the merits and is not dependent on the director's right to indemnification; it is granted while the action against the director is still pending.[29]

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24. *Indemnity*, IRMI, https://www.irmi.com/term/insurance-definitions/indemnity [https://perma.cc/V3ET-YU93] (last visited Feb. 10, 2024).

25. ALLISON L. LAND ET AL., SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, INDEMNIFICATION CONSIDERATIONS FOR DIRECTORS AND OFFICERS OF DELAWARE ENTITIES 1-2 (2021), https://www.skadden.com/-/media/files/publications/2021/02/indemnification considerationsfordirectorsandoffice.pdf [https://perma.cc/4DU6-PRRH].

26. David A. Rothstein et al., *Indemnification Is Good, but Advancement Is Even Better: Make Sure You Know the Difference and Level the Playing Field from the Start*, 93 FLA. BAR J. 8 (2019), https://www.floridabar.org/the-florida-bar-journal/indemnification-is-good-but-advancement-is-even-bettermake-sure-you-know-the-difference-and-level-the-playing-field-from-the-start [https://perma.cc/S3BH-JKDL].

27. *Advancement of Defense Costs Provision*, IRMI, https://www.irmi.com/term/insurance-definitions/advancement-of-defense-costs-provision [https://perma.cc/8K33-D3FL] (last visited Feb. 10, 2024).

28. Rothstein et al., *supra* note 26, at 8.

29. *Id.*

Advancement is not an "irreversible flow of funds," however.[30] The director receiving the funds must repay the advancement if the suit is lost on the merits or if it is otherwise determined that the director is ineligible for indemnification.[31] Thus, the advancement is contingent upon an undertaking by the director to repay any advancement if he fails to meet the requisite standard of conduct defined by statute or the governing documents.[32]

Corporations can substantially alter a director's right to advancement. Attention should be given to language creating a right to advancement in governing documents to determine whether the right applies to expenses incurred by directors only while the director is employed at the company or also after their employment has ended.[33] The agreement may also alter the amount of undertaking required of the director, state whether the undertaking must be secured by collateral, or otherwise identify how soon the company must make advance payments.[34] The philosophy behind advancement is that the corporation should pay, in advance, the expenses incurred by its directors when those expenses allow directors to raise defenses and vindicate actions that may affect a company's liability and optics; however, those expenses must be repaid to the corporation by the director upon a finding of the director's liability.[35]

C. *Director and Officer Insurance*

D&O insurance is intended to protect directors from liability arising out of their work by providing coverage for defense costs, settlements, and other costs from claims asserted against them.[36] When corporations broadly agree to indemnify or provide advancement, there are times when the company is not financially able or legally permitted to do so.[37] Thus, corporations often purchase D&O insurance. D&O insurance fills the gaps created by legal restrictions and insolvent corporations for directors and officers when indemnification and advancement might not otherwise be available.[38]

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30. *Id.*

31. *Id.*

32. LAND ET AL., *supra* note 25, at 1.

33. *Id.* at 3.

34. *Id.*

35. Frances Floriano Goins et al., *Indemnification of Directors of Corporations and Managers of LLCs in Private Equity and Venture Capital Backed Companies*, ABA BUS. L. SECTION (July 28, 2022), https://businesslawtoday.org/2022/07/indemnification-directors-corporations-managers-llcs-private-equity-venture-capital-backed-companies/ [https://perma.cc/VM2R-UAJJ].

36. *Key Issues in Evaluating and Negotiating D&O Insurance Coverage*, MCGUIREWOODS (June 2014), https://www.mcguirewoods.com/client-resources/articles/2014/6/key-issues-d-o-insurance-coverage/ [https://perma.cc/2CG2-S5SF].

37. *Id.*

38. *Id.*

D&O insurance is often obtained to protect directors and officers from potential judgments and legal expenses incurred by defending shareholder derivative claims.[39] D&O policies may also cover "individual directors and officers for specific claims and their legal defense costs."[40] The policy may "reimburse companies that pay covered amounts on behalf of directors and officers."[41] Further, D&O policies may protect directors and officers, even when the corporation is not required or permitted to indemnify them.[42]

Coverage is usually made up of three insuring clauses: Side A; Side B; and Side C.[43] Side A coverage "insures wrongful acts of directors and officers when the company" refuses to do so or is otherwise not permitted to do so by applicable law.[44] Side B coverage reimburses the company for indemnification provided to directors or officers for claims that allege wrongful acts covered by the policy.[45] Finally, Side C coverage insures the company for its own liability.[46]

II. Policy Reasons for Allowing the Provisions

There are several important reasons that companies purchase D&O insurance, among them being the attraction of worthy directors and officers and sponsorship of innovation, explained in detail below. This Note does not argue that D&O insurance in and of itself is a negative thing. Rather, this Note argues in favor of an alternative to traditional D&O insurance, to lessen the risks associated with D&O insurance while still providing the key benefits that the coverage offers. The risks associated with D&O insurance and the alternative will be discussed in depth in the below Sections. First, it is important to understand why companies provide their directors and officers with D&O insurance.

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39. Prac. L. Com. Litig., *Indemnification, Advancement, and D&O Insurance Coverage in Shareholder Derivative Litigation*, THOMSON REUTERS PRAC. L., https://us.practicallaw.thomsonreuters.com/w-034-6034 [https://perma.cc/NW66-DQCZ] (last visited Feb. 10, 2024).

40. *Id.*

41. *Id.*

42. *Id.*

43. Michael Singer, *Sides A, B, C as Easy as 1, 2, 3: D&O Insurance Made Clear*, ABOVE L.: CONTINUING LEGAL EDUC. (Sept. 1, 2016, 8:16 PM), https://abovethelaw.com/lawline-cle/2016/09/01/sides-a-b-c-as-easy-as-1-2-3-do-insurance-made-clear/ [https://perma.cc/CA9R-N4MS].

44. MARSH CAPTIVE SOLS., *supra* note 22, at 2.

45. *Id.*

46. *Id.* at 1.

A. Attraction and Retention of D&Os

Companies often carry D&O insurance to attract individuals to the company.[47] Broad D&O insurance coverage is seen as a critical advantage when attracting directors and officers,[48] with some even arguing that requiring directors to pay for their legal expenses upfront is so oppressive that indemnity becomes an illusory benefit.[49] Often, individuals will opt out of joining companies without these protections, given that during periods of financial distress for the company, plaintiffs' firms examine the company's directors and officers for causes of action.[50] Thus, it is when a company may not be able to afford advancement or indemnification of expenses that the directors and officers need the funds most, making D&O insurance a requirement for many individuals when deciding whether to join a business in a director or officer position. If not for the policy, the directors' or officers' personal assets will constitute the most likely resource to satisfy an adverse judgment.[51]

Without the opportunity for advancement, directors and officers may also have liquidity problems. The director or officer would be forced to pay for the costs of litigation upfront, as well as any damages that might be awarded to the claimant. If their assets are tied up in illiquid assets, the director or officer may not be able to afford an adequate defense, exposing themselves to the risk of losing in court and forfeiting their right to indemnification. It creates poor optics for the company to have a successful suit brought against one of its directors or officers.

B. Risk-Taking Incentives

D&O insurance protects directors and officers for many decisions, including risky decisions made in an attempt to advance the interests of the company. Without D&O insurance, directors and officers are dissuaded from making risky decisions, given that their own capital and assets may be at risk if they are sued in their capacity as a director or officer. Thus, the purchase of D&O insurance sponsors risky decisions that may be made in a good faith attempt to innovate and create greater returns for the company. Without the protection of D&O

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47. John Loughnane, *Five Things to Know About D&O*, ABA BUS. L. SECTION (Sept. 28, 2017), https://www.americanbar.org/groups/business_law/publications/blt/2017/09/11_loughnane/ [https://perma.cc/G9DU-4MHY].

48. Carolyn H. Rosenberg et al., *A "Captive" Audience for D&O Insurance: Delaware to Permit Captive Insurance Companies to Provide D&O Insurance*, REED SMITH (Feb. 9, 2022), https://www.reedsmith.com/en/perspectives/2022/02/a-captive-audience-for-d-and-o-insurance [https://perma.cc/DR9D-MQAR].

49. Rothstein et al., *supra* note 26, at 8.

50. BAINBRIDGE, *supra* note 1, at 481.

51. Loughnane, *supra* note 47.

insurance, directors and officers are likely to make much more conservative choices, which may result in stagnant operations not only within the company, but also within the industry as a whole.

III. THE RISKS ARISING OUT OF AFFORDED PROTECTIONS

D&O insurance, including its provision of indemnification and advancement, is widely viewed as beneficial to not only a company's directors and officers, but also to the company itself. Though there are important reasons for providing the coverage, D&O insurance presents several unanticipated consequences, creating a morally hazardous market for lemons. In fact, in contrast to common American legislation on the matter, many nations severely limit the director and officer rights to indemnification and advancement, even limiting the availability of D&O insurance coverage to avoid those problems.[52] The consequences of D&O insurance are outlined below.

A. Moral Hazard

The IRMI defines moral hazard as "an increase in the probable frequency or severity of loss due to an insured peril that arises from the character or circumstances of the insured."[53] Stated differently, a moral hazard is a situation in which a party is more comfortable taking risks because they are not responsible for negative consequences associated with that choice. Moral hazards remove a party's incentive to do good work since they are otherwise protected from the downsides of their decisions.

Moral hazard is particularly applicable to D&O insurance—in fact, "moral hazard" is a term that was originally coined by the insurance industry.[54] The issue is rooted in informational asymmetry between the insured and the insurance provider, given that the insured will not inform the provider of its intention to act in ways that benefit itself the most, regardless of the associated risks.[55] Thus, directors and officers

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52. Ian M. Ramsay, *Liability of Directors for Breach of Duty and the Scope of Indemnification and Insurance*, 5 CO. & SEC. L.J. 129 (1987).

53. *Moral Hazard*, IRMI, https://www.irmi.com/term/insurance-definitions/moral-hazard [https://perma.cc/W3PD-6TSF] (last visited Feb. 10, 2024).

54. CFI Team, *supra* note 9.

55. *Id.* ("The issue of misinformation or unequal information is that both parties are not on the same page. Such an issue is dangerous in any business situation, but particularly so in regard to taking out insurance. The party acquiring insurance intends to act in a way that benefits them most, knowing the insurance covers any risks taken. The information is typically not passed on to the insurance company because it would typically result in either higher premium requirements or the inability to obtain the insurance policy.").

may be more inclined to take risks in their management and control of a company if they are aware that insurance will incur the risk and potential costs of doing so.

B. Market for Lemons

The market for lemons problem refers to informational asymmetry in which one party has more information regarding the quality of their goods or services than the other.[56] This informational asymmetry creates an abundance of bad actors or "lemons" in a market. Similar to the health insurance example originally provided by George Akerlof in his groundbreaking article *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*,[57] the D&O insurance market also creates a market for lemons.[58] The provision of extensive D&O insurance with high policy limits is attractive to "bad" officers and directors, who will make riskier decisions and increase use of the policy. The informational asymmetry here is that "bad" directors and officers will not reveal to the employer or the insurance company that they forecast making use of the policy.[59] Thus, companies providing D&O coverage to attract "good" directors and officers may, in effect, attract directors and officers who expose the company to more liability than "good" directors, who may cause a company less liability and involvement in less litigation.

56. James Chen, *The Problem of Lemons: Buyer vs. Seller*, INVESTOPEDIA, https://www.investopedia.com/terms/l/lemons-problem.asp [https://perma.cc/V4U9-RW53] (last updated Feb. 13, 2024).

57. Akerlof, *supra* note 10, at 492-93 ("It is a well-known fact that people over 65 have great difficulty in buying medical insurance. The natural question arises: why doesn't the price rise to match the risk? Our answer is that as the price level rises the people who insure themselves will be those who are increasingly certain that they will need the insurance; for error in medical check-ups, doctors' sympathy with older patients, and so on make it much easier for the applicant to assess the risks involved than the insurance company. The result is that the average medical condition of insurance applicants deteriorates as the price level rises—with the result that no insurance sales may take place at any price. This is strictly analogous to our automobiles case, where the average quality of used cars supplied fell with a corresponding fall in the price level. This agrees with the explanation in insurance textbooks: 'Generally speaking policies are not available at ages materially greater than sixty-five. . . . The term premiums are too high for any but the most pessimistic (which is to say the least healthy) insureds to find attractive. Thus there is a severe problem of adverse selection at these ages.' " (alteration in original) (footnote omitted) (quoting O.D. DICKERSON, HEALTH INSURANCE 333 (1959))).

58. *See id.* at 493-94.

59. "Bad" here is used not to indicate moral corruption or any other indication of character. "Bad" here is used to describe directors and officers who will cause liability and litigation for themselves and the company, whether intentional or not.

IV. POTENTIAL SOLUTIONS AND THEIR PITFALLS

The insurance market is no stranger to the above problems, and as mentioned, was the industry to put a name to the moral hazard problem. Thus, it is only natural that the insurance market would attempt to solve these problems itself. Such solutions include high deductibles and carve-outs for certain behavior. Though the insurance industry has taken several steps to mitigate the risks involved with the provision of insurance, it has yet to completely rid the market of these ailments. Similarly, legislatures have also failed in addressing these problems by permitting the provision of D&O insurance in areas that the company itself may not provide coverage.[60]

A. Higher Deductibles on D&O Insurance Plans

D&O policies often have high deductibles and low maximum coverages.[61] The aim of deductibles is to persuade insured parties to undertake greater care, to avoid triggering events that require insurance and the payment of the deductible.[62] Thus, though the director or officer may be more likely to take risks if the potential loss of their risk is insured, having a high deductible will cause the director or officer to take risks with more hesitation than it would without the high deductible. The idea is that the deductible is meant to take some skin off the backs of directors while still providing them coverage from catastrophic damages.[63]

The pitfall of high deductibles is that the corporation itself pays for the deductible, not the director.[64] In fact, Side A coverage, which provides indemnification or advancement when the corporation itself either cannot or will not, does not require a deductible at all.[65] Contrast this with Australian legislation, which allows D&O insurance paid for by the director, not the company.[66] Australia credits this policy with the need to balance protection of shareholders from mismanagement and self-dealing of directors with the need to encourage directors to

60. *See infra* Part V.

61. BAINBRIDGE, *supra* note 1, at 482.

62. *See generally* The Investopedia Team, *Why Do Insurance Policies Have Deductibles?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/071515/why-do-insurance-policies-have-deductibles.asp [https://perma.cc/5FHB-TWBX] (last updated Dec. 29, 2022).

63. *See id.*

64. *See Understanding Retention & Deductible: Side A, B, C of D&O Insurance*, BIMAKAVACH, https://www.bimakavach.com/blog/understanding-retention-deductible-side-a-b-c-of-d-o-insurance/ [https://perma.cc/SG6D-3AV8] (last visited Feb. 10, 2024).

65. Bennett, *supra* note 17.

66. Ramsay, *supra* note 52 (discussing Australian Companies Legislation Section 237).

take good faith risks in their management of business.[67] Thus, the existence of high deductibles in American D&O insurance does not rectify the agency problems because the director or officer responsible for making the risk-taking decision will not bear the cost of either the deductible or the policy itself.

B. Exclusions for Certain Behavior

Insurance companies further take matters into their own hands by writing exclusions into policies. An exclusion is a policy provision that narrows the scope of coverage by excluding specific risks.[68] Such exclusions restrict what the insuring agreement will cover, limiting extensive coverage.[69] This strategy is largely how insurers mitigate their own risk of loss.[70] Many policies include wide and important exclusions from coverage, including violation of anti-pollution laws, conduct in resistance to takeovers, and certain violations of securities laws.[71] Other common exclusions include breaches of contract;[72] personal gain;[73] claims that fall under another policy;[74] discrimination and wrongful termination;[75] dishonest, wrongful, or fraudulent conduct;[76] prior

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67. *Id.*

68. Matt McKenna, *D&O Insurance Exclusions: Red Flags and What to Look Out For*, FOUNDER SHIELD, https://foundershield.com/blog/do-insurance-exclusions/ [https://perma.cc/6U6Y-3MQ6] (last updated Oct. 21, 2022).

69. *Id.*

70. *Id.*

71. BAINBRIDGE, *supra* note 1, at 482.

72. McKenna, *supra* note 68 ("When directors and officers of a company fail to comply with a signed contract, it's known as breach of contract. Contrary to what some might believe, this contractual duty isn't upheld by law. Instead, it's a voluntary obligation. As a result, insurers consider most breaches as having arisen from something other than an act, error or omission (also called a 'wrongful act') that the insurer is willing to cover. But remember, this type of exclusion can be overridden (often) if liability exists against the Ds&Os even if there was no written contract. This exclusion, therefore, may not be the end of the road for coverage.").

73. *Id.* ("Although it might seem like a no-brainer, insurers don't look kindly on insured directors and officers who cause damage to a business by gaining undeserved profit or advantage. Loyalty and integrity are qualifiers for the leadership of a company—even according to an insurance policy.").

74. *Id.* ("D&O insurance policies aim to cover the capacity of specific members of company leadership while they are exercising their actual business judgment (or failing to do so when they should…). Therefore, many workplace situations that wind up as claims will fall outside of the D&O policy's scope and under the coverage of different policies. For example, property damage is usually covered by a general liability (GL) policy and not written into a D&O coverage.").

75. *Id.* ("Employees may file a D&O claim if they believe the company has wronged them. Sometimes these claims don't have a base, but still, cost in defense fees. Also, D&O insurance doesn't always consist of this particular coverage, making it necessary to purchase an employment practices liability insurance (EPLI) policy.").

76. *Id.* ("Each industry upholds its specific laws, statutes, and regulations. Simply said, directors and officers have a duty of obedience to comply with these legal standards. If they fail to meet it due to negligence, they're covered. If they cross the line into dishonesty, etc., coverage could be jeopardized.").

acts;[77] defamation, libel, and slander claims;[78] catastrophic hazards;[79] and fines, penalties, and punitive damages.[80] Another standard exclusion is the "insured vs. insured" exclusion, in which coverage is precluded for claims brought by one insured against another insured.[81] Thus, although there is a moral hazard in providing D&O insurance, policy exclusions help mitigate the fact that directors and officers are incentivized to take substantial risks.

Exclusions do not provide the insurer full protection, however. Exclusions often include "carve backs," creating an exception to the exclusion.[82] Carve backs benefit the insured by making exclusions inapplicable in certain situations.[83] For example, D&O insurance policies often contain carve backs allowing coverage for derivative actions, though without the carve back, the insured vs. insured exclusion would preclude coverage.[84] Another standard carve back preserves coverage for claims brought by a former director or officer after the individual's employment has been terminated.[85] Thus, although the insurance industry tries to mitigate risks associated with the provision of insurance, carve backs limit the provider's ability to adequately do so.

V. STATUTORY APPROACHES

State governments also have their say in when and to what extent indemnification, advancement, and D&O insurance is mandatory, permissive, or disallowed. There is wide variation between the states on approaches taken, and the area is hotly debated when statutes are

77. *Id.* ("D&O insurance is typically written as claims-made policies, which means claims must be filed during the policy period to be covered. Any loss reported outside of this time frame—regardless of occurrence—won't be covered.").

78. *Id.* ("D&O insurance holds directors and officers accountable for their words. This approach only makes sense as company leadership frequently must speak about other individuals. It's not uncommon for others to interpret comments negatively, which often occurs during employee termination or in a company newsletter. Reception and interpretation are two things that no one person can force on another, so this exclusion plays into human nature, per se.").

79. *Id.* ("Many D&O policies exclude losses that arise from catastrophic hazards, such as war, environmental damage, nuclear events, or acts of terrorism (due to the September 11, 2001 attack). Sometimes the policy will include coverage carvebacks for shareholder claims, as well.").

80. *Id.* ("The overall purpose of fines, penalties, and punitive damages is to punish wrong behavior. Many insurers don't cover these fines because it would negate the meaning of the charge.").

81. Kevin M. LaCroix, *D&O Insurance: Coverage Carve-Backs in the Insured vs. Insured Exclusion*, D&O DIARY (Dec. 17, 2017), https://www.dandodiary.com/2017/12/articles/d-o-insurance/insurance-coverage-carve-backs-insured-vs-insured-exclusion/ [https://perma.cc/7U76-GEEM].

82. *Carve Back*, *supra* note 15.

83. *Id.*

84. *Id.*

85. LaCroix, *supra* note 81.

drafted or updated.[86] Though other business entity laws address the matter as well, this Note focuses on corporate law approaches under the Delaware General Corporation Law ("DGCL") rather than the Model Business Corporation Act.

A. The Delaware Act

Delaware greatly influences American corporate law. In fact, as of 2022, Delaware is the state of incorporation for 68.2% of Fortune 500 companies[87] and has a total of 386,254 registered corporations.[88] Between granting mandatory indemnification for directors and officers who mount a successful defense and denying indemnification for bad faith actions, corporations organized under Delaware law have broad discretion to determine their own rules relating to indemnification and advancement.[89] There is no right to advancement, but corporations may require it under their articles of incorporation.[90] By way of contrast, Delaware law governing other business entities, including LLCs, does not make indemnification mandatory under any circumstance.[91]

Delaware corporate law on indemnification is typical—subsection 145(a) allows indemnification for damages and expenses in third-party suits.[92] Subsection 145(b) allows indemnification for expenses in derivative suits.[93] This subsection allows for indemnification of directors

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86. *See* James H. Cheek, III, *Control of Corporate Indemnification: A Proposed Statute*, 22 VAND. L. REV. 255 (1969).

87. JEFFREY W. BULLOCK, DELAWARE DIVISION OF CORPORATIONS: 2022 ANNUAL REPORT (2022), https://corpfiles.delaware.gov/Annual-Reports/Division-of-Corporations-2022-Annual-Report-cy.pdf [https://perma.cc/G384-UMEY].

88. *Id.*

89. Lockwood & Bookout, *supra* note 12.

90. *Id.*

91. *Id.*

92. DEL. CODE ANN. tit. 8, § 145(a) (2022) ("A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation) by reason of the fact that the person is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the person in connection with such action, suit or proceeding if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful. The termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that the person's conduct was unlawful.").

93. *Id.* § 145(b) ("A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit by or in the right of the corporation to procure a judgment in its favor by reason of

and officers who were found not to be liable for whichever claim was brought against them; if the defendant director or officer was found liable to the corporation, the director or officer may only be indemnified with judicial approval.[94] This subsection refuses directors and officers the right to be indemnified for derivative suit settlements and judgments, however.[95] The reason for this is that in derivative suits, judgment or settlement is paid to the corporation itself.[96] Thus, indemnification by the corporation goes against public policy, because "the corporation effectively pays money damages to itself and does not benefit from the successful derivative action."[97] In instances where the corporation may not indemnify its directors and officers, Side A D&O insurance may indemnify the officers.[98] Subsection 145(c) maintains that expenses must be reimbursed if the defendant director or officer was successful in its claim.[99] Subsection 145(e) addresses directors' ad-

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the fact that the person is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against expenses (including attorneys' fees) actually and reasonably incurred by the person in connection with the defense or settlement of such action or suit if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation and except that no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation unless and only to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper.").

94. *Id.*; BAINBRIDGE, *supra* note 1, at 469.

95. Daniel E. Chefitz & Lauren Silvestri Burke, *Delaware Fully Embraces Captive Insurance as an Option to Protect Directors and Officers*, MORGAN LEWIS (Feb. 4, 2022), https://www.morganlewis.com/pubs/2022/02/delaware-fully-embraces-captive-insurance-as-an-option-to-protect-directors-and-officers [https://perma.cc/5BPV-MU4Z].

96. *Id.*

97. *Id.*

98. *Id.*

99. DEL. CODE ANN. tit. 8, § 145(c) (2022) ("(1) To the extent that a present or former director or officer of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) and (b) of this section, or in defense of any claim, issue or matter therein, such person shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection therewith. For indemnification with respect to any act or omission occurring after December 31, 2020, references to "officer" for purposes of paragraphs (c)(1) and (2) of this section shall mean only a person who at the time of such act or omission is deemed to have consented to service by the delivery of process to the registered agent of the corporation pursuant to § 3114(b) of Title 10 (for purposes of this sentence only, treating residents of this State as if they were nonresidents to apply § 3114(b) of Title 10 to this sentence). (2) The corporation may indemnify any other person who is not a present or former director or officer of the corporation against expenses (including attorneys' fees) actually and reasonably incurred by such person to the extent he or she has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) and (b) of this section, or in defense of any claim, issue or matter therein.").

vancement rights. Under subsection 145(e), advancement is permissive, with the statute stating that the corporation "may" pay expenses in advance.[100] Importantly, subsection 145(g) creates the ability for companies to draft greater protection for their directors and officers and foresees the provision of insurance coverage for costs that the corporation is either unable or unwilling to provide.[101]

Other than indemnification required by statute, Delaware corporations have no obligation to further indemnify or provide any advancement to directors and officers.[102] Corporations formed under Delaware law may, however, require mandatory indemnification or advancement in their articles of incorporation.[103] The company may in turn require that directors and officers receiving advancement to execute an undertaking repay any funds if they are found to be ineligible for indemnification.[104] The undertaking may be unsecured if the corporation allows, however.[105]

Though Delaware law gives corporations broad discretion to grant indemnification and advancement rights to officers, such discretion is not limitless.[106] Directors and officers may not be indemnified for actions made in "bad faith."[107] For third-party actions, to meet the statutory standard of care, a director must show that he acted "in good faith," "in a manner reasonably believed to be in or not opposed to the best interests of the company," and "with respect to any criminal action or proceeding, he or she must have no reasonable cause to believe that his or her conduct is unlawful."[108] Further, Delaware limits rights to indemnification and advancement through the derivative settlement exclusion and the "by reason of" limitation, in which actions arising outside of the scope of employment are not provided protection by the company.[109]

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100. *Id.* § 145(e).

101. *Id.* § 145(g).

102. LAND ET AL., *supra* note 25.

103. Lockwood & Bookout, *supra* note 12.

104. *Id.*

105. *Id.*; James Chen, *Unsecured Loans: Borrowing Without Collateral*, INVESTOPEDIA, https://www.investopedia.com/terms/u/unsecuredloan.asp [https://perma.cc/BQJ6-BFSS] (last updated Dec. 11, 2023) ("Unsecured loans—sometimes referred to as signature loans or personal loans—are approved without the use of property or other assets as collateral.").

106. Lockwood & Bookout, *supra* note 12.

107. *Id.*

108. LAND ET AL., *supra* note 25.

109. Lockwood & Bookout, *supra* note 12 ("Companies have also refused to advance expenses on the grounds that the action did not arise 'by reason of' that person's service to the company, especially when the suit was filed after the director or officer left the company. The outcomes of these cases have been mixed; however, even if the director or officer is ultimately successful in pursuing indemnification, the delay in advancing expenses could harm the director's or officer's ability to mount a vigorous legal defense in the underlying litigation." (citation omitted)).

B. Contrast to the Uniform Act

One important difference between the Delaware statutory code and the Model Act is the mandatory indemnification created by DGCL 145(c), stating that individuals must be indemnified by the corporation for actual and reasonable expenses "[t]o the extent that a present or former director or officer of a corporation has been successful on the merits or otherwise."[110] Consider *Merritt-Chapman & Scott Corp. v. Wolfson*, in which the director defendants, who successfully defended against some criminal counts but plead nolo contendere and were convicted of others, were entitled to indemnification for the counts on which they were acquitted.[111] Contrast with section 8.52 of the Model Act which states that indemnification is required for a "director who was *wholly* successful, on the merits or otherwise, in the defense of any proceeding to which he was a party because he was a director of the corporation."[112] Thus, the addition of the word "wholly" avoids the *Merritt-Chapman* result under Delaware law.[113]

Another important difference is that under Delaware law, a director or officer found liable in a derivative suit is only entitled to indemnification expenses incurred in litigation if granted by a Court of Chancery.[114] "In contrast, Model Act section 8.51(d)(1) permits a corporation to award reasonable expenses to a director" if they meet the standard of conduct outlined in 8.51(a), even if they were found to be liable to the corporation.[115]

VI. "CAPTIVATING" THE D&O INSURANCE MARKET

A. Captive Insurance

The IRMI defines captive insurance as an "insurance subsidiary of a noninsurance entity or parent and is owned by the insured."[116] The purpose of captive insurance is to pay losses, afford businesses more control over their own risk, and to generate revenue.[117] In the wake of

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110. DEL. CODE ANN. tit. 8, § 145(c) (2022); Michael P. Dooley & Michael D. Goldman, *Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law*, 56 BUS. LAW. 737, 760 (2001).

111. 321 A.2d 138 (Del. Super. Ct. 1974).

112. Dooley & Goldman, *supra* note 110, at 761 (quoting MODEL BUS. CORP. ACT ANN. § 8.52 (emphasis added)).

113. *Id.* ("It was the thinking of the Model Act drafters that although this approach may result in requiring the corporation to eventually incur greater indemnification costs, it also relieves the pressure to plea bargain by a defendant . . . .").

114. *Id.*

115. *Id.*

116. Mead & McDonald, *supra* note 19.

117. *Id.*

COVID-19 and a "hardening" insurance market, more and more companies are turning to captive insurance programs.[118] Captive insurance is commonly used for workers' compensation, general liability, auto liability, and professional liability.[119]

Some companies combine to form their own captive insurance company to provide coverage.[120] Group captives are defined as "a captive that insures the risks of a heterogeneous or homogeneous group of unrelated insureds."[121] Group captives may be set up in a way where the captive is jointly owned amongst several unrelated businesses.[122] A recent study showed that almost three-quarters of new bound policies in group captives resulted in lower premiums compared to the members' previous plans, with roughly 30% of new policies producing savings of 20-30%.[123] Thus, if a company cannot afford the initial capital contribution required to operate a wholly-owned captive, group captives are a viable alternative, providing the benefits of a wholly-owned captive.

The best candidates for captive insurance are sophisticated companies looking for greater control over their risk management and financing, who understand their risk profile better than the traditional market does.[124] Captive insurance provides companies a cost-effective structure in which they can profit off of their own risk, rather than accepting the costs of insurance without the potential additional benefits.[125] To make the most out of captive insurance and achieve cost-savings, the captive should be structured to finance more than small risks.[126]

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118. *Id.*; *see also* Rosenberg et al., *supra* note 48 ("Commentators cite the reasons for this 'hard market' as increased litigation in the financial industry, increased securities litigation in prior years, increasing monetary judgments or settlements in securities cases, and the economic disruptions and rise of litigation due to the COVID-19 pandemic, among other reasons."); Huskins & Hessel, *supra* note 23 ("The reason the cost of D&O insurance has gone up so dramatically is that losses have been outpacing premiums for years. The volatile, high-severity nature of outcomes for D&O claims makes underwriting a particularly difficult challenge—especially for the biggest companies. Carriers have long felt that providing D&O insurance for some companies is much like providing fire insurance for mansion-size cabins in the middle of a forest experiencing drought.").

119. Mead & McDonald, *supra* note 19. It is important to note that professional liability and D&O insurance are not the same. *See, e.g.*, *The Difference Between D&O and PI Insurance*, RED ASIA INS. (Mar. 25, 2022), https://www.redasiainsurance.com/do-and-pi-insurance/ [https://perma.cc/T6FT-WJWU] ("D&O insurance covers only managers and directors for claims related to their work and duties to the business. PI insurance covers any professional and business from third-party claims regarding their service or advice.").

120. BAINBRIDGE, *supra* note 1, at 482.

121. *Group Captive*, IRMI, https://www.irmi.com/term/insurance-definitions/group-captive [https://perma.cc/WE22-T6HA] (last visited Feb. 10, 2024).

122. INS. INFO. INST., *supra* note 21, at 1.

123. *Id.* at 2.

124. Mead & McDonald, *supra* note 19.

125. *Id.*

126. *Id.*

Captive insurance provides several benefits that attract companies. First, captives can invest the risk premium.[127] When the insured makes a payment to the captive, the risk premium is retained by the captive, as opposed to a traditional insurance company, and is invested for the benefit of its parent company, or companies in the case of a group captive.[128] Second, captives also allow for tailored coverage for specific needs of the insured, providing coverage that meets the specific needs of the company.[129] Importantly, accounting and tax rules allow for the deduction of insurance premiums by insurance companies.[130] Specifically, reserve funds held by an insurance company (including captives) for the payment of future losses are deductible.[131] This contrasts with companies who increase their retention or are self-insured, whose retained funds do not constitute an insurance premium and therefore cannot be used to realize the tax benefit.[132] Third, joining a captive often results in a reduced insurance premium, given that the premium is based on the company's own most recent five-year history, as opposed to a traditional provider whose premium is based on industry-wide loss experience, overall portfolio performance, and other market conditions.[133] Fourth, a company may be given dividends by its captive when it achieves better-than-expected performance and makes lower usage of the policy than expected.[134] Further benefits of captive insurance include freedom to choose vendors and service suppliers, reinsurance structure options, and the creation of a new profit center.[135]

B. Producing vs. Procuring Insurance

An important caveat regarding the use of captive insurance relates to a company's decision to produce a product rather than procure it from the market. Here, a business must weigh several important factors, including the cost of producing insurance themselves as opposed to the cost of purchasing insurance from the market.[136] The use of captive insurance may lower information asymmetry between the insured and the provider; however, transaction costs are not totally eliminated by the choice to produce insurance. To operate, the captive must meet

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127. Chefitz & Burke, *supra* note 95.
128. *Id.*
129. *Id.*
130. Mead & McDonald, *supra* note 19.
131. *Id.*
132. *Id.*
133. *Id.*; INS. INFO. INST., *supra* note 21, at 2.
134. INS. INFO. INST., *supra* note 21, at 2.
135. *See id.* at 3.
136. R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 391-93 (1937).

all regulatory standards required of traditional insurance companies,[137] including licensure, capital, and surplus requirements.[138] There are further administrative and overhead costs associated with the operation and management of captive insurance—costs that are otherwise paid for by the insurance provider rather than by the insured.[139] Thus, producing insurance as a firm does not eliminate transaction costs associated with the provision of insurance.

Producing insurance through a captive does, however, insulate the insured from market externalities that may otherwise drive the price of their insurance up. When underwriting a policy, traditional insurance providers consider, among many things, market forces and other drivers beyond the control of the insured.[140] Thus, the price of insurance is often based on factors that the insured cannot prevent, no matter how careful they are. However, by producing their own insurance, captives are able to insulate the insured from market forces and provide insurance at a rate that captures the company's exposure to risk and risk appetite, rather than considering market forces. Thus, though exposed to the costs of producing its own insurance, a captive may save the insured money through reduced insurance rates and premiums.

Choosing to produce rather than to procure insurance leads to less informational asymmetry for all involved. The insured understands the exact costs incurred by the captive and is aware of the profit margins maintained by the captive, as opposed to traditional insurance in which the insured is not privy to the overhead and operating costs of the provider nor the profits made by the provision of insurance. Similarly, the captive insurer has complete information about the insured and can better write a policy which provides coverage for specific risks and needs, rather than a traditional insurance provider who would not be fully informed by the insured due to the risk of being denied coverage or increased premiums arising out of the disclosure of certain risks. Thus, both parties to a captive are fully informed about the profits being made off of the coverage and the risks assumed by the provider through the coverage, and the informational asymmetry typical of the insurance market is lowered, if not eliminated.

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137. *Captive Insurance Companies*, NAT'L ASS'N INS. COMM'RS, https://content.naic.org/cipr-topics/captive-insurance-companies [https://perma.cc/GT8T-8QP5] (last updated Jan. 31, 2024).

138. *Commercial Insurance: Regulation*, INS. INFO. INST., https://www.iii.org/publications/commercial-insurance/how-it-functions/regulation [https://perma.cc/W6KW-AAD5] (last visited Feb. 10, 2024).

139. *See generally* Michael Stoop, *What Is the Cost to Run a Captive Insurance Program?*, METRO. RISK, https://www.metropolitanrisk.com/what-is-the-cost-of-a-captive/ [https://perma.cc/A3C5-URUY] (last visited Feb. 10, 2024).

140. Jeff Hirsch, *7 Crucial Cost & Drivers of D&O Insurance*, FOUNDER SHIELD, https://foundershield.com/blog/do-insurance/ [https://perma.cc/XTV9-XZLF] (last updated Oct. 18, 2022).

The decision to use captive insurance involves weighing the costs associated with captives against the potential savings, which can show that the use of captive insurance may be better suited for some parties than others. Some companies may not be able to adequately capitalize a captive if they do not have a strong balance sheet or ability to obtain letters of credit.[141] Thus, large and otherwise financially strong companies may be better suited to produce insurance through a captive. Considering that captives can be used to provide many lines of insurance, companies with strong balance sheets are likely to find that the initial transaction costs incurred to begin a captive insurance company are recaptured in saved premiums.[142] Transaction costs are even lower for companies who already own a captive, and adding the D&O line to the captive will be even more cost effective.[143] Smaller companies, which may not be able to afford the start-up costs of a captive, may seek to continue procuring insurance through the market, though they are a candidate for group captives, in which the initial capital required to become a member is significantly less than that for starting a wholly-owned captive.[144] Transaction costs are shared amongst several owners in group captives while still enabling the insured to own the captive (i.e., the costs of providing insurance are split among the insureds; the more members of the captive, the more ways the costs are split).

C. Addressing Hesitancy Towards Using Captive Insurance

Historically, there has been hesitancy regarding the use of captives to provide Side A D&O coverage.[145] The concern here is that the coverage is circular in nature—the captive steps in to provide indemnification where the company either cannot or will not, but the captive is owned by the company. The arising issue is whether the company is in effect completing the indemnification or advancement that it other-

141. Chefitz & Burke, *supra* note 95.

142. *See id.*

143. *See generally* Donald Riggin, *Things to Know About Captive Insurance Companies*, IRMI (Nov. 16, 2018), https://www.irmi.com/articles/expert-commentary/things-to-know-about-captive-insurance-companies [https://perma.cc/G3Y2-7H64] (discussing start-up costs of captives).

144. *See* INS. INFO. INST., *supra* note 21, at 3.

145. MARSH CAPTIVE SOLS., *supra* note 22, at 2 ("An example would be a situation where a derivative claim is brought by shareholders against senior executives. In most jurisdictions, derivative action settlements and judgments can only be funded under Side A D&O, i.e., they are non-indemnifiable. If the claim funding is provided via the captive, there is a circularity argument in that the claim is being funded by the company itself, via its single-parent captive (an entity owned by the company). To the extent that a company is in a jurisdiction that permits indemnification of derivative claims, this conflict is less of a concern.").

wise would not have. For this reason, many believed that even if a company used a captive, it must still buy Side A coverage from a traditional commercial insurance carrier.[146]

The solution here is simple: for the provision of Side A insurance, ensure that the captive is operated under different management than the insured. Thus, the directors of the insured are not the directors of the captive, and the entities are treated as distinct from one another. Another option would be to operate the Side A coverage under a protected cell company. Protected cell companies are entities with separate and independent management, ownership, and control from the insured company.[147] Under a protected cell company, policy decisions regarding Side A coverage can be made independently of both the captive and the insured company.[148] Both of these solutions also limit the risk of ring-fencing assets,[149] ensuring that separate control of the entities disallows horizontal veil piercing among the captive and its owner.[150]

Though historically there has been hesitancy regarding the use of captives for D&O insurance, it is gaining viability as an option. Importantly, in 2022, the Delaware legislature passed a bill recognizing "captive insurance [as] a viable alternative to traditional D&O insurance."[151] The Delaware legislature passed a bill to amend subsection 145(g) of the DGCL to clarify that captives are included in the definition of insurance.[152] Thus, regardless of whether the corporation is able or willing to provide indemnification, subsection 145(g) now explicitly allows directors and officers to be covered by captive D&O insurance. To further relieve the above concerns, the amended statute states that captive D&O insurance may not provide coverage if it is determined in a final judgment that the individual received a financial benefit or engaged in deliberate criminal or fraudulent actions.[153] The amendment

146. Huskins & Hessel, *supra* note 23.

147. MARSH CAPTIVE SOLS., *supra* note 22, at 3.

148. *Id.*

149. *See generally* JOHN M. ORR & ROB YELLEN, WILLIS TOWERS WATSON, CONSIDERATIONS FOR D&O INSURANCE IN CAPTIVES 3 (2020), https://www.wtwco.com/-/media/wtw/insights/2020/06/considerations-for-directors-and-officers-dando-insurance-in-captives.pdf [https://perma.cc/36AC-M36M].

150. *See generally* Bryan R. Battina, *Limits of Limited Liability*, BRYAN R. BATTINA, https://bryanbattina.com/practice-areas/shareholder-disputes/limits-of-limited-liability/ [https://perma.cc/F3KA-X3ME] (last visited Feb. 10, 2024) ("The concept of corporate piercing may be applied both 'vertically' and 'horizontally.' Vertical piercing describes instances in which limited liability is cast aside to hold individuals (i.e., officers, directors, or shareholders) personally liable. Horizontal piercing occurs when the courts allow a plaintiff to seek the assets of a parent or sister company. While vertical piercing is more often successful, horizontal piercing is not uncommon. Creating multiple legal entities is of little value if the formalities are not honored.").

151. Huskins & Hessel, *supra* note 23.

152. *Id.*

153. Rosenberg et al., *supra* note 48.

reflects the type of conduct that exclusions cover in traditional D&O markets.[154] Further, under the amendment, notice must be given to stockholders if any captive insurance is used to fund an indemnification of directors and officers.[155] Market experts predict, however, that the amended definition may not permit captive D&O insurance in totality, and that the captive may not be able to provide coverage for non-indemnifiable losses under federal law.[156] A potential solution for anticipated issues with captive D&O insurance is to maintain a hybrid program with coverage provided in part by the captive and in part by a traditional provider.[157] Both the developments in Delaware law and the concerns raised by some market experts remain untested; thus, companies and market experts alike should closely monitor the actual effects of the amendment moving forward. Captive D&O insurance nonetheless may greatly resolve the moral hazard and market for lemons problems caused by the provision of insurance.

D. How Captive Insurance Rectifies the "Morally Hazardous Market for Lemons"

The moral hazard problem is a type of agency cost, in which the insured agent may not act in the best interests of the principal insurance provider, given that risk of loss will not be placed on the insured but instead on the provider. Captive insurance rectifies this problem by making a company both the agent and the principal. Though operated as two separate entities, the ownership of a captive realigns the interests of the insured agent by creating incentive for the agent to act in the best interest of the principal. This incentive is created due to the benefits of operating a captive, including the opportunity to be paid dividends. Thus, the interests of the insured agent and the principal insurance provider are realigned, and the insured will be less likely to take risks that may lead to litigation, creating a profitable captive.

Captives require an initial financial investment from the insured, and use of the policy puts the company's own capital at risk.[158] Therefore, the moral hazard of the insurance policy is lowered, as the directors and officers who are protected by the policy have less incentive to rely on the policy. Because there is the potential for dividends to be paid to the company for a less-than-projected use of the policy,[159] and

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154. *Id.*

155. *Id.*; DEL. CODE ANN. tit. 8, § 145(g)(3) (2022).

156. RICHARD PORTER ET AL., CHUBB, *Proceed with Caution: Understanding How Delaware's New D&O Captive Statute Can Leave Executives Vulnerable* (2022), https://www.chubb.com/content/dam/chubb-sites/chubb-com/microsites/global/global/documents/pdf/ChubbDelCaptivePaper.pdf [https://perma.cc/A3T2-MKCS].

157. *Id.*

158. Rosenberg et al., *supra* note 48.

159. INS. INFO. INST., *supra* note 21, at 3.

because directors and officers have a duty to put the welfare and best interests of the corporation above their own personal interests,[160] the directors are then incentivized to avoid litigation that would require use of the captive. By contrast, no such incentive to avoid litigation exists when a company obtains traditional insurance, as the cost for the policy has already been expended and directors and officers have less hesitation to use the policy.

Captive insurance also lessens informational asymmetry in obtaining an insurance policy. The directors and officers who are obtaining the policy are more aware of and understand their risk better than the underwriters in a traditional insurance company and are more likely to reveal that information to a captive than to a traditional company.[161] Choosing to produce insurance rather than procuring it from the market provides the captive underwriter with much more information about the insured than if the insurance company was an unrelated third party.[162] By producing insurance, the policy can be tailor-made to fit the specific needs and risks of the insured, risks that the insured might not otherwise disclose to a traditional insurance provider for fear of being denied coverage or being forced to pay higher premiums. Further, policies in a captive are based on the company's own history and risk exposure, as opposed to traditional insurance which is based on several market factors that are beyond the control of the insured.[163] The reduced informational asymmetry allows the company to pay less in premiums than it would if its premiums were based on volatile market conditions while also receiving coverage specific to its own risks, rather than the risks of the industry at large. Consequently, the company loses less by providing D&O insurance, though the coverage is still in place to attract competent and risk-averse directors and officers.

Similarly, using a captive diminishes the chances of a market for lemons and mitigates the adverse selection problem, given that "bad" directors might be dissuaded from joining a company that is insured by a captive. That is, a "bad" director may not feel adequately protected if D&O insurance is provided by a captive nor appreciate the incentive to engage in less risky performance. On the other hand, a "good" director or officer who takes reasonable risks and does not require or anticipate heavy usage of D&O insurance will not show the same hesitancy towards joining a company insured by a captive. Instead, they might welcome the opportunity to earn dividends and other benefits from the

160. *Fiduciary Duty*, CORNELL L. SCH.: LEGAL INFO. INST., https://www.law.cornell.edu/wex/fiduciary_duty [https://perma.cc/8LMN-U6UX] (last visited Feb. 10, 2024).

161. *See supra* Part VI.

162. *See supra* Part VI.

163. *See Advantages of Group Captive Insurance*, CAPTIVE RES., https://www.captiveresources.com/advantages-of-member-owned-group-captives/ [https://perma.cc/BMK7-XNTF] (last visited Feb. 10, 2024).

captive, rather than worry that a captive cannot cover their own bad actions. Thus, a director's hesitancy to join a company which provides captive D&O insurance might reveal that the director or officer is a high-risk director or officer who does not share similar risk-aversion values as the hiring company, lessening informational asymmetry during the hiring process. The company is then able to hire directors and officers who share their attitude and stature of risk aversion, limiting the adverse selection problem presented in providing D&O insurance.

Further, group captives typically involve levels of risk sharing among members.[164] Thus, directors and officers become accountable for their actions not only to shareholders, but also to the co-owners of the captive.[165] To maintain a profitable captive, or at a minimum a captive that breaks even, the directors and officers are incentivized to make decisions that are less likely to lead to litigation and liability. Members of a group captive insurer have been observed to support one another through sharing best practices to help each other succeed, making the captive stronger.[166] Group captives enable companies without the capital to operate a wholly-owned captive to reap the same benefits of diminished informational asymmetry and risk of adverse selection.

CONCLUSION

D&O insurance is necessary for companies to attract and retain directors and officers. The insurance is key to allowing directors and officers to take risks to sponsor growth within a company. Without the insurance, companies would have to provide indemnification and sometimes advancement out of pocket. When the company cannot or will not provide advancement, the director or officer themselves must pay legal expenses and other costs arising out of litigation up front. D&O insurance is inarguably a must; however, every good has its downsides.

The provision of D&O insurance creates a morally hazardous market for lemons. There is a moral hazard created by providing the insurance, in that directors and officers who know that they are insured are less hesitant about making decisions that may result in litigation. Similarly, "bad" directors and officers who intend to make higher usage of the policy than the average director or officer may be more attracted to companies with high policy limits. Thus, D&O insurance creates a risk to any company providing it that the company will hire a "bad" officer or director, who lacks incentive to avoid litigation.

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164. Huskins & Hessel, *supra* note 23.
165. INS. INFO. INST., *supra* note 21, at 4.
166. *Id.* at 2.

The insurance industry and state governments alike are no strangers to these problems. The insurance market attempts to address the morally hazardous market for lemons through high deductibles and exemptions from coverage. These solutions fall short of solving the issues, however, due to the lack of a deductible for Side A coverage and carve-outs, which create exceptions to the exemptions. Similarly, although state governments include some statutory limitations on when indemnification or advancement may be afforded to directors and officers, the statutes leave much discretion to the companies to decide for themselves when indemnification and advancement will be afforded. The statutes also contemplate insurance paying for expenses when the company cannot. Thus, the statutory protections from the problems also fall short of fully remedying the morally hazardous market for lemons.

This Note argues that one solution is captive insurance, in which the company itself either owns or partially owns the insurance provider. This ownership style creates incentives for directors and officers to avoid using the policy to make the captive a successful venture. The insured has several incentives for the captive to succeed, including tax incentives, potential dividends, and more.

Some argue that captive insurance's provision of Side A coverage is "circular," and that the company is providing its directors and officers with indemnification when otherwise prohibited from doing so by either statute or the company's bylaws.[167] Delaware has eased these concerns by passing a bill to amend the definition of insurance in DGCL 145(g) to include captive insurance, however. DGCL 145(g) anticipates the use of insurance to indemnify a company's officers and directors when the company cannot.[168] Thus, including captive insurance in 145(g) allows captives to provide Side A D&O insurance.[169] Given that Delaware is largely influential in corporate law, this Note proposes that other jurisdictions should take the same approach and that companies and market experts alike should closely analyze the developing application of amended DGCL 145(g).

Participation in captives lowers the moral hazard associated with director and officer insurance. By having ownership in the insurance provider, directors and officers are incentivized to see not only their company succeed, but also their captive. In group captives, participants even work together to make one another more risk averse, therefore making the captive more successful. The market for lemons problem is also addressed by using captive insurance. A "bad" director might be deterred from joining a company insured by a captive, given

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167. *See supra* Section VI.C.

168. *See supra* Section VI.C.

169. *See supra* Section VI.C.

that the director may not want to be accountable for the captive's success. Consequently, a company may avoid the hiring of "bad" directors who show hesitancy towards being insured by a captive, lessening the risk of adverse selection. The decision to produce insurance rather than procure it from the market enables a company to insulate its insurance cost from market forces and lessens the informational asymmetry typical to underwriting, enabling the policy to provide tailored coverage for the company.

Captive insurance gives the insured an opportunity to become a shareholder or owner in its insurance provider. That ownership creates incentives for directors and officers to make wise business decisions and may deter the company from hiring directors and officers who seek a high level of D&O insurance because they need high coverage. Captive insurance creates a potential solution to the morally hazardous market for lemons, and state governments should follow in Delaware's footsteps by explicitly defining insurance as including captive insurance.