

PREDICTING CORPORATE GOVERNANCE RISK:  
EVIDENCE FROM THE DIRECTORS' & OFFICERS'  
LIABILITY INSURANCE MARKET

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ABSTRACT

*This Article examines how liability insurers transmit and transform the content of corporate and securities law. D&O liability insurers are the financiers of shareholder litigation in the American legal system, paying on behalf of the corporation and its directors and officers when shareholders sue. The ability of the law to deter corporate actors thus depends upon the insurance intermediary. How, then, do insurers transmit and transform the content of corporate and securities law in underwriting D&O coverage?*

*In this Article, we report the results of an empirical study of the D&O underwriting process. Drawing upon in-depth interviews with underwriters, actuaries, brokers, lawyers, and corporate risk managers, we find that insurers seek to price D&O policies according to the risk posed by each prospective insured and that underwriters focus on corporate governance in assessing risk. Our findings have important implications for several open issues in corporate and securities law. First, individual risk-rating may preserve the deterrence function of corporate and securities law by forcing worse-governed firms to pay higher D&O premiums than better-governed firms. Second, the importance of*

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*corporate governance in D&O underwriting provides evidence that the merits do matter in corporate and securities litigation. And third, our findings suggest that what matters in corporate governance are “deep governance” variables such as “culture” and “character,” rather than the formal governance structures that are typically studied. In addition, by joining the theoretical insights of economic analysis to sociological research methods, this Article provides a model for a new form of corporate and securities law scholarship that is both theoretically informed and empirically grounded.*

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## INTRODUCTION

Liability insurers bankroll shareholder litigation in the United States. Directors' and officers' liability insurance policies cover the risk of shareholder litigation.<sup>1</sup> Nearly all public corporations purchase D&O policies.<sup>2</sup> And nearly all shareholder litigation settles within the limits of these policies.<sup>3</sup> As a result, the D&O insurer serves as an intermediary between injured shareholders and the managers who harmed them. This intermediary role has important implications for corporate governance that have been largely overlooked by corporate and securities law scholars.<sup>4</sup>

The primary goal of liability rules in corporate and securities law, it is often said, is to deter corporate officers and directors from

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<sup>1</sup> Hereinafter "D&O" insurance. On the coverage of D&O policies, see *infra* Part II.B.1.

<sup>2</sup> See TILLINGHAST TOWERS PERRIN, 2005 DIRECTORS AND OFFICERS LIABILITY SURVEY 20, fig. 21(2006) (reporting that 100% of public company respondents in both the U.S. and Canada purchased D&O insurance) (hereinafter TILLINGHAST, 2005 SURVEY). Prior surveys report slightly lower percentages. The annual Tillinghast D&O survey is based on a non-random, self-selecting sample of companies. It is also the only systematic source of information on D&O insurance purchasing patterns in the U.S. We therefore draw upon it as a source of aggregate data in spite of its methodological weaknesses.

<sup>3</sup> See, e.g., James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 512 (1997) ("[A]pproximately 96% of securities class action settlements are within the typical insurance coverage, with the insurance proceeds often being the sole source of settlement funds."). Using U.S. data, Cornerstone reports that "over 65% of all [securities class action] settlements in 2004 were for less than \$10 million," a figure within the policy limits of most publicly traded corporations, and that only 7 settlements were larger than \$100 million. See LAURA E. SIMMONS & ELLEN M. RYAN, POST-REFORM ACT SECURITIES SETTLEMENTS; UPDATED THROUGH DECEMBER 2004 (Cornerstone Research 2005). Small cap companies typically have D&O insurance policies in excess of \$20 million, and large cap companies typically have D&O insurance policy limits in excess of \$100 million. See TILLINGHAST, 2005 SURVEY *supra* note 2. There may be a recent trend in the U.S. toward increasing (but still small) numbers of settlements above the D&O policy limits. See ELAINE BUCKBERG, TODD FOSTER & RONALD I. MILLER, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: ARE WORLD COM AND ENRON THE NEW STANDARD? (NERA 2005). Recent research demonstrates that outside directors almost never have to use their own funds. See Bernard S. Black, Brian R. Cheffins & Michael Klausner, *Outside Director Liability*, 58 STANFORD L. REV. 1055 (2006).

<sup>4</sup> Notable exceptions include: Black et al, *supra* note 3; Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L. J. 1155 (1990) (studying the effect of the D&O insurance crisis on corporate governance). See also, Roberto Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1 (1989) (exploring the causes of the D&O insurance market crisis of the mid 1980s).

engaging in conduct harmful to their shareholders.<sup>5</sup> Yet it is typically a third party insurer that satisfies these liabilities under the terms of the corporation's D&O policy. The deterrence goals of corporate and securities liability are thus achieved indirectly, through an insurance intermediary, if indeed they are achieved at all.<sup>6</sup>

The D&O insurer has several means of reintroducing the deterrence function of corporate and securities law and, because it is the one ultimately footing the bill, ample incentive to do so. First, D&O insurers may screen their risk pools, rejecting firms with the worst corporate governance practices, and increasing the insurance premiums of firms with higher liability risk. Second, D&O insurers may monitor the governance practices of their corporate insureds and seek to improve them by recommending changes, either as a condition to receiving a policy or in exchange for a reduction in premiums.<sup>7</sup> Third, D&O insurers may manage the defense and settlement of shareholder claims, fighting frivolous claims, managing defense costs, and withholding insurance benefits from directors or officers who have engaged in actual fraud.<sup>8</sup>

This Article is devoted to the first strategy for reintroducing the content of corporate and securities law—the underwriting process. Its core inquiry is how, in that process, D&O underwriters *transfer* the impact of the law and whether, in doing so, they also *transform* it. This is an empirical question. To answer it, we interviewed insurance market participants, including underwriters, actuaries, brokers, lawyers, and corporate risk managers, asking such questions as how underwriters evaluate the D&O liability risk of public corporations, what attributes they look for, and how these factors are taken into

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<sup>5</sup> Reinier Kraakman, Hyun Park & Steven Shavell, *When Are Shareholder Suits in Shareholder Interests*, 82 GEO. L. J. 1733 (1994) (modeling when shareholder litigation should and should not be pursued) [hereinafter Kraakman, Park & Shavell, *Shareholder Suits*]. In this Article, we adopt the standard assumptions of mainstream corporate and securities law scholarship—that the corporation is designed to maximize shareholder welfare (as opposed to some other constituency) and that deterrence is affected principally through the costs of liability rules. See STEPHEN M. BAINBRIDGE, *CORPORATION LAW & ECONOMICS* (2002). These assumptions have been critiqued. See LAWRENCE A. MITCHELL, ED., *PROGRESSIVE CORPORATE LAW* (1995). But that debate is beyond the scope of this Article.

<sup>6</sup> The emotional impact of shareholder litigation and its reputational consequences, of course, will affect directors and officers directly, but essentially all financial consequences are mediated by the D&O insurer. See Black et al, *supra* note 3.

<sup>7</sup> See Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' and Officers' Liability Insurer* (working paper 2006) [hereinafter Baker & Griffith, *Missing Monitor*] (reporting that D&O insurers do not provide governance services and addressing the related puzzles of why corporations buy D&O insurance and how insurers control moral hazard).

<sup>8</sup> See Tom Baker & Sean J. Griffith, *The Defense and Settlement of Shareholder Litigation* (work in progress) (studying the role of D&O insurance in the defense and settlement of shareholder litigation).

account in pricing. We also allowed our participants simply to talk, to describe the underwriting process to us, to tell us what they find interesting or troubling and to illustrate their explanations with stories and anecdotes.

Our findings shed light on several important corporate and securities law issues. First, we find that D&O insurers seek to price policies according to the risk posed by each corporate insured and that, in doing so, they make a detailed inquiry into the corporate governance practices of the prospective insured. The underwriting process thus transforms the insured's expected losses from shareholder litigation into an annual cost. Because this cost is, in part, a function of the quality of the insured's corporate governance practices, it fulfills a necessary condition for advancing the deterrence objectives of corporate and securities law. Second, our findings also provide evidence that the merits do matter in corporate and securities litigation. D&O insurers have the greatest at stake in that question, and their conduct in risk-assessment and pricing demonstrates a belief that the merits matter. Third and finally, our findings offer a unique perspective on what (if anything) matters in corporate governance, underscoring the role of "deep governance" variables such as "culture" and "character" in contrast to the formal governance structures commonly emphasized in previous scholarship. Our analysis of what underwriters are looking to uncover beneath these seemingly vague concepts may illuminate new paths for corporate governance research.

Our research also belongs to a tradition in legal scholarship that seeks to comprehend the role of liability insurance in legal regulation.<sup>9</sup> When the content of legal rules is transmitted through liability insurance intermediaries—as, for example, in accident law, medical malpractice, and products liability—we cannot understand how the law ultimately works until we first understand how the insurance intermediary works: how it packages the liability risk, spreads the costs, and *transforms* the law as it *transfers* the risk. Torts scholars have long appreciated this role, but ours is the first empirical research project to offer a detailed study of the role of liability insurance in corporate governance. Our aim is to learn what D&O insurance can teach us about corporate and securities law in action.

The Article proceeds as follows. Part I describes our empirical methods. Part II provides brief background, both on shareholder

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<sup>9</sup> The foundational empirical study is H. LAURENCE ROSS, SETTLED OUT OF COURT: THE SOCIAL PROCESS OF INSURANCE CLAIMS ADJUSTMENTS (1970). For a recent tort summary, see Tom Baker, *Liability Insurance as Tort Regulation: Six Ways that Liability Insurance Shapes Tort Law*, in LIABILITY IN TORT AND LIABILITY INSURANCE (Gerhard Wagner, ed., Eur. Ctr. for Tort and Ins. Law 2005), also published in 12 CONN. INS. L. J. 1 (2006).

litigation and D&O insurance. Part III reports our findings on what matters to D&O insurance underwriters when they assess D&O insurance risk, how they gather that information, and how they translate their risk assessments into prices. Part IV applies our findings to several open issues in corporate and securities law scholarship. We close, finally, with a brief summary and conclusion.

## I. RESEARCH METHOD

Our research on D&O insurance underwriting contributes to the growing body of literature on “insurance-as-governance.” Prior research has engaged the question of the governance function of liability insurance from two methodologically distinct approaches. We will refer to these as the economic and sociological approaches.

The economic approach to the study of liability and insurance is likely to be the one most familiar to many legal scholars. The classical economic approach to liability insurance has been to view it as a means to further the deterrence function of law by reducing either or both of the cost of prevention or the expected harm.<sup>10</sup> In addition to this approach, institutional economists studying insurance have emphasized the comparative advantages of liability insurance over other loss prevention institutions.<sup>11</sup> Thus, one might expect liability insurance to serve a governance role not only because insurers assume responsibility for losses but also because this assumption of responsibility makes them more credible providers of loss prevention services than alternative governance institutions.

The second major approach is the sociology of risk and insurance. Researchers have used sociological tools—especially qualitative interviews and participant observation – to explore the governance role of insurance institutions.<sup>12</sup> Epitomized by the recent

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<sup>10</sup> See STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* (1987).

<sup>11</sup> George M. Cohen, *Legal Malpractice Insurance and Loss Prevention: A Comparative Analysis*, 4 CONN. INS. L. J. 305 (1997-98). He observes that liability insurers in effect guarantee their loss prevention advice by assuming responsibility for the liability losses that result. This bundling of loss prevention and risk distribution services gives liability insurers an incentive to get the loss prevention right and, thus, should make their loss prevention services more valuable than those of other loss prevention services providers, such as experts, who do not assume any of the risk.

<sup>12</sup> For a review of this literature through 2001, see TOM BAKER & JONATHAN SIMON, *EMBRACING RISK: THE CHANGING CULTURE OF INSURANCE AND RESPONSIBILITY* 7-21 (Tom Baker & Jonathan Simon, eds., 2002). See also RICHARD V. ERICSON, AARON DOYLE & DEAN BARRY, *INSURANCE AS GOVERNANCE* (2003); RICHARD V. ERICSON & AARON DOYLE, *UNCERTAIN BUSINESS* (2004); *RISK AND MORALITY* (Richard V. Ericson & Aaron Doyle, eds., 2002); Tom Baker & Thomas O. Farrish,

work of Ericson, Barry and Doyle,<sup>13</sup> this approach offers a view inside a field that quantitative data cannot provide.<sup>14</sup> While qualitative research of this sort does not provide conclusive evidence regarding the prevalence or extent of the practices observed, it can be used to frame more systematic quantitative analysis that may provide that evidence.<sup>15</sup> In the meantime, the persuasive power of qualitative research depends, like traditional doctrinal and policy argument, on the reader's response to the coherence and plausibility of the analysis.

Our research seeks to join these two paths, analyzing the role of D&O insurance in corporate governance in a way that is both theoretically informed and empirically grounded. We merge insights drawn from economics and sociology to offer a contextually informed understanding of the role that the directors' and officers' insurance underwriting process plays in regulating publicly traded corporations in the United States.

To gather our data, we interviewed, observed, and to a small extent even participated in the professional development of D&O insurance specialists. Our goal was to test the predictions of economic theory regarding the relationship between D&O insurance and corporate governance in the U.S., a relationship that has not been studied previously and that is not amenable to quantitative empirical research for at least two reasons. First, the relevant quantitative data concerning D&O insurance (pricing and limits) are not publicly

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*Liability Insurance and the Regulation of Firearms*, in *SUING THE GUN INDUSTRY* 292 (Timothy Lytton, ed., 2005)

<sup>13</sup> See ERICSON ET AL, *GOVERNANCE*, *supra* note 11 (offering an institutionally informed account of the governance role of a variety of forms of first party insurance). See also ERICSON & DOYLE, *UNCERTAIN*, *supra* note 11 (describing the underappreciated prominence of uncertainty, as opposed to risk, in the insurance business).

<sup>14</sup> The techniques are, as noted, sociological. But they may be most familiar to legal scholars in the law and norms literature. See, e.g., ROBERT C. ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* (1991); Lisa Bernstein, *Private Commercial Law In The Cotton Industry: Creating Cooperation Through Rules, Norms, And Institutions*, 99 MICH. L. REV. 1794 (2001); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992).

<sup>15</sup> See, e.g., Charles Silver, Kathryn Zeiler, Bernard Black, David A. Hyman & William M. Sage, *Physicians' Insurance Limits and Malpractice Payouts: Evidence from Texas Closed Claims, 1990-2003* (working paper January 2006) (confirming qualitative reports in Tom Baker, *Blood Money, New Money, and the Moral Economy of Tort Law in Action* regarding the extreme reluctance of plaintiffs personal injury lawyers to require individual defendants to contribute their own money to the settlement of tort claims); Jonathan Klick & Catherine Sharkey (working paper March 2006) (confirming the phenomenon of "transforming punishment into compensation" reported on the basis of qualitative research in Tom Baker, *Transforming Punishment Into Compensation: In the Shadow of Punitive Damages*, 1998 WIS. L. REV. 101).

available.<sup>16</sup> And second, the “deep governance” factors that, as we will report, matter so much to D&O insurance underwriters are neither adequately specified nor publicly available.

We conducted in-depth, semi-structured interviews with forty-one D&O professionals from late 2004 to early 2006.<sup>17</sup> Identifying prospective interviewees in snowball fashion, beginning with references from leaders of the Professional Liability Underwriting Society,<sup>18</sup> our interviewees included: twenty-one underwriters from fourteen companies (including primary, excess, and reinsurance underwriters), three D&O actuaries from three companies (two of whom were the chief professional lines actuaries in their firms), six brokers from six brokerage houses, four risk managers employed by publicly traded corporations to purchase their insurance coverage, three lawyers who advise publicly traded corporations on the purchase of D&O insurance, and four professionals involved in the D&O claims process (two claims managers, one monitoring counsel, and one claims specialist from a brokerage house).<sup>19</sup>

Because the D&O insurance market is concentrated at the top—two insurers (AIG and Chubb) together account for more than half of the market for primary insurance (by premium volume)—and because the market is intermediated through the personal connections of a few brokerage firms, we are confident that we can accurately describe D&O insurance practices based on a number of interviews that may seem very small to researchers used to working with large quantitative data sets.<sup>20</sup> In addition, we attended six conferences for D&O professionals and engaged in many informal conversations, supplementing our interviews with industry documents as well as regular reading of trade and industry publications.

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<sup>16</sup> See Sean J. Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors’ and Officers’ Liability Insurance Policies*, 154 U. PA. L. REV. 1147 (2006) (hereinafter, Griffith, *Uncovering a Gatekeeper*) (arguing for public disclosure of D&O insurance policy premiums and contract provisions). See also *infra* note 202 (describing existing quantitative research on this question).

<sup>17</sup> Pursuant to a research protocol approved by the Institutional Review Board of the University of Connecticut, we interviewed the participants under a promise of confidentiality. The interviews were recorded and transcribed and participant-identifying information was removed from the transcripts. Copies of the transcripts have been provided to the editors of --- for verification but returned to us.

<sup>18</sup> The Professional Liability Underwriting Society is an association of specialists—including underwriters, brokers, consultants and advisors in the professional lines insurance market. See The Professional Liability Underwriting Society, available at <http://www.plusweb.org>.

<sup>19</sup> These roles are described in Part II.B.2., below.

<sup>20</sup> See TILLINGHAST 2005 SURVEY *supra* note 2, at 85, tbl. 70 (reporting on primary market share).



Clearly, this was not a random sample. However, the goal was in-depth exploration of the D&O underwriting process, not the measurement of pre-defined variables. Moreover, it is clear that our sources of information were not unbiased. However, we sought to interview professionals on every side of the insurance transaction—brokers, underwriters, actuaries, insureds, and their advisors—in order to counteract this problem, and except as noted in our discussion, the participants provided consistent reports to us during the interviews. Thus, we are reporting shared understandings of how the D&O insurance market operates.

## II. D&O INSURANCE AND SHAREHOLDER LITIGATION

D&O insurance protects corporate directors and officers and the corporation itself from liabilities arising as a result of the conduct of directors and officers in their official capacity.<sup>21</sup> For private or non-profit corporations, employment-related claims are the most common source of D&O liabilities.<sup>22</sup> For public corporations, however, the dominant source of D&O risk, both in terms of claims brought and liability exposure, is shareholder litigation.<sup>23</sup> Because our research exclusively examines D&O insurance for public corporations, we treat the central purpose of D&O insurance as providing coverage against shareholder litigation.

This Part provides a brief overview of covered claims and the structure of D&O coverage. Section A describes the basic types of shareholder claims and the principal liability exposures arising from them. Section B describes the core features of D&O policies. We

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<sup>21</sup> See, e.g., *AIG Specimen Policy 75011(2/00)* § 2.aa (providing coverage for “any actual breach of duty, neglect, error, misstatement, misleading statement, omission or act... by such Executive in his or her capacity as such or any matter claimed against such Executive solely by reason of his or her status as such...”) [hereinafter, *AIG Specimen Policy*]; *Chubb Specimen Policy 14-02-7303(Ed. 11/2002)* § 5.a, p. 7 (“Wrongful act means any other matter claimed against Insured Person solely by reason of his or her serving in an Insured Capacity.” [hereinafter, *Chubb Specimen Policy*, The Hartford, *Directors, Officers and Company Liability Policy, Specimen DO 00 R292 00 0696*, § IV.O. (defining coverage to include “any matter claimed against the Directors and Officers solely by reason of their serving in such capacity...”) [hereinafter, *Hartford Specimen Policy*].

<sup>22</sup> See TILLINGHAST 2005 SURVEY *supra*, at 5 (reporting that “96% of the claims brought against nonprofit [participating companies] were brought by employees”)

<sup>23</sup> See *id.*, at 4 (reporting that “57% of the claims against [participating] public [companies] were brought by shareholders”). See also Interview with Confidential Source, D&O Advisor, Outside Counsel, in New York, N.Y. (Oct. 12, 2004) [hereinafter D&O Advisor Interview] (confirming that for public companies, shareholder litigation is by far the larger liability risk under a D&O policy).

invite readers already familiar with these matters to read selectively or to skip ahead to the next Part, which begins on page --.

#### A. Shareholder Litigation—Principal Liability Exposures

Shareholder litigation is a significant liability risk for publicly traded corporations. Liability risk can be measured in terms of both frequency and severity. Frequency takes into account the probability of suit, and severity takes into account the probable loss once a suit is filed.

A rough estimate of frequency—dividing all shareholder class actions by all publicly traded companies—suggests that public companies have a 2% chance of being sued in a shareholder class action in any given year.<sup>24</sup> The exposure for some companies, of course, is much higher. Large companies are sued more often than small ones.<sup>25</sup> Companies in certain industries tend to be sued more than others.<sup>26</sup> And Nasdaq companies are sued more often than NYSE companies.<sup>27</sup>

A rough estimate of severity can be taken by examining settlement amounts.<sup>28</sup> The numbers are not small. Average

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<sup>24</sup> CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2005, A YEAR IN REVIEW 4 (2006) [Hereinafter CORNERSTONE] (estimating susceptibility to a federal securities class action for “companies listed on the NYSE, Nasdaq, and Amex” at the start of 2005 at 2.4%); Ronald I. Miller, et al., *Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, is Stabilization Ahead?* (NERA Economic Consulting, April 2006), at 3 (estimating susceptibility of all publicly traded corporations in 2005 at 1.9%).

<sup>25</sup> See TILLINGHAST 2005 SURVEY *supra* note 2, at 99.

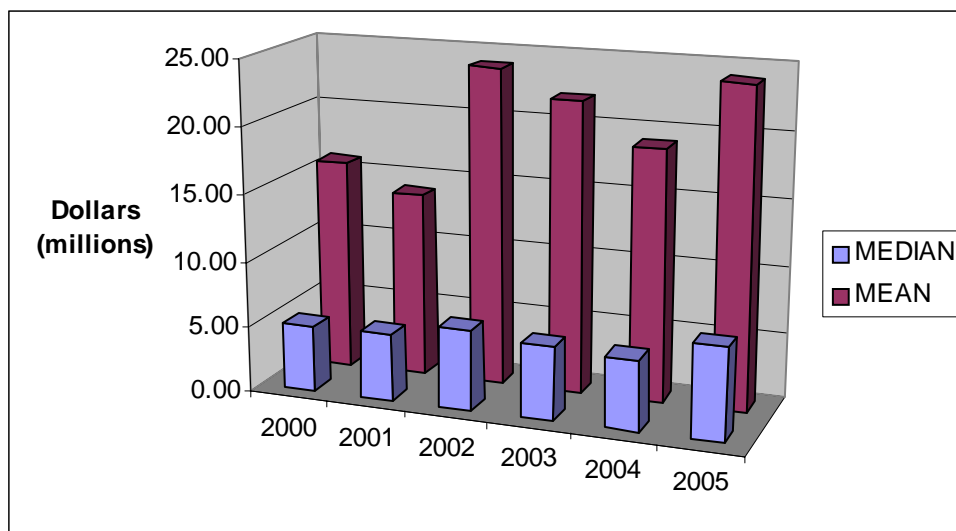
<sup>26</sup> Which industries are sued most often fluctuates somewhat from year to year, suggesting a *scandal du jour* pattern in securities litigation. In 2005, the three industrial sectors receiving the most securities class action filings were Consumer Non-Cyclical, Consumer Cyclical, and Finance. The year before, however, the top three industries in terms of filings were Consumer Non-Cyclical, Technology, and Communications. CORNERSTONE, *supra* note 24, at 14.

<sup>27</sup> CORNERSTONE, *supra* note 24, at 12.

<sup>28</sup> Because the vast majority of shareholder claims are either settled or dismissed, settlement amounts may be a fair measure of the value of a claim. Settlement values, however, are a poor measure of the total cost of shareholder litigation since they do not include defense costs: a large but not well documented portion of D&O loss costs. Because D&O insurers reimburse policyholders for their defense costs as part of the indemnity coverage (as opposed to providing a defense and paying for that defense in addition to the indemnity coverage), the loss data that insurers file with regulators do not distinguish between settlement payments and defense costs. At one industry conference we attended, lawyers and claims managers disputed the total extent of the defense costs, but agreed that defense costs were at least 25% of a typical class action settlement. The claims manager reported that in recent years defense costs that were 50% or even 100% of the settlement amounts were

settlement values of shareholder class actions exceeded \$24 million in 2005, up from \$19 million in 2004.<sup>29</sup> The average settlement value for the years 2002-2005 was \$22.3 million, significantly higher than the average settlement value of \$13.3 million for the years 1996-2001.<sup>30</sup> Comparing median settlement values reveals a significant skew in these numbers. Median settlements in 2005 were \$7 million, and the median annual settlement for the period 2002-2005 was \$5.8 million, compared to \$4.6 million for the period 1996-2001.<sup>31</sup> Shareholder suits are thus characterized by a handful very large settlements, while the typical case settles for a considerably lower amount.<sup>32</sup>

**Figure 1:**  
**Median and Mean Securities Litigation Settlements 2000-2005<sup>33</sup>**



Doctrinally, shareholder suits include both corporate fiduciary duty claims, whether derivative or direct,<sup>34</sup> and securities law

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increasingly common. Of course when a case is dismissed without payment the defense costs are the only covered losses.

<sup>29</sup> Miller, et al., *supra* note 24, at 5.

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

<sup>31</sup> *Id.*

<sup>32</sup> Lower, but by no means insignificant. In 2005, only 27% of settlements were below \$3 million, compared to 45% in 1996. *Id.*

<sup>33</sup> Data Source: Miller, et al., *supra* note 24, at 5.

<sup>34</sup> See Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 137 (2004) (finding that approximately 80% of all fiduciary duty claims filed in Delaware

claims.<sup>35</sup> The possible grounds for complaint are many.<sup>36</sup> However, the basic concern underlying all such claims is a divergence between managerial conduct and shareholder welfare—the problem, in other words, of “agency costs.”<sup>37</sup> Whether the claim is that managers looted the company or negligently managed it or lied to investors in order to inflate their own compensation packages, the basic concern is that management has sought to serve its own interests rather than the interests of its investors.<sup>38</sup> Of all the litigation that such conduct can generate, securities law claims represent by far the greatest liability risk.<sup>39</sup>

Securities law claims, whether brought by as an enforcement action by the Securities and Exchange Commission<sup>40</sup> or by private

Chancery Court in 1999 and 2000 were class actions challenging board conduct in an acquisition and that only 14% of fiduciary duty claims over the same period were derivative suits).

<sup>35</sup> Securities litigation arises under both the Securities Act of 1933 and the Securities Exchange Act of 1934. 15 USCA §§ 77a-77aa (1997 and Sup 2005) [hereinafter Securities Act]; 15 USCA §§ 78a-78mm (1997 and Sup 2005) [hereinafter Exchange Act].

<sup>36</sup> See, e.g., WILLIAM E. KNEPPER & DAN A. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* §17.02 (7th ed. 2003) (listing 170 possible grounds for liability in shareholder litigation).

<sup>37</sup> See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (identifying the divergence in interests between shareholder principals and manager agents as a central feature of the corporate form). See also Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 903 (2003) (arguing that the basic corporate governance concern—the divergence between managerial interests and shareholder welfare—has become a common underlying basis in securities fraud claims).

<sup>38</sup> Misstatements designed to keep the firm afloat, as opposed to those designed merely to pad executive pay packages, because they arguably benefit the firm may not seem to arise out from agency costs. However, any benefit to current shareholders—through, for example, overstated earnings—comes at the expense of future shareholders—those who buy in under the misrepresentation and therefore pay too much for their shares and also those who fail to sell prior to the corrective disclosure. This reveals a temporal conflict between investors generally. See generally Steven L. Schwarcz, *Temporal Perspectives: Resolving The Conflict Between Current and Future Investors*, 89 MINN. L. REV. 1044 (2005) (discussing the potential for conflict between present and future shareholders’ interests). But the securities laws do not excuse fraud designed to benefit one class of investors (current shareholders) over another (prospective shareholders). Instead, the securities laws adopt an *ex ante* perspective in order to curb managerial conduct harmful to the investor class generally.

<sup>39</sup> See Counsel #1, p. 11 (“The big exposure to D&O, as I am sure you know, is that No. 1 head and shoulders above everything else is securities class actions...”). See also Counsel #3, p. 5 (“[S]ecurities litigation outweighs derivative litigation by far.”).

<sup>40</sup> See 15 U.S.C. § 77s (empowering the SEC to investigate possible Securities Act violations), § 77t (empowering the SEC to seek injunctive relief for violations of the

plaintiffs through the class action mechanism,<sup>41</sup> are typically framed around a misrepresentation. Most often, a company releases false or misleading information that has the effect of inflating its share price and inducing investors to buy; when the information is later revealed as false, the company's share price drops, and all investors who bought in at the artificially high price lose a portion of their investment.<sup>42</sup> The securities laws create several causes of action for dealing with such situations, the most important of which is Rule 10b-5 under Section 10(b) of the Exchange Act.<sup>43</sup> Sections 11 and 12(2) of the Securities Act are a distant second and third, respectively.<sup>44</sup> In 2005, 93% percent of securities class actions alleged violations of Rule 10b-5.<sup>45</sup> Only 9% alleged a Section 11 violation, and only 5% alleged a Section 12(2) claim.<sup>46</sup>

In sum, D&O risk is shareholder litigation risk, which essentially involves issues of shareholder (or, more generally, investor) welfare.<sup>47</sup> The principal liability exposure is securities litigation and, more specifically, 10b-5 claims, typically framed around a corporate misrepresentation.

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Securities Act), §78u(a) (empowering the SEC to investigate Exchange Act violations), § 78u(d) (empowering the SEC to seek injunctive relief for violations of the Exchange Act).

<sup>41</sup> See, e.g., *Herman & McLean v. Huddleston*, 459 U.S. 375, 380 (1983) (“[A] private right of action under Section 10(b) ... and Rule 10b-5 has been consistently recognized for more than 35 years. The existence of this implied remedy is simply beyond perventure.”) See also John C. Coffee, Jr., *Rescuing The Private Attorney General: Why The Model Of The Lawyer As Bounty Hunter Is Not Working*, 42 MD. L. REV. 215 (1983) (describing and critiquing private enforcement of the securities laws).

<sup>42</sup> See LOSS & SELIGMAN, SECURITIES REGULATION, [PIN] (discussing typical patterns in securities litigation).

<sup>43</sup> 15 U.S.C. § 77i (2000); 17 C.F.R. § 240.10b-5 (1995). Rule 10b-5 claims may be brought against a broad spectrum of defendants for any misrepresentation made “in connection with” the purchase or sale of a security. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 753-55 (1975). Rule 10b-5 plaintiffs must show materiality, scienter, causation, and reliance. In practice, however, these elements tend to blend together, at least for actively traded securities. See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (discussing elements of a 10b-5 claim and establishing presumption of reliance on basis of “fraud-on-the-market” theory).

<sup>44</sup> 15 U.S.C. §§ 77k, 77l (2000). Section 11 claims involve misrepresentations made by the issuer, underwriter, auditors or attorneys involved in a registered public offering of securities and, unlike 10b-5 claims, do not require a plaintiff to show scienter, causation, or reliance. Section 11 defendants, however, have mechanisms at their disposal to rebut scienter and reliance and to reduce or eliminate damages by disproving causation. LOSS & SELIGMAN, SECURITIES REGULATION, [PIN].

<sup>45</sup> Cornerstone, *supra* note 24, at 16-17.

<sup>46</sup> *Id.*

<sup>47</sup> Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 903 (2003).

## B. The Anatomy Of D&O Insurance

Directors' and Officers' liability insurance coverage evolved from basic corporate liability policies but was not commonly purchased by U.S. corporations until the early to mid-1960s.<sup>48</sup> Although it was initially unclear whether corporations would be legally permitted to insure directors and officers against losses that the corporation could not legally indemnify,<sup>49</sup> the question was settled when state legislatures enacted statutes expressly permitting D&O insurance regardless of whether the loss was one that the corporation itself could indemnify.<sup>50</sup> This section discusses, first, typical coverage terms, then the basic structure of the market for D&O insurance.

### 1. Coverage

A typical D&O policy sold to a publicly traded corporation contains three different types of coverage. First, there is coverage to

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<sup>48</sup> See Joseph F. Johnston, Jr., *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 993 (1978) ("Although [D&O] policies have been marketed since the 1950s, the coverage had little attention until the mid-1960s.").

<sup>49</sup> Joseph W. Bishop, Jr., *New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability*, 22 BUS. LAW. 92, 106 (1966). Although corporate indemnification is broadly permitted under the law of most states, many states including Delaware do not permit indemnification for amounts paid in settlement of derivative claims. See Del. Code Ann. tit. 8 §145(a) (2004) (permitting indemnification for expenses, judgments, and settlements except for those actions "by or in right of the corporation"). Although the SEC has long maintained that indemnification for securities law claims is contrary to public policy, it is firmly established that the settlement of federal securities law claims may be paid for through indemnification or insurance. See, e.g., *Raychem Corp. v. Federal Ins. Co.*, 853 F. Supp. 1170 (N.D. Cal. 1994).

<sup>50</sup> For example, Delaware General Corporate Law §145(g) provides:

A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation... against any liability asserted against such person and incurred by such person in any such capacity, or arising out of such person's status as such, whether or not the corporation would have the power to indemnify such person against such liability under this section.

Del. Code Ann. tit. 8, § 145(g) (2004). See also JOSEPH WARREN BISHOP, JR., *THE LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE* §8.01 (rev. ed. 1998) ("All states authorize the corporation to purchase and maintain insurance on behalf of directors and officers against liabilities incurred in such capacities, whether or not the corporation would have the power to indemnify against such liabilities.").

protect individual managers from the risk of shareholder litigation.<sup>51</sup> This type of coverage is typically referred to by industry professionals as “Side A” coverage, and we believe it is what most non-specialists think of as D&O insurance. However, D&O policies also contain two other, less widely-known types of coverage. The second type, referred to within the industry as “Side B” coverage, reimburses the corporation for its indemnification payments to officers and directors.<sup>52</sup> And the third, “Side C” coverage, protects the corporation from the risk of shareholder litigation to which the corporate entity itself is a party.<sup>53</sup> Side A coverage typically includes no retention (deductible) or co-insurance amount.<sup>54</sup> Sides B and C,

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<sup>51</sup> Basic coverage terms obligate an insurer to pay covered losses on behalf of individual directors and officers when the corporation itself cannot indemnify them. *See Hartford Specimen Policy, supra* note at § I.A. *See also Chubb Specimen Policy, supra* note 6, at § 1, p. 2; *AIG Specimen Policy, supra* note 6, at § 1.A.

<sup>52</sup> Typical policy language provides:

The Insurer will pay on behalf of the Company Losses for which the Company has, to the extent permitted or required by law, indemnified the Directors and Officers, and which the Directors and Officers have become legally obligated to pay as a result of a Claim ... against the Directors and Officers for a Wrongful Act....

*Hartford Specimen Policy, supra* note 6, at § I.B; *Chubb Specimen Policy, supra* note 6, at § 2, pg 2 (providing similar language); *AIG Specimen Policy, supra* note 6, at 1.B. Policies typically deem indemnification to be required in every situation where it is legally permitted, thus preventing the corporation from opportunistically pushing the obligation to the insurer by simply refusing to indemnify its directors and officers. *See Hartford Specimen Policy, supra* note 6, at §VI.F (providing that if a corporation is legally permitted to indemnify its officers and directors, its organizational documents will be deemed to require it to do so). *See also Chubb Specimen Policy, supra* note 6, at § 13, p. 11; *AIG Specimen Policy, supra* note 6, at § 6.

<sup>53</sup> Typical policy language provides:

[T]he Insurer will pay on behalf of the Company Loss which the Company shall become legally obligated to pay as a result of a Securities Claim... against the Company for a Wrongful Act...

*Hartford Specimen Policy, §I.C; Chubb Specimen Policy, at § 3, p. 2; AIG Specimen Policy, at § 1.C.* A securities claim is defined in the policy to include claims by securities holders alleging a violation of the Securities Act of 1933 or the Securities Exchange Act of 1934 or rules and regulations promulgated pursuant to either act as well as similar state laws and includes claims “arising from the purchase or sale of, or offer to purchase or sell, any Security issued by the company” regardless of whether the transaction is with the company or over the open market. *Hartford Specimen Policy, at IV.M; Chubb Specimen Policy, at § 5, p. 6; AIG Specimen Policy, at § 1.y.* If the company purchases Side C coverage, the definitions of “claim,” “loss,” and “wrongful act” expand to include the company and not just the directors and officers.

<sup>54</sup> *See TILLINGHAST, 2005 DIRECTORS & OFFICERS LIABILITY SURVEY 53 (2006)*, (reporting that 98% of U.S. respondents who purchased D&O insurance had no deductible associated with their Side A coverage).

however, do.<sup>55</sup> Covered losses include compensatory damages, settlement amounts, and legal fees incurred in defense of claims arising as a result of the official acts of directors and officers—principally including, as described above, shareholder litigation.<sup>56</sup>

D&O policies have three principal exclusions: (1) the “Actual Fraud” exclusion for claims involving actual fraud or personal enrichment,<sup>57</sup> (2) the “Prior Claims” exclusion for claims either noticed or pending prior to the commencement of the policy period,<sup>58</sup> and (3) the “Insured v. Insured” exclusion for litigation between insured persons.<sup>59</sup> The Actual Fraud exclusion prevents insureds from receiving insurance benefits when they have actually committed a wrongful act, often defined as a “dishonest, fraudulent, criminal act or omission or willful violation of any statute, rule or law.”<sup>60</sup> When such an act can be deemed “actual” depends upon the wording of the policy, which may require “final adjudication” of the wrongful act or merely evidence that the act “in fact” occurred.<sup>61</sup> The Prior Claims exclusion carves out any claims noticed or pending prior to the

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<sup>55</sup> For further discussion of the types of coverage and the puzzles and problems created by each, see Baker & Griffith, *Missing Monitor*, *supra* note 7; Griffith, *Uncovering a Gatekeeper*, *supra* note 16.

<sup>56</sup> *Hartford Specimen Policy*, *supra* note 6, at § IV.J. (including compensatory damages, settlement amounts, and legal fees). *See also Chubb Specimen Policy*, *supra* note 6, at § 3.a, pg 5; *AIG Specimen Policy*, *supra* note 6, at § 1.p. Other important definitions in the policy include “claims,” defined as the receipt of a written demand for relief, the filing of a civil proceeding, or the commencement of a formal administrative or regulatory proceeding. *Hartford Specimen Policy*, *supra* note 6, at § IV.A.; *Chubb Specimen Policy*, *supra* note 6, at § 5.1, p. 3; *AIG Specimen Policy*, *supra* note 6, at § 1.b. Wrongful acts are defined by the policy to include errors, misstatements, omissions, and breaches of duty committed by directors and officers in their official capacities as well as any other claim against the directors and officers solely by reason of their position. *Hartford Specimen Policy*, *supra* note 6, at § IV.O.; *Chubb Specimen Policy*, *supra* note 6, at § 5.a, p. 7; *AIG Specimen Policy*, *supra* note 6, at § 2.aa.

<sup>57</sup> *See AIG Specimen Policy*, §§ 4.b.-c.; *Chubb Specimen Policy*, §§ 7-8; *Hartford Specimen Policy*, § V.J.

<sup>58</sup> *See AIG Specimen Policy*, §§ 4.h., l.; *Chubb Specimen Policy*, §§ 6.a.-b.; *Hartford Specimen Policy*, § V.C.

<sup>59</sup> *See AIG Specimen Policy*, §§ 4.i., j.; *Chubb Specimen Policy*, § 6.c.; *Hartford Specimen Policy*, § V.D.

<sup>60</sup> Executive Risk Indemnity, Inc., Executive Liability Policy, III.A.1. Similar language appears in both the AIG, Chubb, and Hartford policies. *See supra* note 57. A related exclusion prevents insurers from making payments to indemnify an insured person against unjust enrichment claims, thus preventing the insured from retaining any such gains. *See AIG Specimen Policy*, § 4.a.; *Chubb Specimen Policy*, §§ 7-8; *Hartford Specimen Policy*, § V.I.

<sup>61</sup> Insureds typically seek to include “final adjudication” language to clarify that the actual fraud only applies if there has been a final adjudication of actual wrongdoing by the insured while the insurer may seek less strict “in fact” language, setting a lower threshold for the determination of actual fraud and, therefore, applicability of the exclusion. *See Counsel #3*, pp. 2-3.



commencement of the current policy, which ordinarily would be covered under a prior policy.<sup>62</sup> Finally, the Insured v. Insured exclusion withholds insurance proceeds for losses stemming from litigation between insured parties, such as, for example, directors suing the corporation or the officers or the corporation suing an officer or director.<sup>63</sup> Other common exclusions remove peripheral claims—such as environmental claims,<sup>64</sup> ERISA claims,<sup>65</sup> claims alleging bodily injury or emotional distress,<sup>66</sup> and claims arising from service to other organizations<sup>67</sup>—from the scope of coverage, leaving shareholder litigation as the principal covered risk.<sup>68</sup>

The discussion above captures several key terms of D&O policies, but it is worth noting that coverage terms can be negotiated and therefore are difficult to generalize. Both buyers and sellers are highly sophisticated and have legal expertise at their disposal. Moreover, there is no standardized form to this line of insurance.<sup>69</sup> Shopping for coverage thus requires comparing, and to some degree negotiating, both prices and terms. Nevertheless, all D&O policies have the effect of shifting the risk of shareholder litigation from individual directors and officers and the corporation they manage to a

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<sup>62</sup> This exclusion plus the claims-made nature of the policy forces the insured to notify its current insurer of any potential claims activity at the earliest possible date in order to assert its rights prior to the expiration of the policy period because such claims are likely to be excluded under any subsequent policy.

<sup>63</sup> See, e.g., *Fidelity & Deposit Co. of Maryland v. Zandstra*, 756 F.Supp. 429 (N.D. Cal., 1990) (construing an Insured v. Insured exclusion clause). Like the family member exclusion in homeowners' insurance policies, the purpose is to avoid collusive litigation. See ROBERT JERRY, *UNDERSTANDING INSURANCE LAW* (3rd ed. 2002). Derivative litigation, when successfully maintained independent of the board—as for example, when demand has been excused—is carved out of the exclusion, with the effect that the Insured v. Insured provision operates to exclude from coverage only those actions that are willfully maintained by insured persons. See generally *Zapata v. Maldonado*, 430 A.2d 779 (Del. 1981) (discussing the demand mechanism in derivative litigation).

<sup>64</sup> See AIG Specimen Policy, § 4.k.; Chubb Specimen Policy, § 6.d.; Hartford Specimen Policy, § V.E.

<sup>65</sup> See AIG Specimen Policy, § 4.m.; Chubb Specimen Policy, § 6.f.; Hartford Specimen Policy, § V.G.

<sup>66</sup> See AIG Specimen Policy, § 4.h., 1.; Chubb Specimen Policy, § 6.e.; Hartford Specimen Policy, § V.A.

<sup>67</sup> See AIG Specimen Policy, § 4.f., g.; Chubb Specimen Policy, § 6.g., h.; Hartford Specimen Policy, § V.F.

<sup>68</sup> All of these peripheral claims are covered by other forms of liability insurance. Why the insurance market addresses all these risks in separate insurance products is an interesting question that is beyond the scope of this project.

<sup>69</sup> See, e.g., SUSAN J. MILLER & PHILIP LEFEBVRE, *MILLER'S STANDARD INSURANCE POLICIES ANNOTATED* (1997 and supp.) (collecting clause by clause case citations to a variety of standard insurance policies published by the Insurance Services Office, Inc.).

third-party insurer. When shareholders sue their officers or directors, it is usually an insurer that pays.<sup>70</sup>

## 2. The Market for D&O Insurance

As noted, the D&O market has sophisticated parties on both the buyer's and seller's side of the transaction. In addition, expert intermediaries—specialized D&O insurance brokers—typically facilitate the transaction. The D&O market thus has several key participants—corporate buyers, insurance company sellers, and insurance brokers. The following paragraphs describe the roles performed by each of these three basic participants in the market for D&O insurance.

The buyers of D&O insurance that we focused on in this study are publicly traded corporations.<sup>71</sup> The most commonly cited reason for the purchase of D&O insurance is the recruitment and retention of qualified officers and directors.<sup>72</sup> Corporations are eager to assure their officers and directors that their personal assets will not be at risk as a result of accepting a board seat or other position with the company.<sup>73</sup> However, as we discuss at length elsewhere, this explanation only applies to the purchase of one of the three lines of coverage—Side A coverage—in a typical D&O policy.<sup>74</sup> The actual purchase of D&O insurance, at least for larger corporations, is likely to be handled by the company's "Risk Manager," a management position that typically reports to the Treasurer or Chief Financial Officer.<sup>75</sup> However, as we describe below, decisions on D&O insurance and assistance in the marketing of the company to

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<sup>70</sup> See sources cited note 3, *supra*.

<sup>71</sup> As we noted above, D&O insurance is also purchased by private and non-profit corporations, but the insurance market for these organizations is distinct from the market for public corporations and therefore outside of the scope of this research. X-REF.

<sup>72</sup> [CITATION PENDING (industry publication)]. See also TILLINGHAST, 2005 SURVEY *supra*, note 3, at 3 (reporting that in 2005 approximately 50% of for-profit survey respondents had received an inquiry from directors about the company's D&O coverage).

<sup>73</sup> See Black et al, *supra* note 3 (reporting that insiders are at greater risk than outsiders).

<sup>74</sup> See Baker & Griffith, *Missing Monitor*, *supra* note 7; Griffith, *Uncovering a Gatekeeper*, *supra* note 16.

<sup>75</sup> The Risk Manager is responsible for all of a company's insurance lines. Our participants reported that the chief financial officer of a smaller corporation may handle the insurance purchasing directly.

prospective underwriters often involve the firm's legal department and top-level management.<sup>76</sup>

The amount of D&O insurance purchased correlates with the market capitalization of the corporate buyer.<sup>77</sup> According to Tillinghast, in 2005, small cap companies—defined here as those with market capitalizations between \$400 million and \$1 billion—purchased an average of \$28.25 million in D&O coverage limits.<sup>78</sup> Mid cap companies—market capitalization \$1-10 billion—purchased an average of \$64 million in limits.<sup>79</sup> And large cap companies—market capitalization in excess of \$10 billion—purchased an average of \$157.69 million in D&O coverage.<sup>80</sup> According to the participants in our study, the largest available coverage limit is \$300 million.<sup>81</sup>

**Figure 2:**  
**Annual D&O Policy Limits By Market Capitalization Category<sup>82</sup>**

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<sup>76</sup> See *infra* note 121.

<sup>77</sup> This is perhaps unsurprising—the largest companies attract the most attention in the press and also offer the highest payoffs for plaintiffs' lawyers and therefore are more likely to attract lawsuits. Similarly, the largest companies have farther to fall in terms of share valuation and therefore create the highest settlements.

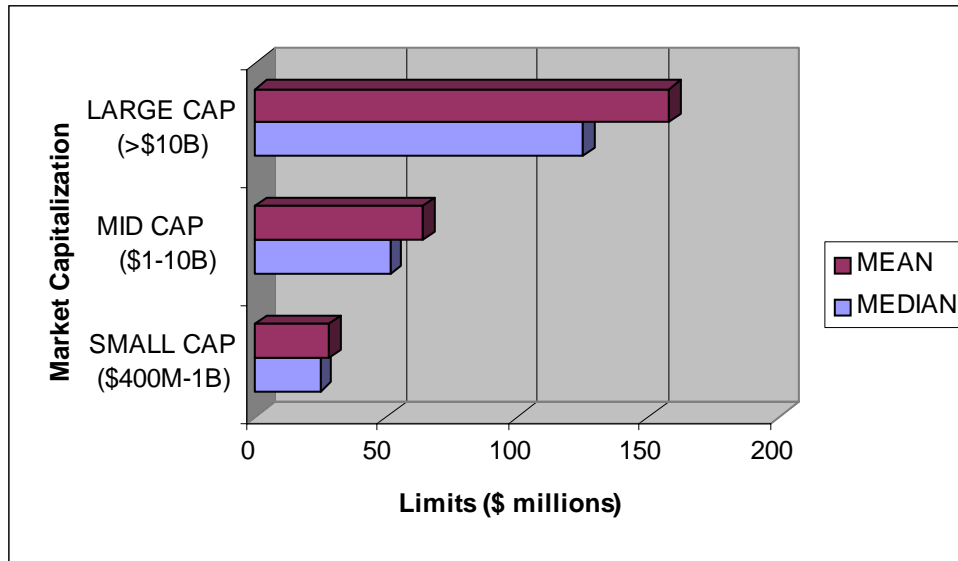
<sup>78</sup> TILLINGHAST, 2005 SURVEY, *supra* note 2, at 29, tbl. 17C.

<sup>79</sup> Tillinghast reports mid-cap limits in three categories. The first, companies with market capitalizations between \$1 billion and \$2 billion, purchased mean limits of \$44.88 million and median limits of \$30 million. The second, companies with market capitalizations between \$2 billion and \$5 billion, purchased mean limits of \$83.2 million and median limits of \$75 million. Finally, the third group, companies with market capitalizations between \$5 billion and \$10 billion, purchased mean limits of \$79.4 million and median limits of \$65 million. See *id.* The number reported in the text is an average of these three categories, weighted for the number of observations in the Tillinghast sample.

<sup>80</sup> See *id.* The median reported for companies with market capitalizations in excess of \$10 billion was \$125 million.

<sup>81</sup> See Risk Manager #3, p. 6. See also Underwriter #13, pp. 37-38

<sup>82</sup> Source: TILLINGHAST, 2005 SURVEY, *supra* note 2 (2005 data). We derived the "Mid-Cap" category as a weighted average of three market capitalization classes reported by Tillinghast. See *supra* note 79.



In general, no one insurer is willing to underwrite the entire limits purchased by any one corporation. This is especially true for the high limits policies purchased by large and mid cap companies. Our participants reported that \$50 million was the largest limit available from a single insurer and noted that in the late 2005 market, no insurance company was offering a policy larger than \$25 million and that most policies had limits of \$10 million or less.<sup>83</sup> As a result of these constraints, corporations must purchase several D&O policies in order to reach the aggregate amount of insurance they desire. D&O insurance packages are thus said to come in “towers”—separate layers of insurance policies stacked to reach a desired total amount of insurance coverage.

The bottom layer of a D&O tower is called the “primary policy,” and the insurance company offering that policy is referred to as the “primary insurer.” Primary insurers have the closest relationship with the policyholder. Because the primary insurer’s policy is the first to respond to a covered loss and therefore is the most likely to incur a payment obligation, the primary insurer charges a higher premium than those higher up in the tower of coverage. The market for primary insurance is dominated by a small number of companies, most significantly AIG and Chubb.<sup>84</sup>

<sup>83</sup> See, e.g., Actuary #3 at 10.

<sup>84</sup> According to Tillinghast, in 2005 AIG and Chubb together controlled 53% of the total U.S. market measured by premium volume and 36% of the total U.S. market

Excess insurers—those higher up in the tower—become responsible for covered losses on a layer-by-layer basis as the limits of each underlying policy becomes exhausted by loss payments.<sup>85</sup> Excess policies typically are sold on a “following form” basis, meaning that the contract terms (other than limits and price) in the excess policy are the same as those in the underlying policy. Because all excess policies are less likely to respond to a covered loss than the primary policy and each successive layer of excess insurance is less likely to respond to a claim than the layer immediately beneath it, the premiums associated with excess policies are lower the higher the policy is situated in the tower of coverage. As a result, the total premium that a corporate insured pays for its D&O coverage will be a blended amount of several distinct premiums paid to separate insurance companies.<sup>86</sup> The higher the limits a corporation buys, the more companies that are likely to make up the tower of coverage.

It is brokers who assemble these towers of coverage. The D&O market, like the corporate insurance market generally, is a brokered market. The largest retail insurance brokers—Marsh, Aon, Willis, and other national or large regional brokers—have in-house D&O specialists, while smaller brokerage firms may use a specialist wholesale broker (a broker’s broker) to shop for and assemble a client’s D&O coverage. Recent investigations into the insurance brokerage industry suggest that there are opportunities for the intermediary to profit from the “informational monopolies” created by their role.<sup>87</sup> Whether any such conduct took place in brokerage firms’ D&O lines is beyond the scope of this research.<sup>88</sup> What we can report, however, is that a substantial role for brokers in the D&O market seems inescapable as a result of: (1) the non-uniform nature of D&O insurance policies; (2) the need to assemble a tower of coverage from the policies of many different insurance companies; and (3) the need for a trusted intermediary to convey information between buyer and seller.

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by policy count. TILLINGHAST, 2005 DIRECTORS AND OFFICERS LIABILITY SURVEY 86 (2006).

<sup>85</sup> Although the claims process is outside the scope of this article, it is worth noting that a settlement that involves multiple layers – commonly the case in a low frequency, high severity line of insurance like public D&O – requires consent from all the insurers. Insurance law has mechanisms that address the hold up problem presented by settlements involving multiple insurers.

<sup>86</sup> When, later in this Article, we refer to premiums, we are referring to this total premium amount—the cost of the total coverage package, consisting of several policies and, technically, several premiums.

<sup>87</sup> CITATION PENDING

<sup>88</sup> Cf. Sean Fitzpatrick, *The Small Laws: Eliot Spitzer and the Way to Insurance Market Reform*, 74 *FORDHAM L. REV.* 3041 (2006).

Rounding out our list of the main participants in the D&O market are reinsurers. Not every D&O insurer uses reinsurance—our participants reported, in fact, that at least some of the market leaders did not use it at all during the period of our study—but many do.<sup>89</sup> Reinsurers insure the risks undertaken by insurance companies, effectively providing a further means of risk-spreading.<sup>90</sup> Reinsurance also provides new entrants with an easy means of accessing the D&O insurance market and established insurers with a quick means of increasing their D&O exposure. Similarly, the easiest way for an insurance company to reduce its D&O exposure without eliminating existing customers is to reinsure a larger share of its business.

### 3. Market Cycles

No description of the D&O insurance market would be complete without some mention of the insurance underwriting cycle. For reasons that have yet to be fully explained, insurance markets follow a boom and bust pattern that is similar to, but not closely correlated with, other business cycles.<sup>91</sup> More specifically, the underwriting cycle refers to the tendency of premiums and restrictions on coverage and underwriting to rise and fall as insurers tighten their standards in response to the loss of capital or, alternately, loosen their standards in order to maintain or grow market share when new capital enters the market.<sup>92</sup> The tightening of underwriting standards accompanies a

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<sup>89</sup> Our participants reported that most of the leading global and domestic reinsurance companies active in the U.S. liability insurance market have provided D&O reinsurance in the recent past and that D&O reinsurance is also offered by some Lloyds syndicates and by several of the newer, Bermuda-based reinsurers.

<sup>90</sup> D&O reinsurance, like reinsurance generally, may be provided on either a *treaty* or a *facultative* basis. In treaty reinsurance, the reinsurer assumes a portion of all risks underwritten by the insurer within a defined category, such as public company D&O, and therefore evaluates the insurer's risk portfolio as a whole. In facultative reinsurance, the reinsurers assume a portion of a particular policy and therefore underwrite each risk individually, typically on an excess of loss basis. See generally STANFORD MILLER, REINSURANCE (Robert W. Strain, ed., 1st ed. 1980).

<sup>91</sup> For a detailed examination of the underwriting cycle that reviews the literature, see Tom Baker, *Medical Malpractice and the Insurance Underwriting Cycle*, 54 DEPAUL L. REV. 393 (2005). For a claim that the underwriting cycle is correlated with interest movements, see Robert T. McGee, *The Cycle in Property/Casualty Reinsurance*, 11 FED. RES. BANK N.Y. Q. REV. 22 (1986).

<sup>92</sup> See, e.g., Scott E. Harrington, *Tort Liability, Insurance Rates, and the Insurance Cycle*, in BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 2004 (Robert E. Litan & Richard Herring, eds., 2004). Some economists have recently suggested that the pattern is more variable and random than the term "cycle" implies. See, e.g., Anne Gron and Andrew Winton, *Risk Overhang and Market Behavior*, 74 J. Bus.

“hard market” in which premiums and, after a lag, underwriting profits rise.<sup>93</sup> Increased underwriting profits, of course, spur competition, whether from new entrants or established companies seeking to increase market share, and competition leads to another “soft market” of loosening of underwriting standards and declining profits. The process is described as cyclical because each market condition contains the seed to generate the other.<sup>94</sup>

All aspects of underwriting are affected by the cycle. Underwriters become more selective, less willing to offer high limits, more interested in higher attachment points, less willing to negotiate contract terms, and able to command dramatically higher prices for what amounts to less coverage. The D&O insurance market went through this “hard” phase in the mid 1980s and again in 2001-2003.<sup>95</sup> More recently, the D&O insurance market has been shifting to the “soft” phase.<sup>96</sup>

The underwriting cycle has significant consequences for the research reported in this Article. Because of the cycle, no snapshot of the underwriting process can present an adequate basis for understanding insurance underwriting over time. Our snapshot of the underwriting process took place at a transition period when the underwriting practices of the hard market were largely still in place but prices were beginning to soften. Although we tried to compensate for this snapshot by asking our participants to take a historical view, and not to focus only on the very recent past, it is possible that our research overemphasizes practices more prevalent in a particular phase of the underwriting cycle.<sup>97</sup>

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591 (2001). Nevertheless, the concept of a “cycle” is so firmly established within the industry that we will continue to use the term. *See, e.g.*, Matthew Dolan, Repeating the Sins of Market Cycles, Insights (Oct. 2003), at 1, [http://www.onebeaconpro.com/insights/instights\\_vol2\\_sp.pdf](http://www.onebeaconpro.com/insights/instights_vol2_sp.pdf).

<sup>93</sup> The lag occurs because at the start of a hard market insurers increase the reserves set aside to pay claims under policies previously sold, suppressing profits for a least one year. *See Baker, Underwriting Cycle, supra* note 91 at 400.

<sup>94</sup> *See* Sean M. Fitzpatrick, *Fear is the Key: A Behavioral Guide to Underwriting Cycles*, 10 CONN. INS. L. J. 255 (2004). One of our participants reported, “It is funny how you find sometimes that questions either go away or they are not as substantial as they were maybe in a harder insurance market where the premiums were higher and there is less capacity.” Underwriter #14, p. 17.

<sup>95</sup> *See* Roberto Romano, *What Went Wrong with Directors and Officers Liability Insurance?*, 14 DEL. J. CORP. L. 141 (describing hard market conditions in the mid 1980s).

<sup>96</sup> *See* Underwriter #4, p. 4. *See also* TILLINGHAST, 2005 DIRECTORS AND OFFICERS LIABILITY SURVEY 3 (2006).

<sup>97</sup> For example, one underwriter describing the excesses of a recent soft market reported that underwriters occasionally offered coverage without even requiring an application. Underwriter #12, p. 7.

### III. UNDERWRITING AND RISK ASSESSMENT

Underwriting is the process through which an insurer decides whether or not to offer coverage to a prospective insured and, if so, at what amounts, at which layer of the tower, and of course, at what price.<sup>98</sup> Each of these basic underwriting decisions depends upon the insurer's assessment of the risk posed by the prospective insured. This risk assessment is the most critical aspect of the underwriting process and the subject of this Part of the Article.

#### A. Assessing the Risk of Shareholder Litigation

The underwriters we interviewed all had their own method of assessing D&O risk, the precise details of which they were typically unwilling to share.<sup>99</sup> Some claimed that their underwriting process was driven by a mathematical model,<sup>100</sup> while others described hashing out these decisions in discussion with colleagues around a large table.<sup>101</sup> All of the underwriters we talked to, however, emphasized the importance of individual risk-rating. This surprised us somewhat since, by analogy to portfolio theory, we expected at least some insurers to take an index approach and seek to diversify their risks by underwriting a portion of the entire D&O market.<sup>102</sup> None did. In fact, one of the underwriters we interviewed sharply rebuffed the suggestion:

That is not enlightened thinking. If you followed that through to the end, why wouldn't you just simply regress to the mean...? I mean, if your actuary assumes that you are

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<sup>98</sup> One of our participants abbreviated these basic underwriting tools with the acronym "SLAP" – selection (of risk), limits (of coverage), attachment point (within the tower), and pricing (of the policy). *See* Underwriter #9, p. 9.

<sup>99</sup> One joked, "I would have to kill you if I told you." Underwriter #2, p. 8. In the words of another, "we spend a lot of time studying [what factors correlate to D&O risk]. We know quite well, but it's private." Underwriter #4, p. 3.

<sup>100</sup> Underwriter #8 at 12.

<sup>101</sup> In the words of a former line underwriter:

I am not familiar with say auto insurance or these other lines of insurance where an underwriter can actually plug in numbers into an actuarial model. ... We didn't do that. We literally sat at a round table and just based on the experience of the more senior folks, we would say this is a great number, and we threw a number out of the hat.

Underwriter #6, p. 24-25.

<sup>102</sup> *See generally* EDWIN J. ELTON, MARTIN J. GRUBER, STEPHEN J. BROWN, WILLIAM N. GOETZMAN, *MODERN PORTFOLIO THEORY AND INVESTMENT ANALYSIS* (6<sup>th</sup> ed. 2003). Applying the lesson of portfolio theory, an underwriter might seek to underwrite a thin sliver of each risk and thus participate in the returns of the D&O market as a whole.



just going to do average and he is going to make you price the business for average, right, how do you get more aggressive on the better business?<sup>103</sup>

Every underwriter in our sample sought to underwrite “better business”—that is, better D&O risks. One participant candidly described his firm’s goal to “out-select [its] peers.”<sup>104</sup>

Some underwriters described moving toward a more portfolio-based approach, in which their firms attempt to balance their exposure by industry sector and market cap.<sup>105</sup> But these insurers still stress risk selection.<sup>106</sup> In other words, even as insurers seek to spread their exposures, they nevertheless take care in the design of their risk pools and select insureds on the basis of individual risk characteristics. In this way, risk assessment is a competitive tool. D&O insurance companies have strong incentives—avoiding losses and out-selecting competitors—to assess the risk of shareholder litigation accurately. Thus, if we want to understand shareholder litigation risk, D&O insurance underwriting practices are a good place to start. And if we want to find the annualized present value of shareholder litigation risk for any particular corporation, D&O insurance premiums are the only place to look.<sup>107</sup>

In making their risk assessments, underwriters look to three principal sources of information about the prospective insured.<sup>108</sup> First, there is an application process through which underwriters elicit

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<sup>103</sup> Underwriter #15, p. 31.

<sup>104</sup> Underwriter #8, p. 35. Whether, in fact, this can be done or whether, instead, D&O underwriters simply succumb to the Lake Woebegone illusion—where all the children are above average—we leave for another day. More generally, we discuss reasons to doubt underwriters’ ability accurately to predict D&O risk at *infra* note 184.

<sup>105</sup> Several participants did describe their “limit management” strategy—that is, reducing the insurer’s exposure to any one D&O risk by reducing the maximum limits available to any one insured. *See, e.g.*, Actuary #3, p. 13 (“[W]hat we try to stress in our portfolio is diversification by industry, diversification by size, and... laying a good limits management strategy on top of that.”); Underwriter #1, at – (reporting a strategy of risk pool diversification by industry); Underwriter #9, at 23 (“portfolio underwriting in D&O, which is stepping away from an individual risk and looking at a portfolio of risk, is also merging into yet other corporate finance concepts”).

<sup>106</sup> Actuary #3, at pp. 13-14 (stating that “most underwriters still feel that selection is important” and describing the insurer’s efforts, within a given risk category, “to pick the best in class within the industry”).

<sup>107</sup> Cf. Griffith, *Uncovering a Gatekeeper*, *supra* note 16 (arguing on this basis for public disclosure of D&O insurance premiums and other policy terms).

<sup>108</sup> Underwriter #9, NYC Tape 1&2, pp 29-30 (describing the importance of “applications.... [and] specialized questionnaires often-times focused on specific industry categories” as well as “meetings in which underwriters are posing questions to officers of the company in regard to business practices, in regard to their current activities, and in regard to their future plans”).

basic information, including the experience of covered officers and directors and the claims history of the corporation,<sup>109</sup> plans for acquisitions or securities issuances,<sup>110</sup> and whether any prospective insured has “prior knowledge” of acts or omissions likely to give rise to a claim.<sup>111</sup> The written application also contains an important bonding mechanism—forcing the prospective insured to commit to the veracity of all written statements and documents furnished in connection with the application.<sup>112</sup> Because an applicant furnishing untrue information creates the basis for a subsequent rescission action, the credibility of information provided through the application is enhanced.<sup>113</sup>

Second, underwriters conduct their own independent research. They use a wide variety of publicly available data sources including SEC filings, Bloomberg reports, analyst ratings, corporate governance reviews from specialized providers such as the Corporate Library, and

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<sup>109</sup> Applicants are asked both to describe any claims activity under a previous carrier and whether any covered individual has ever been involved in securities or antitrust litigation, criminal or administrative actions, derivative claims or such representative proceedings. Chubb D&O Elite Application, Item II.5. AIG Application, Item IV.10.

<sup>110</sup> Hartford Specimen Application, at item 3. Chubb D&O Elite Application, Item II.4. AIG Application, Item IV.6-9.

<sup>111</sup> AIG Application, Item IV. 8-9; Chubb Application, Item II.6; Hartford Specimen Application, item 5. This representation in the application typically interacts with the Prior Claims exclusion to exclude or limit the insurer’s exposure to such claims. *See supra* note 64.

<sup>112</sup> For example, a Chubb D&O application provides:

The undersigned ... declare that to the best of their knowledge and belief, after reasonable inquiry, the statements made in this Application and in any attachments or other documents submitted with this Application are true and complete. The undersigned agree that this Application and such attachments and other documents shall be the basis of the insurance policy...; that all such materials shall be deemed to be attached to and shall form a part of any such policy; and that the Company will have relied on all such materials in issuing any such policy.

Chubb D&O Elite Application, Item V (2003), <http://www.chubb.com/businesses/csi/chubb3495.pdf>.

<sup>113</sup> Basic attachments called for in the application and thereby captured in the bonding mechanism include organizational documents, recent SEC filings and copies of any correspondence between outside auditors and management, as well as prior D&O policies. *See* Chubb D&O Elite Application, Item II.1; AIG Application, Item VI, 14 and Item V. The bonding mechanism would also capture written answers to interrogatories and any other information provided in connection with the underwriting process. However, one underwriter pointed out that it is difficult for insurers to win rescission cases—pointing out that attempts to rescind against Dennis Kozlowski (Tyco) and Richard Scrushy (HealthSouth) had failed. The rescission threat therefore may be an empty one, substantially weakening the bonding mechanism.

industry-specific forensic accounting studies that identify potential problem areas for further inquiry.<sup>114</sup>

In addition to this publicly available data, underwriters have access to private information through a series of meetings with the prospective insured's senior managers—often the Chief Financial Officer or Treasurer as well as members of the accounting and legal departments and occasionally, for smaller companies, the Chief Executive Officer.<sup>115</sup> At these “Underwriters’ Meetings,” prospective insureds present information about their business model, strategies, and risks—as one corporate risk manager described the goal of the presentation: “We don’t buy insurance. We sell risk.”<sup>116</sup>—while underwriters ask questions and gather further information.<sup>117</sup> Much of the information gathered during the Underwriters’ Meeting and in any subsequent inquiries may not be publicly available.<sup>118</sup> It is therefore customary in the underwriting process for underwriters to enter into non-disclosure agreements with prospective insureds,<sup>119</sup> thus permitting a free exchange of otherwise unavailable information.<sup>120</sup>

Participants in our study repeatedly described the underwriting process as onerous and detail-oriented.<sup>121</sup> This, of course, begs the

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<sup>114</sup> See, e.g., Underwriter #7 at 16-17 (Corporate Library); Underwriter #8 at 19-20 (Corporate Library); Underwriter #9, at 14 (forensic accounting); Underwriter #12 at – (web and Bloomberg); Underwriter #10 at 3 & 55 (Web and Bloomberg); Actuary #1 at 25 (Web and Bloomberg).

<sup>115</sup> Broker #5, p. 11.

<sup>116</sup> Risk Manager #4, p. 7 (elaborating further that “[t]he best way to sell risk is to bring evidence to them... to reduce any uncertainty about your risk.”).

<sup>117</sup> Describing the Underwriters’ Meeting, one broker said:

It is like a first date. The insured, everyone is dressed very well. Generally, an insured’s CFO or general counsel or maybe even the CEO might give a presentation.... There will be questions that are asked by the underwriters. Some of them may involve confidential information about a public company. ... [T]he insurance companies will sign confidentiality agreements.... I think that insureds for the most part are pretty forthcoming.

Broker #2, pp 16-17.

<sup>118</sup> As a risk-manager described the process: “[The underwriters] look at [the publicly available information] side by side by what is the account telling us in terms of what they are doing, and where is the evidence that they are actually doing it.” Risk Manager #4, p. 13.

<sup>119</sup> See, e.g., Underwriter #1, pp. 17-18 (noting that most Underwriters’ Meetings are subject to non-disclosure agreements that provide underwriters with access to non-public information). See also Griffith, *Uncovering a Gatekeeper*, *supra* note 15, (emphasizing role of non-disclosure agreements in the underwriting process).

<sup>120</sup> There is some information, of course, that prospective insureds will not share even under the terms of a non-disclosure agreement. Broker #1, p 18.

<sup>121</sup> Risk Manager #2, p. 11 (noting that “there is very thorough review and research into the guts of the finance [and] the guts of the operation of the company”). Another Risk Manager noted:

critical question of what information underwriters seek to gather during this process. What do underwriters ask for? What information do they value most? What do they believe best predicts the risk of shareholder litigation?

We will now focus on those questions. Before beginning, however, we offer an extended quotation from one of our participants—the top D&O underwriting officer at a leading insurer—that describes the underwriting process at his firm. In his words:

We look at the industry that the company operates in, trying to figure out if we are in a mature industry, a growth industry, a start up section of the industry, whatever. Are we working with proven technology, new technology, proven consumer goods, new consumer goods?

We look at the history of the company and see if M&A is a prominent part of their planning process for the future or not. We look if there are takeover risks. We look if there is a restructuring perhaps necessary in the future of the company. We examine the type of securities filings they did at the SEC.... We look at any SPEs, SPVs, joint ventures that they are using to grow strategically.

Then we dive into the corporate governance. We examine who the directors and officers are, their applicable experience. We look at interlocking board relationships. We actually keep a separate database here. Since 1996 we can run our database and tell you if any one director or officer was a defendant in a securities class action or derivative action. ... [W]e record which company they were serving in when they were sued, but what we can then do is go back and look to see if the folks that we are underwriting now were sued in what was a fender bender or if it was a complete corporate meltdown.... So we have a driving record in this.

We look at the organization of the corporate governance committees and independence of those committees and how active they are and then we look at insider ownership [and] compensation packages. Then we move into a broader understanding of the entire ownership of the company and...

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I can recall probably 15 years ago where a D&O renewal might take me a half hour to fill out the applications. It [now] takes me about a week to do all the financial projections, just to get them assembled and to determine where I need to go for information.... They want detailed information. .... That is followed by an interview process and sometimes followed by another set of application questions.

Risk Manager #4, p. 3. The cyclical nature of the insurance market, however, also seems affect the rigor of the underwriters' diligence process. Risk Manager #3, p. 13 (noting that "prior to [the corporate] meltdowns, [D&O] was a cake coverage"). Whether the current level of scrutiny will be a lasting feature of the marketplace therefore remains to be seen.

what conflicts may or may not may exist within the ownership interest.

We take a serious look at the equity trend of the company over recent years and what made its price earnings multiple what it is. We examine insider trades. We look at any intellectual property that the company may be relying upon. We look at the regulatory structure and who the regulators may be and what the history with the regulatory relationships were. We look at both former existing director and officer litigation as well as general litigation that the corporation may be involved in that could be a threat to the future value of the company. We look at how they handle corporate investor communications. We look at how they are handling legislative or environmental issues that may face the company. We look at how they may handle employment practices and bankruptcy of course. We have an entire dedicated review of the bankruptcy and potential emergency or liquidation.

Then we go into a very meticulous breakdown of the financials of both the balance sheet and the cash flow statement and profit and loss statement. You know, your typical ratio analysis is supported by about 55 or so different ratios. Underneath those ratios we look meticulously at who the auditors are, what the revenue recognition policies are, how they manage accounts receivable, inventory, payables, valuing intangibles, you know, formulating debt and appreciation, capital expenditures, pension obligations, and we look even at vendor financing if it exists. Then we take all that stuff and we rate it for risk. We summarize, you know, what makes us want to write the account and what makes the necessity of the insurance relevant to the risk of the company. And then we price it.<sup>122</sup>

In the discussion that follows, we seek to analyze and elaborate aspects of this description.

## B. Financial Analysis

Insurance underwriters think of risk in terms of frequency and severity.<sup>123</sup> What is the likely frequency of an insured loss? And what is the probable magnitude of the loss once incurred? All of the underwriters we interviewed agreed that D&O insurance “is a high

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<sup>122</sup> Underwriter #2, pp 6-7. Another leading underwriter described a similarly broad range of factors and described using them in a way that was largely “intuitive.” Underwriter #7, p. 6 (“[T]he public D&O business is something that to some extent you can only be taught 75%. Zero to 25% has to be intuitive.”).

<sup>123</sup> See Underwriter #4, p. 5.

severity, low frequency game.”<sup>124</sup> And all of them glean an initial estimate of frequency and severity from financial analysis. The reason is simple. Virtually all shareholder litigation stems from investment loss. Thus, a major part of assessing the risk of shareholder litigation is assessing the risk of investment loss.

Underwriters begin the process of risk assessment with an analysis of basic financial information about a company. This financial analysis includes such factors as the prospective insured’s industry and maturity,<sup>125</sup> its market capitalization,<sup>126</sup> volatility,<sup>127</sup> and various accounting ratios.<sup>128</sup> Industry and volatility are associated with frequency: some industries are sued more often than others and shareholder litigation tends to coincide with sudden declines in share price (volatility). Market capitalization, meanwhile, is used to predict both frequency and severity: larger firms are sued more often, and larger capitalization firms have farther to fall in measuring damages. As a result, these financial factors enable underwriters to form an initial estimate of a prospective insured’s exposure to shareholder litigation risk.

In this regard, an underwriter’s evaluation of these financial factors differs from an equity analyst’s. Insurers, unlike investors, do not look favorably upon high-growth companies.<sup>129</sup> Insurers focus

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<sup>124</sup> Underwriter #1, p. 8 [CONSENT].

<sup>125</sup> Broker #1, pp. 4-5; Broker #2, pp. 14-15; Underwriter #13, pp. 14-15; Underwriter #2, p. 6; Actuary #1, pp. 24-26, Underwriter #7, pp. 18-19 and 29 (noting that “underwriters rarely offer the same kind of limits to a company going public as they would a mature company”).

<sup>126</sup> One participant explained on how market cap came to be important to D&O risk-rating as follows:

[I]nitially these policies were rated by the number of people on the board. So if you had a larger board, you had more risk. It was sort of a per person type of rating scheme. Then people thought about it and said, well we really need a proxy for decision making. What are the size of the decisions and the frequency that decisions need to be made in a corporation? The first proxy they came up with was assets. ... That has evolved as we look at the tech companies in the 90s and we said to ourselves, wait a minute. This tech company has very little revenues, very little assets, but a huge market cap. Therefore, the potential for liability is not necessarily correlated with assets for that industry. We saw carriers moving toward using market capitalization now as a basis for the initial premium. ...Once the initial premium is determined though, we can factor out mildly or dramatically depending [upon a variety of qualitative factors].

Broker #6, p. 15-16.

<sup>127</sup> See Underwriter #5, p. 18, Underwriter #4, pp. 5, 26, Broker #1, p. 4.

<sup>128</sup> Participants especially emphasized accounting ratios indicating volatility or stability of cash flows and earnings. Actuary #1, pp. 24-26, Underwriter #7, pp. 18-19, Underwriter #13, pp. 14-15, Broker #1, pp. 4-5, Broker #2, pp. 14-15, Broker #5, pp. 25-26.

<sup>129</sup> A D&O broker described this difference in the following exchange:

more on downside risk because they have a fixed return (the policy premium) that is modest in relation to their exposure to loss (the policy limits), while equity investors have a fixed exposure to loss (their initial investment) and a potentially unlimited upside (their share of the business's growth).<sup>130</sup> This makes a significant difference in risk evaluation performed by an underwriter versus an equity analyst.<sup>131</sup> In the words of an underwriter:

[Evaluating D&O risk] is not the same as [evaluating] investment risk.... [T]here are companies that would be terrific companies [to invest in] that would be terrible D&O risks. There are companies that you would never ever put a penny of investment in, but they are great [D&O risks] because they are just not going to have this kind of class action lawsuit.<sup>132</sup>

For a D&O underwriter, growth prospects are largely irrelevant or, worse, a source of volatility that may lead to disappointed shareholder expectations and therefore litigation. In the words of one underwriter, "it is not about picking winners as much as avoiding losers.... If I avoid three or four bad claims a year, we had a great year."<sup>133</sup>

### C. Governance Factors

As one participant in our study remarked: "[there are] two major pillars in D&O underwriting: one is financial analysis, two is

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Q: So what are [underwriters] looking for? I mean I understand when I'm buying an equity investment.... I want the earnings to look like a hockey stick. ... But that's not what an underwriter cares about, right?

A: Just the opposite. They do not want the hockey stick. The hockey stick, I think, causes them to believe that if there's such a spike, then can a company accommodate that? Can it grow like that without getting to the top of that hockey stick and then dropping like a rock? So they want to make sure that the company is on a platform of sustainable growth, they feel comfortable with the management, understand all of the compliance issues that are in place.

Broker #5, p. 26 [CONSENT].

<sup>130</sup> [CITATION PENDING (corp fin text)].

<sup>131</sup> In addition to the differences in the risks evaluated by each, discussed in the text, the incentive structure of analysts and insurers is different. Analysts typically operate under a fee-for-services model where they derive income from their reputation for accuracy, while D&O underwriters stake their firm's capital on their judgments. Although damage to one's reputation can certainly lead to a loss of income, it is less immediate than, for example, paying out \$10-\$25 million in covered losses as a result of a failing to accurately gauge governance risk. As a result, D&O insurers may be more sensitive to errors and therefore more eager to avoid them. See also Griffith, *Uncovering a Gatekeeper*, *supra* note 16, (comparing loss sensitivity of reputational capital and capital reserves).

<sup>132</sup> Underwriter #4, p. 3.

<sup>133</sup> Underwriter #7, p. 21.

evaluation of corporate governance.”<sup>134</sup> As just described, the financial analysis assesses the potential for a sudden investment loss of any sort. Evaluation of corporate governance assesses the probability that the investment loss will be linked to corporate or securities law violations. Having discussed financial analysis above, we turn, in this section, to our discussion of corporate governance. Before beginning, however, we pause to address the problem of definitions.

“Corporate governance” is a broad concept that the legal literature has tended to give a narrow definition. Scholars discuss it most often in the context of specific regulatory reforms<sup>135</sup> or in terms of charter provisions and other easily observable structural characteristics on which regressions can be run.<sup>136</sup> But corporate governance may refer more broadly to any aspect of the system incentives and constraints operating within a firm. Indeed, the participants in our study tended to give corporate governance this broader definition, referring repeatedly to the importance of “culture” and “character” in D&O underwriting.<sup>137</sup>

Culture and character, we were regularly told, are at least as important as and perhaps more important than other, more readily observable, governance factors in assessing D&O risk.<sup>138</sup> In the words of one underwriter:

I don't view my [underwriters] as financial experts to begin with. If I am going to toe to toe with a CFO of X Corp., am I getting to the bottom of what is going on here? The answer is no. To me, my style in terms of underwriting has been to look for the way people deal with certain issues and how they view their goals and how they are going to achieve them.<sup>139</sup>

Terms such as culture and character, however, need some decoding. As described in greater detail below, we took “culture” to refer to the

<sup>134</sup> Underwriter #9, NYC Tape 1&2, p 30.

<sup>135</sup> Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

<sup>136</sup> See, e.g., Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 48 J. L. & ECON. 371 (2005) (analyzing the relationship between earnings restatements and board and audit committee independence, the financial expertise of directors, auditor conflicts of interest, director block-holding, and the influence of the chief executive officer on the board). See also *infra* note 239.

<sup>137</sup> Culture and character were recurrent themes in our interviews. Typical remarks included: “I believe that really what it comes down to is the culture and the people.” Broker #1, p. 14. “[U]ltimately the insurance underwriter is really betting on the ethics and confidence of the management of the company.” Broker #2, p. 17. “The only way you are ever going to be able to underwrite this stuff is through people. It is your ability to assess character” Seminar Tape 1, p 26.

<sup>138</sup> Broker #4, p. 5.

<sup>139</sup> Underwriter #15, p.12



system of incentives and constraints operating within the organization, including both formal rules and informal norms. “Character” we took to refer to the likelihood that top managers would defect from corporate interests when given an opportunity to do so.

### 1. Culture: Incentives & Constraints

The system of incentives and constraints operating within a firm may be based upon formal rules, informal norms, or as is most likely, some combination of the two.<sup>140</sup> Participants in our study emphasized each of these aspects of corporate culture. Several underwriters cited executive compensation as a key indicator of intra-firm incentives. An equally large number also emphasized the constraint of internal controls. In their discussion of these incentives and constraints, it was clear that underwriters looked past the formal rules, seeking a sense of how strong the norm of compliance is within the organization or whether, by contrast, there is a norm of defection. As one senior underwriter described:

No company ever just dropped out of the sky. There is a history, which is a narrative of how they got in this business. Who are the players? Who founded them? What is their culture? You might get to the ethics of the culture of the company, but you [need to] understand how it got there, into the state that it's in. ... Who are they? And where they come from? How did they know each other? In a fraternity? Did they know each other in business? ... I mean, there is a story. They didn't just all land out of the sky, and *you should understand that matters*.<sup>141</sup>

One frame through which underwriters examine corporate culture is executive compensation. In the words of this same underwriter:

You have a hard time convincing me when a guy makes a fortune and the board signs off on the increases or the other demands or the perks or the airplane flights or the bonus packages, severance packages, or the balloons, or whatever it is. You have a hard time telling me that that board has a real grip on that CEO....<sup>142</sup>

Given recent criticism of corporate compensation practices in both the academic and the mainstream press, it is not surprising that insurers

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<sup>140</sup> Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619 (2001) (describing non-legally enforceable norms and standards).

<sup>141</sup> Underwriter #7, pp. 27-28

<sup>142</sup> Underwriter #7, p. 16.

also pay attention to compensation.<sup>143</sup> However, it is worth pointing out that there is not a shareholder cause of action for excessive executive compensation. Shareholders cannot sue simply because the CEO is making too much money but must argue instead that the board was grossly negligent in approving the compensation package<sup>144</sup> or that management misstated earnings in order to maximize the value of their option compensation.<sup>145</sup> Executive compensation itself, in other words, does not create liability risk. Rather, the liability risk comes from what the firm's executive compensation practices suggest about the incentives operating within the firm.<sup>146</sup> Not only do lax firms pay too much, but greedy executives may also seek to manipulate the rules in order to protect their pay packages, potentially leading to shareholder litigation. For similar reasons, our participants cited the stringency of a firm's insider trading policies (and the care with which they are observed) as significant factors in risk-assessment.<sup>147</sup>

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<sup>143</sup> See, e.g., LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004) (describing how managerial interests taint a variety of common forms of executive compensation); Charles M. Elson, Corporate Law Symposium: The Duty of Care, Compensation, and Stock Ownership, 63 U. Cin. L. Rev. 649, 649 n.2 (1995) (noting the public outcry over excessive executive compensation); Arthur Levitt, Jr., *Corporate Culture and the Problem of Executive Compensation*, 30 J. CORP. L. 749 (2005) (“If there is anything that engages the public today about the business community, it is the issue of compensation.”).

<sup>144</sup> Shareholders may sue under state corporate law for excessive executive compensation, but such claims typically do not get very far in the absence of a clear conflict of interest due to corporate exculpation provisions and application of the business judgment rule. See, e.g., *In re The Walt Disney Co. Derivative Litigation*, No. Civ.A. 15452, 2005 WL 2056651 (Del. Ch. Aug. 9, 2005).

<sup>145</sup> See generally John Hechinger & Gregory Zuckerman, *Stock-Option Grant Probes Gain Steam As More Firms' Practices Get Scrutiny*, WALL ST. J., May 23, 2006, at C1 (describing investigations of public companies whose option grants appear linked to share price manipulation). See also Charles Forelle, *How Journal Found Options Pattern*, WALL ST. J., May 22, 2006, at A11 (describing statistical methodology used by newspaper to uncover share price manipulation surrounding option grants).

<sup>146</sup> Cf. BEBCHUK & FRIED, *supra* note 143, at 4 (“directors have been influenced by management, sympathetic to executives, insufficiently motivated to bargain over compensation, or simply ineffectual in overseeing compensation”).

<sup>147</sup> See Broker #6, p. 17 (“They certainly do put a lot of weight on things like what are your insider trading guidelines. They want them to be fairly stringent.”). Unlike executive compensation, insider trading itself may form the basis of a shareholder claim. See 10b-5 and EA §16. But insider trading, especially unusual trading patterns, is perhaps most important as “hard evidence” of securities fraud. See M.F. Johnson, R. Kasznik, & K.K. Nelson, *Shareholder wealth effects of the Private Securities Litigation Reform Act of 1995*, 5 REV. ACCTG. STUD. 217 (2000); Marilyn F. Johnson, et al., *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, J.L. ECON. & ORG. (forthcoming), available at <http://ssrn.com/abstract=883684> (finding “a significantly greater correlation between litigation and both earnings restatements and insider trading after the PSLRA.”) (hereinafter Johnson et al., *Merits Matter More*).

In addition to the internal incentive structure of the firm, D&O underwriters also review a prospective insured's internal constraints. Indeed, if there was one central corporate governance variable that our respondents sought to emphasize, it was the quality of the prospective insured's internal controls. In the words of a prominent risk manager, "the one word that really captures the heart of the process is evidence that there is controllership."<sup>148</sup> Internal controls involve a wide variety of industry-specific practices,<sup>149</sup> but revenue recognition procedures, because they can lead to restatements and thereby to securities claims, were repeatedly emphasized as a core concern.<sup>150</sup> One underwriter gave the example of Harley Davidson:

Harley Davidson got sued because they were channel stuffing motorcycles. ... [T]hat wasn't happening at the board level. That was probably the VP for sales had a monthly sales target that he was desperate about making because his bonus compensation was tied to meeting his target, and so they started [channel] stuffing motorcycles....<sup>151</sup>

Because pressures to manipulate results may exist throughout the firm, as this example suggests, the question of internal controls is

<sup>148</sup> Risk Manager #4, p 5.

<sup>149</sup> See Underwriter #5, p. 10 ("You need to understand some of the accounting issues that were driving claims, particularly revenue recognition procedures at companies. ... [E]ach of those industries had different... revenue recognition issues. You need to be able to drill down, see if the answers were there, and if not, ask the right questions to get them.").

<sup>150</sup> Note earnings management and 10b-5, role of a restatement as "hard evidence". See *supra* note 147

<sup>151</sup> Underwriter #4, p. 32. A manufacturer that engages in "channel stuffing" intentionally sends its retailers more products than they are able to sell in order to inflate (temporarily) its sales figures. Unless sales suddenly increase or, in the case of channel stuffing after a downturn, recover, the manufacturer will ultimately have to adjust its accounts receivable, resulting in a loss. One of our participants illustrated the problem with an example:

Division president is having a bad quarter and says, you know what? We will fix it next quarter. He brings in temps. They ship more product. Their revenue recognition, which is a huge question in these interviews, is if it is shipped, you can book the revenue, so we make the quarter. The next quarter we don't recover. So we bring in the temps a little bit earlier. Instead of just the last couple weeks, we actually bring them in 3-4 weeks. We say, we'll make it up next quarter. We ship more product and we make our numbers. Now we are in quarter number 3 and I'm having trouble as division president making my numbers. Things have not recovered in my sector, so I start to look into my reserve for returns. I say, you know what? That's pretty high. I am going to take down my reserves, which translates into more dollars, which allows me to make my numbers. I tell my accountant, if anyone asks about this, don't talk to them. Send them to me. Well, you know then in the fourth quarter everything blows up. That is the first time the CFO and the CEO and other people in corporate find out about it.

Broker #6, pp 33-36.

really the question of whether the organization can constrain these temptations throughout the firm.<sup>152</sup>

The investigation into internal controls does not stop at the board level, nor does it end once underwriters are given a corporation's statement of controllership principles.<sup>153</sup> Instead, our participants noted, underwriters investigate how information flows throughout the firm:

How does 'bad news' flow upward within the organization? Does the corporate culture encourage such news to be brought to the attention of senior management? Are significant developments shared with the Board of Directors as they become available?<sup>154</sup>

Underwriters investigate who reports to whom.<sup>155</sup> They inquire into the norms and actual practices underlying formal policies.<sup>156</sup> They retain forensic accounting consultants to detect inadequacies in internal controls before they lead to fraud.<sup>157</sup>

The quality of constraints within a corporation may also be indicated indirectly—as a prospective insured's plans for mergers and acquisitions activity was described to us. Of course, M&A itself is a litigation risk,<sup>158</sup> and for this reason insurers inquire, often in both the

<sup>152</sup> See, e.g., *supra* note 151 (describing the role of lower-level sales managers in channel stuffing schemes).

<sup>153</sup> Underwriters take board independence into account as an aspect of controllership. Underwriter #7, pp. 14-15 ("There is a lot of cronyism still. ... I mean, you still have entrenched boards, boards that only work for the CEO as opposed to vice versa. It is a fundamental underwriting question we ask people, who works for whom."). The incremental value of more or less independence, however, does not seem to weigh heavily. Cf. Broker #1, p. 8 (describing the value of board independence as follows: "if you had a board that was, you know, one independent and everybody was inside directors, that is viewed as a negative"). Instead, independence is important only insofar as it indicates the strength of constraints operating within the organization.

<sup>154</sup> *Examples of Questions Being Asked by D&O Underwriters*, (unpublished broker's document designed to prepare clients for underwriters' meeting).

<sup>155</sup> To an underwriter, good governance involves centralized control and multiple levels of review. As a leading broker described a good D&O risk: "They review everything. Everything is done early. ... The CFO knows about a sale that is going on in Europe in real time and has to approve it. ... Everything is centralized control." Broker #6, p. 33.

<sup>156</sup> Risk Manager #4, pp 5-6 ("[Not only] is there a process, but how are you exercising the process? And what evidence do you have to support your controllership process? ... All the questions are around that subject.").

<sup>157</sup> According to one participant, "a cottage industry that has blossomed over the years, the whole area of forensic accounting. [I]t really goes to an area that deals with business operations and how risks are actually managing their business..." Underwriter #9, NYC Tape 1&2, pp. 30-31.

<sup>158</sup> See Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 137 (2004) (finding that approximately 80% of all fiduciary duty claims filed in Delaware

application and the underwriters' meeting, about the prospective insured's M&A plans.<sup>159</sup> But in our interviews it became clear that D&O insurers are not interested merely in *whether* a prospective insured will engage in M&A activity, but also *how* it will do so.<sup>160</sup> M&A, in the words of one risk manager, again comes down to the question of process and controls: "[A]re you just going to go out and buy a company, or do you have a process and what is the process? We actually show them the process."<sup>161</sup> Insurers are interested in the quality of acquisition planning or whether, by contrast, acquisition

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Chancery Court in 1999 and 2000 were class actions challenging board conduct in an acquisition and that only 14% of fiduciary duty claims over the same period were derivative suits); Elliot J. Weiss & Lawrence J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions*, 57 VAND. L. REV. 1797 (2004) (finding evidence of litigation agency costs in acquisition-oriented class actions).

<sup>159</sup> Risk Manager #3, p. 12 ("M&A is a bad thing when you are talking D&O insurance. It just opens you up to potential for more claims. I mean, M&A might be a good thing if you are talking to that equity analyst, you know, depending on their views..., so the emphasis is different."); Underwriter #7, p. 27 ("Frankly, most D&O claims if you were to look into them, there was a merger."); Underwriter #4, p. 20 ("we also look at M&A and what is going on in their business from an M&A perspective, whether you are an acquirer or people are acquiring in your business, because there is a correlation between that and lawsuits"); Broker #6, p. 16 (describing factors that influence price: "Have you been in any mergers and acquisitions recently? What is your M&A outlook?").

<sup>160</sup> See, e.g., Broker #1, p. 5 (emphasizing the prospective insured's "track record... with respect to such things as mergers and acquisitions or divestitures"). Moreover, insurers limit their exposure to acquisition-related claims in the policy itself. First, with respect to making acquisitions, if the insured acquires a target over a threshold size (often 10-25% of the total assets of the insured), the policy terminates within 60 days unless renegotiated. See AIG Specimen Policy, §12(b) (providing a 25% of assets threshold); Chubb Executive Protection Portfolio, §20. Accord Risk Manager #4, p. 9 ("[M]ost contracts have a threshold for additional premium as a result of acquisition, and a typical one might be 10% of sales and/or 10% of asset value. Either one of those ... could allow the underwriter to assess additional premiums."). The policy remains in effect for acquisitions below the threshold size. Second, with respect to acquisition of the insured, the policy terminates when the transaction closes. See AIG Specimen Policy, §12(a); Chubb Executive Protection Portfolio, §21. Claims may still be litigated under the prior policy—if, for example, the claim arises upon announcement of the acquisition but prior to closing, as many such claims do. See Thompson & Thomas, *supra* note, at [PIN] (discussing filing times for acquisition-oriented class actions); Weiss & White, *supra* note, at [PIN] (same). But any future coverage for the combined company must be renegotiated. The merging companies will often purchase a "runoff D&O program" to cover premerger wrongful acts. Risk Manager #1, p. 16. The underwriter thus crafts the policy to respond to two threats—the acquisition itself and a larger than expected insured after the merger. See Risk Manager #4, pp. 9-10 ("The event of the acquisition is one threat to them if you will, a potential claim, and the management of that new company and the integration of that company creates a whole another set of probabilities or possibilities.").

<sup>161</sup> Risk Manager #4, pp. 8-9.

activity is merely empire-building, further evidence of unconstrained management.<sup>162</sup>

In addition, underwriters reported that they take the ownership structure of a prospective insured into account.<sup>163</sup> D&O applications typically require disclosure of insider ownership and significant outside block-holdings.<sup>164</sup> This makes sense because a controlling shareholder may be a substitute for the governance constraints embedded in corporate law or charters, and significant insider share ownership may indicate an alignment of shareholder and management interests.<sup>165</sup> Accordingly, a prospective insured's ownership structure is an important factor in underwriting risk-assessment.

Finally, although less often discussed in our interviews than other risk factors, underwriters did note that they take into account such structural governance features as state of incorporation, board independence, committee composition, and separation of the chief executive and board chair roles.<sup>166</sup> Underwriters also described using third-party governance rating services such as the Corporate Library, to identify "red flags."<sup>167</sup> In addition, underwriters acknowledged that they consider structural indicia of management entrenchment, such as staggered boards and poison pills, but only in response to our direct questioning.<sup>168</sup> Because entrenchment was never listed independently by an underwriter as an important factor in D&O risk-assessment however, we hesitate to conclude that it is a key underwriting risk factor.

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<sup>162</sup> Underwriter #2, p. 22 (describing indicators of management stupidity and describing "proposed mergers that make no sense" as one such factor).

<sup>163</sup> Underwriter #2, p. 6; Underwriter #4, p. 21 ("We look at the equity of the company very closely. It is obviously a key driver on the rating model that we use. We look at who owns the stock and why.").

<sup>164</sup> See, e.g., AIG Application, Item III (inquiring into the percentage of shares are held by executives and other insiders and the presence of significant outside block-holders).

<sup>165</sup> See generally Ronald D. Gilson, *Controlling Shareholders And Corporate Governance: Complicating The Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1662 (2006) (noting that block-holding and diffuse ownership structures "may in some circumstances be functional substitutes; that is, they may have equivalent monitoring capacity").

<sup>166</sup> See, e.g., Broker #5, p. 28 ("They're asking – if the [CEO and chairperson of the board] are the same person – 'Why? Have you evaluated whether it should be split and can you help us out as to why you haven't?'").

<sup>167</sup> Underwriter #7, p. 16. Corporate Library reports governance scores in a report-card format, A through F. Underwriters reported offering credits and debits of up to 15% based upon the governance score. See Underwriter #8 at 31. Others reported that the narrative portion of the Corporate Library report is as important in their risk-rating process as the score itself. See Underwriter #1, p. 11.

<sup>168</sup> Underwriter #5, pp. 48-50.

In summary, underwriters investigate corporate culture by uncovering the buried structure of incentives and constraints operating within the firm. They do not confine their investigations to the presence or absence of big-picture structural features, such as an independent board or a formal controllership program. Instead they dig between the formal rules in an effort to unearth the firm's internal culture of compliance or defection.<sup>169</sup> That they expend resources to conduct this investigation when assessing D&O risk suggests that corporate culture affects the risk of shareholder litigation.

## 2. Character: "It was a small aquifer"

The other perhaps under-appreciated aspect of shareholder litigation risk (at least in mainstream corporate and securities law literature) is an aspect our participants referred to as "character."<sup>170</sup> "Ultimately," as one broker said, "the underwriter is really betting on the ethics and confidence of the management of the company."<sup>171</sup> Character, of course, is an amorphous concept. When we pressed underwriters to define it, they often responded by emphasizing arrogance and excessive risk-taking.

Arrogance, our interviews suggested, may indicate individuals who hold themselves above rules and norms.<sup>172</sup> Several underwriters described warning signs, such as "a CFO who has got all the answers, doesn't want to listen... Or a senior management team where all you see is the CEO and no one else. ...[J]ust one person out front and no one else. You never see them, and it is I, I, I."<sup>173</sup> Others offered anecdotes, including the following:

I am interviewing a CFO once at a company, and they were a manufacturing company. ... I said, "Do you have any pollution issues?" He said, "well..." "You know, recent

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<sup>169</sup> Cf. Kenneth Arrow, *The Economics of Moral Hazard: Further Comment*, 58 AM. ECON. REV. 537, 538 (1968) ("One of the characteristics of a successful economic system is that the relations of trust and confidence between principal and agent are sufficiently strong so that the agent will not cheat even though it may be 'rational economic behavior' to do so").

<sup>170</sup> On the history of character-based underwriting and the contrast between character based underwriting and the economic understanding of insurance, see Tom Baker, *Insuring Morality*, 29 ECONOMY AND SOCIETY 559 (2000).

<sup>171</sup> Broker #2 at 17. See also Actuary #1 at 10 ("What you're really underwriting when you underwrite D&O is you're underwriting the people, you're underwriting the senior management, the quality of the management team.").

<sup>172</sup> Underwriter #7, p. 17 (emphasizing perks such as "country club memberships, airplane travel, [and corporate] homes" as indicia of arrogance or lack of accountability).

<sup>173</sup> Underwriter #8, p. 27.

problems?” He said, “what do you mean by problems?” Stuff like that. ... I said, “Have you ever polluted an aquifer?” And to my surprise he says, “It was a small aquifer.” And then he goes on to rationalize ... how small three parts per billion is, or whatever the number was. He said it was ridiculous.... To my way of thinking, this is a bad insured. This is a guy who looks at his problems, [and] he doesn’t look at solving the problems or doesn’t look at what the law says. He is extemporizing on how he thinks the law ought to be applied. That is very bad. Because when things go wrong, those things will cause you to pay big time.<sup>174</sup>

Understood in this way, arrogance indicates a lack of susceptibility to restraint, as well as the ability and willingness to rationalize one’s conduct in a way that makes the rules seem not to apply.

With regard to risk-taking, insurers seek to avoid those executives whose appetite for risk exceeds the norm. As one actuary explained:

[M]aybe the most important question you can ask a CEO is how many speeding tickets do you have? What kind of car do you drive? How many times have you been married? How often do you drink? How much do you drink? ... [D]o you have extramarital affairs? Simply because you’re looking for risk takers. *Risk takers above the norm*—those are the people that get in trouble. ... [I]n a lot of situations, [that kind of information is] more important than how much cash or what their balance sheet looks like, or what new products they have coming out.<sup>175</sup>

What risks are excessive? Risk, after all, is good a thing in private enterprise, and it is certainly possible to distinguish fraud (which involves lying or deceit) from risk-taking (which, alone, does not). Because the underlying exposure is securities fraud, not business risk, we would expect insurers to be focused on fraud in particular, not risk-taking generally.

Pressed on these points, underwriters indicated that they look for evidence that the company is overcommitted to growth because in

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<sup>174</sup> Underwriter #15, pp. 12-13. Similarly, another described ways in which managers inadvertently reveal their own arrogance:

I met with a guy the other day. It is just amazing. He mailed me back an E-mail to thank me for meeting. We are supposed to have another meeting in two weeks. So he meticulously let me know how he is going to be in Paris, London and Brussels in the intervening two weeks and the very important things he is doing there, and you know, when he gets back he will definitely be looking me up. Then he went into a whole bunch of other things. ... I never asked this guy what he is doing for the intervening two weeks! It is nice to know he is in Europe. I hope he enjoys himself, but does this tell us something. You get stuff like that. A lot of times though it is more like, “I want to be king of the world and I am going to roll up other companies” and stuff like that.

Underwriter #2, 18-19.

<sup>175</sup> Actuary #2, pp. 23-24 (emphasis added).



such situations there will be a strong temptation to misstate results when reality falls behind expectations.<sup>176</sup> Excessive risk-taking, in other words, can lead to fraud. An underwriter illustrated this situation as follows:

One company ... [said] they were going to grow 20%. ... [Some of them said], "I'm not sure how we are going to grow 20%, but the CEO said we are going to grow 20%." You know, without that clear articulation of *how* we are going to grow 20%. In the absence of really great controls—and maybe they had them, maybe they didn't—you are going to have somebody who [when] the pressure is on [starts thinking] "I had better make my numbers."<sup>177</sup>

Underwriters derive much of this information from their meetings with management. "We insist on talking to people," one underwriter said. "We stare down a lot of people, and if we get this comfort level we tend to get very solidified with a group of managers."<sup>178</sup> In addition to meeting with top management, underwriters also investigate the reputation, skill set, and litigation history of each individual board member.<sup>179</sup> As with the evaluation of corporate culture, this character aspect of risk-assessment in D&O underwriting reflects a broader conception of corporate governance that goes well beyond formal provisions such as charter terms and state-of-incorporation.

### 3. Again, the Cycle

That underwriters screen for these factors, of course, does not mean that they always identify and act upon the red flags. There are, in fact, a number of reasons to doubt that they do so consistently, including short-term pressure on underwriters to generate premium volume notwithstanding possible long-term losses<sup>180</sup> and the simple

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<sup>176</sup> Character, one underwriter quipped, can best be understood in terms of the seven deadly sins, of which "greed, stupidity, and ego" most often lead to D&O claims. Underwriter #2, p. 18-19 (noting that greed can be detected through an analysis of compensation packages, stupidity through a history of business mistakes, and ego through meetings with management).

<sup>177</sup> Underwriter #15, pp. 13-14.

<sup>178</sup> Underwriter #7 p. 32. *See also* Underwriter #8 at 24-25 (explaining that underwriting involves "getting a sense of ... trust. Can you have confidence in what they filed in their Q's and K's?").

<sup>179</sup> Underwriter #7, p. 26; Underwriter #2, p. 15-16.

<sup>180</sup> *See, e.g.*, Broker #3, p. 4. Even without intra-firm pressures to generate underwriting profit, underwriters may fail due to resource constraints—a finite amount of time and attention to devote to all possible D&O risks. *See, e.g.*, Underwriter #5, p. 12 ("[an] analyst is following a dozen or two dozen companies max. Our underwriters are looking at companies. You know, they will look at two

possibility that those who are good at deceiving bosses and markets are likely to be good at deceiving underwriters too.<sup>181</sup> Our answer to such objections is simply to report what underwriters reported to us—they are indeed trying even if they do not always succeed—and to note that that the rewards for having only one less bad risk in an underwriting portfolio, considering typical limits of \$10-25 million, are great. Consideration of culture and character in risk-assessment is a revealed preference. Those with the most to lose are paying attention.<sup>182</sup>

A more difficult objection for us to answer points to the cyclical nature of the insurance market: the world as it is now has not always been and may not be for long.<sup>183</sup> Indeed, participants in our study frequently noted that scrutiny of formal governance factors in D&O underwriting is relatively new.<sup>184</sup> Character and culture have been

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dozen companies a month or more. So they won't have the in depth knowledge.”). See Broker #2 at 21 (“If an underwriter is under pressure to write a premium, he is going to deal with cognitive dissonance a lot differently than if he isn't under pressure”) and 24 (“X is a company that can be very inconsistent depending on what day of the month it is, depending upon whether they are making their [premium] budget or not. If you come to X with a tough account at the end of the month and they haven't made their budget, guess what? You can get a really good deal.”).

<sup>181</sup> See *infra* note 239 and accompanying text (describing role of self-deception and deception of others in corporate success).

<sup>182</sup> It is possible, of course, that the *underwriters'* claim to analyze corporate governance variables may not point to a revealed preference of the D&O *insurer*. An insurance company has several departments, which may not be perfect agents of the company as a whole. In this context, for example, underwriters may claim to have special expertise in evaluating corporate governance in order to promote and protect their group in the competition for intra-firm resources. Similarly, the underwriting department may resist a indexing approach to risk-selection not because it would lead to worse risk-selection but because it would end the underwriters' claimed expertise and lead, inexorably, to the elimination of the department. See *supra* notes 102-104 and accompanying text (describing underwriters' rejection of an indexing approach to underwriting). Underwriters, according to this story, emphasize governance not because governance variables lead to better risk-selection but because the claim to possess governance expertise enables them to protect their jobs. Our research does not support this hypothesis—none of our participants, neither underwriters, risk managers, brokers, nor counsel suggested it during the course of our interviews—but neither can our research disprove it.

<sup>183</sup> In the words of one underwriter:

The problem is the market the way it is, the guy who asks the hard question gets put at ... the back of the line. And we don't get answers that we used to get. You know, the last soft cycle, if you asked this question and nobody else was asking it, somebody [else] would write the business.

Underwriter #5, p. 13.

<sup>184</sup> In the words of a D&O actuary, corporate governance “might have crossed people's minds, but I don't recall it being part of the discussion [prior to 2002]....” Actuary #1, p. 27. See also Actuary #3 at 7 (dating the new focus on corporate governance to 2001).

perennial concerns, but scrutiny tends to ebb and flow as markets harden and soften.<sup>185</sup> Since, as noted above, all of our interviews occurred during the sunset of the most recent hard market, we cannot confidently conclude that scrutiny of corporate governance will be a lasting feature of D&O risk-assessment. Indeed, one broker suggested that it has already begun to fade:

A: In essence, [the underwriters] all got caught off guard by the likes of Enron and had never focused really on governance. So the reaction was very extreme.

Q: Has it started to go away?

A: Yes.

If, in the next soft market, D&O underwriters stop paying attention to governance factors, our claim that that corporate governance plays a meaningful role in assessing the risk of shareholder litigation will be weakened.

#### D. From Risk Assessment to Pricing

All of the factors discussed above, our participants reported, are considered in the risk assessment and ultimately the pricing of a prospective insured. In the words of the underwriter quoted at the beginning of this Part, “[w]e take all that stuff and we rate it for risk. We summarize what makes us want to write the account and what makes the necessity of the insurance relevant to the risk of the company. *And then we price it.*”<sup>186</sup> Our question, of course, was how. How do D&O underwriters derive a price from this extensive list of risk factors?

As we learned, D&O underwriters begin with a simple algorithm, which differs from company to company, and then employ a highly discretionary, largely unobservable (even for the companies’ own pricing actuaries<sup>187</sup>) system of credits and debits, the application of

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<sup>185</sup> See *supra* note 125.

<sup>186</sup> Underwriter #2, *supra* note XX, p. 6 (emphasis added).

<sup>187</sup> A senior actuary at a leading D&O insurer described the problem as follows: The other concern we have is just the validity of the data that is entered into our system, particularly in this area where you have a very small group of experienced underwriters who kind of know, who think they know what to charge for a Fortune 500 company just based on the fact that they do the market every day, and they can probably tell you in a couple minutes, you know, this one should be getting this much and this one over here is worth that much. So what we find is they don’t spend a lot of time making sure that the entries into our system are necessarily precisely what they think about a company. You know, they delegate it to an assistant who has to go through this rate process in order to get the account off books, and they don’t spend a lot of time making sure that the entries are actually reflective of what they are going to feel about the

which may be constrained by a competitive underwriting market. As described by one of the underwriters in our study, “the market cap and the volatility and some of those easily observed things will get you your first price. [Then the question] is whether ... the risk is ... clean enough to make the next cut, [where] some of these other more qualitative factors will come into play.”<sup>188</sup> The sections that follow explore each of these three components: the algorithm, the system of credits and debits, and the market constraint.

## 1. The Algorithm

Each of the underwriters and actuaries reported to us that their companies have developed simple algorithms to generate an initial price. One very senior executive with a long history in D&O insurance reported that in the early days this algorithm was based on the number of directors on the board. Later, the measure of base risk shifted to the value of the assets of the company, and relatively recently shifted again to market capitalization and the other factors that we are about to describe.<sup>189</sup> No underwriter or actuary would provide us with their company’s precise algorithm,<sup>190</sup> but they did tell

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company. So that is a challenge for us internally, you know, to make this more of a priority so that we have experienced people, you know, making those kinds of decisions about what is going into the data.

Actuary #3 at 19.

<sup>188</sup> Underwriter #5, p. 18.

<sup>189</sup> Underwriter #15, p. 10. Broker #6, p. 15.

<sup>190</sup> Some version of the insurer’s basic pricing algorithm is disclosed to state insurance commissioners. In a rate schedule filed in the state of California, for example, Chubb disclosed that base rates depend first upon a combination of market capitalization and volatility (beta) with specified increases from the base rate factored in on the basis of limits and industry. The rate schedule then lists a large number of “Rating Modifications”—including “risk relative to industry,” “financial trends,” “board/ management architecture and controls,” “individual qualifications,” and “overall board/ management quality”—most of which require a qualitative (as opposed to quantitative) analysis. *See* Chubb Group of Ins. Cos., D&O Elite Directors & Officers Liability Insurance Actuarial Memorandum, in Application for Approval of Insurance Rates exhibit 23, at 1-2 (Cal. Dep’t of Ins. file no. EO CA0019310C01, filed Dec. 22, 2003). After investigation, however, we concluded that the state filings are not a good source of D&O pricing information. The plans include such a broad range of underwriter discretion that they would provide very little guidance even if the companies actually used the plans to generate premiums. *See* Actuary #3, at p. 7 (“[T]here is very wide latitude given to underwriters in terms of what is filed with the state regulators.”). And, in fact, they do not use the plans to generate their premiums. Not one underwriter that we interviewed described starting the pricing process with the formula in the rating plan. Instead, they described a process in which premiums were checked against that plan after the fact (if at all), only as part of a regulatory compliance process. Moreover, a senior

us the factors that are factored into their algorithms: market capitalization (all insurers), industry sector (most insurers), stock price volatility (many insurers), accounting ratios (many insurers), and age/maturity of the applicant corporation (some insurers).<sup>191</sup>

## 2. Credits and Debits

All underwriters reported using some form of debit and credit system to arrive at an ultimate price, which as a result, can vary widely from the output of the basic pricing algorithm. As described by one of our participants: “actuaries set the overall rates for an insurance company, but then within that rating system, an underwriter has a lot of leeway. I mean, they probably have judgments that are plus or minus forty percent.”<sup>192</sup> The influence of actuarial science thus declines once underwriters begin to issue credits and debits.

Insurers differ widely on how they determine their system of credits and debits. A small number of insurers use quantitative guidelines based upon the presence or absence of specific governance features.<sup>193</sup> An underwriter from an insurance company with a highly quantitative model described the process as follows:

So, for example, if you are in a certain industry class, you are going to get debited between 5-10% or credited between 5-

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underwriter at the most heavily quantitatively oriented firm said that the algorithm that they actually use “is very different” than what is in the plan. He explained that they file and use “a traditional rating method to see if we comply with the state or not from a guidelines standpoint, because ... we don’t want [their proprietary algorithm] in the public domain.” Underwriter #8 at 33. Two of our participants were closely involved in preparing rating schemes that are considerably more detailed than is the norm for D&O insurance. Like all the other rating schemes we examined, these employ a debit and credit adjustment system that allows for adjustments that, in combination, easily exceed the base premium.

<sup>191</sup> A senior reinsurance underwriter described the evolution of the pricing algorithm as moving toward “a merging of ... corporate finance concepts and actuarial pricing concepts” and pointed out that “writing a D&O insurance liability policy [is] very very similar to a put option for stock.” Underwriter #9, at 19-20. In this view, the financial analysis underlying the pricing algorithm may address the likelihood of sudden investment loss of any kind, while the debit and credit process described next attempts to determine the likelihood that the loss will be linked to corporate or securities law violations. For excess layers some participants reported that they simply apply a discount factor to the premium quoted by the primary carrier, while others reported that their company does a ground up pricing exercise.

<sup>192</sup> Broker #2, pp 18-19.

<sup>193</sup> Underwriter #8 p 20 (“We have a clear set of guidelines around pricing plus or minus on certain items.”).

10%. If you have got a very poor board score, you are going to pay anywhere from 10-20% more.<sup>194</sup>

Even for this insurer, however, the range of credits and debits grants underwriters significant discretion.<sup>195</sup> Most insurers allocate even more discretion to individual underwriters in setting premiums,<sup>196</sup> although additional layers of monitoring apply—committee oversight or peer consultation—as account sizes increase.<sup>197</sup> The goal of all such processes is to adjust premiums so that higher-risk firms pay more while better-governed firms “instead of getting debits... get credits.”<sup>198</sup>

How much influence, then, do specific corporate governance factors have in D&O pricing? We cannot say with any precision, first, because our participants would only describe pricing in general terms, and second, because the system is so highly discretionary that insurance companies and even individual underwriters may make inconsistent choices. In particular, the actuaries we interviewed doubted that underwriters have a consistent system of evaluation that applies the same factors in the same way over time.<sup>199</sup> In spite of the

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<sup>194</sup> Underwriter #8, p 20. Note that the “board score” refers to the score on the company report prepared by the Corporate Library. *See supra* [X-REF].

<sup>195</sup> There is a debate within the D&O insurance industry about the merits of more and less quantitative approaches to D&O insurance pricing. Our impression is that the qualitative approach is ahead at the moment, both because of tradition and because of stories like the following:

[O]ne carrier that we know developed a very sophisticated pricing model using the Black-Scholes formula. So they looked at it very much as volatility being the driver of loss ..., and as they were testing the model, the guy who is doing the model, an absolute brilliant mathematical statistical gentleman, absolutely brilliant. But he went to the underwriters, and I thought this was clever as well, and he said, “What do you think the right price should be on this account?” And what was surprising was... how often their gut instinct on the price was close to the model.

Underwriter #10, pp. 20-21.

<sup>196</sup> *See* Underwriter #9, p. 19 (“An underwriter ultimately whether he consciously or unconsciously formulates an opinion about a risk, and that opinion leads him to make a certain decision” about price.)

<sup>197</sup> Underwriter #2, p. 6 (stating that underwriters must “summarize, you know, what makes us want to write the account and what makes the necessity of the insurance relevant to the risk of the company and then we price it”); Risk Manager #2, p. 19 (describing the formation of underwriting committees before which individual underwriters must justify their pricing decisions); Actuary #3, pp. 8-9 (“[W]e have concluded that the best thing is to let a very small group of experienced underwriters manage [the pricing process] without giving them a lot of constraints... We have less than five underwriters who have the authority to quote [large public company] accounts.”); Actuary #2, p. 10 (“We have a centralized, one location shop here” with “250 years of D&O experience on this 11,000 square feet”).

<sup>198</sup> Broker #6, p. 33-34

<sup>199</sup> Actuary #1, p. 28; Actuary # 3, pp. 3-4. *See also* William M. Grove & Paul E. Meehl, *Comparative Efficiency of Informal (Subjective, Impressionistic) and*

potential for inconsistent application and the evolving nature of the underwriting process, our participants reported that “there is no question... whatsoever” that corporate governance information “works its way into pricing.”<sup>200</sup> The degree of influence and precision of the measuring system, however, are much more debatable.<sup>201</sup> If the data were available, this would be an excellent area for econometric research.<sup>202</sup>

### 3. The Market Constraint

Underwriters want to sell insurance and generate large premiums. Their ability to do so, however, depends on the premiums charged by their competitors.<sup>203</sup> An underwriter that charges significantly more than its competitors for the same risk will find that it has relatively few underwriting opportunities. As a result, the market for D&O insurance operates as a constraint on the ability of underwriters to factor risk into price. If a D&O underwriter attaches a very high-risk premium to a particular account, it may not have the opportunity to underwrite that account.

As they go through the debit and credit process, underwriters are highly aware of the price the competition has quoted or is likely to quote for the risk in question. They know historical premiums paid

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*Formal (Mechanical, Algorithmic) Prediction Procedures: The Clinical-Statistical Controversy*, 2 PSYCH., PUB. POL'Y & L. 293, 315 (1996) (“Humans simply cannot assign optimal weights to variables and they are not consistent in applying their own weights.”).

<sup>200</sup> Risk Manager #2, p 20. See also Risk Manager #4, p 12 (noting that “underwriters finally woke up that they needed to underwrite the program and not just offer the coverage” and as a result that corporate governance and internal controls are now central considerations in pricing).

<sup>201</sup> Risk Manager #3, pp. 14-15 (noting that the issue was in fact debated within his firm).

<sup>202</sup> See, e.g., John E. Core, *The Directors' and Officers' Insurance Premium: An Outside Assessment of the Quality of Corporate Governance*, 16 J.L. ECON. & ORG. 449, 468 (2000) (using Canadian data); ZHIYAN CAO & GANAPATHI NARAYANAMOORTHY, ACCOUNTING AND LITIGATION RISK, (Nov. 2005) (matching Tillinghast data with publicly available information to test the influence of corporate governance risk on D&O insurance premiums on U.S. firms); George D. Kaltchev, *The Demand for Directors' and Officers' Liability Insurance by US Public Companies* 52 (working paper, July 2004,) available at <http://ssrn.com/abstract=565183> (using privately obtained panel data). See also Griffith, *Uncovering a Gatekeeper*, *supra* note 16 (advocating disclosure of this information).

<sup>203</sup> Although two large insurers underwrite more than half of all primary policy limits, the D&O market is a generally fluid market with low barriers to entry. See *supra* note 20 and accompanying text.

by a prospective insured and are finely attuned to prevailing market conditions.<sup>204</sup> They can draw on their personal networks for information, and in some cases will simply be told by the broker what other carriers are quoting, both on the particular risk and on similar risks in the market.<sup>205</sup> Moreover, the primary insurer's quotation is disclosed to all excess carriers before they provide their final quote, putting them in an even better position to predict the prices charged by their competitors. As a result, underwriters may adjust their risk-assessments to arrive at a competitive quotation.

This dynamic may contribute to the herd behavior of the D&O market and, in conjunction with intra-firm pressures to generate underwriting premiums, explain the winner's curse scenario frequently lamented by participants in our study.<sup>206</sup> Here, however, we wish only to note that these pricing dynamics, like the cycle itself, complicate the insurer's ability to match premiums to risks.

#### IV. CORPORATE AND SECURITIES LAW APPLICATIONS

Having described in the last Part how the underwriting process for D&O liability insurance interacts with corporate governance, we now seek to apply our findings to several ongoing debates in corporate and securities law. In this Part, we describe what our findings suggest about the deterrence effect of shareholder litigation, the question of whether the merits matter in corporate and securities litigation, and the question of which corporate governance terms or

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<sup>204</sup> As we witnessed at the industry conferences we attended, D&O brokers and underwriters talk constantly about the market.

<sup>205</sup> Brokers' and underwriters' personal networks are a source of information in this highly interconnect market.

<sup>206</sup> See *supra* note 183 and accompanying text (noting that pressures within insurance companies to generate premium volume may lead them to underwrite policies even when the premium does not fully compensate the insurer for the risk undertaken). See Richard Thaler, *Anomalies: The Winner's Curse*, 2 J. ECON. PERSPECTIVES 191 (1988) (explaining the winner's curse); Scott E. Harrington & Patricia M. Danzon, *Price Cutting in Liability Insurance Markets*, 67 J. BUS. 511, 520-21 (1994) (introducing the concept of the winner's curse into analysis of the insurance underwriting cycle). When considering the importance of the winner's curse, it is worth noting the following:

The obvious question is this: "Why do insurers not protect themselves against the winner's curse?" Insurers have a good understanding of their market and the institutional incentives. We should not lightly expect that they would tolerate below-cost pricing, unless it is beneficial to them in the long run. It is possible that there are benefits to market share, such that it is rational to "spend" capital by maintaining market share during the soft market in order to reap the high profits of the hard market and, therefore, there is in fact no "curse." For the moment, this is an important, open question.

Baker, *Underwriting Cycle*, *supra* note 91 at 421 n.97.



practices matter most. As we describe below, our qualitative research offers a unique contribution to each of these debates.

#### A. Does D&O Insurance Diminish the Deterrence Effect of Corporate and Securities Law?

Because virtually all corporations purchase D&O insurance to cover the risk of shareholder litigation and because virtually all shareholder litigation settles within the D&O insurance limits,<sup>207</sup> the D&O insurance premium represents the insurer's best guess of the insured's expected liability costs.<sup>208</sup> The D&O premium, in other words, represents an insured's expected corporate and securities law liability charged as an annual fee. One of our first research questions was whether this transformation of the liability rules of corporate and securities law into an annual fee alters the deterrence effect of the law. Does this annual fee reduce or increase the deterrence of fraud and the improvement of corporate governance?<sup>209</sup>

Our research supports the proposition that D&O insurers seek to price policies according to the risk posed by each corporate insured, which if successful, would fulfill a basic requirement of deterrence theory—that the burden of liability fall more heavily on bad actors.<sup>210</sup> As described in detail above, we find that insurers actively seek to distinguish good companies from bad ones. They gather information through detailed applications and personal meetings with top-level management. They analyze a variety of factors, focusing on the accounting risk and governance practices of the prospective insured. Underwriters report that all of these factors influence D&O pricing, at least since the most recent hard market cycle. Ideally, then, we can expect worse-governed firms to pay more for an equivalent amount of D&O insurance than their better-governed peers.<sup>211</sup> They will have systematically higher operating costs than peer firms, making it more

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<sup>207</sup> See *supra* notes 2-3 and accompanying text.

<sup>208</sup> As noted above, premium amounts also include a loading fee reflecting the expenses and profits of the insurance company. X-REF.

<sup>209</sup> We address other approaches to managing the moral hazard of D&O insurance in Baker & Griffith, *Missing Monitor*, *supra* note 7.

<sup>210</sup> Steven Shavell, *On the Social Function and the Regulation of Liability Insurance* (Geneva Papers on Risk and Insurance Theory, March 2000) available at <http://ssrn.com/abstract=224945>.

<sup>211</sup> Shareholder litigation and corporate governance are complements. We would therefore expect firms with stronger ex ante corporate governance to experience less ex post shareholder litigation. See Eric Talley & Gundrun Johnsen, *Corporate Governance, Executive Compensation and Securities Litigation*, at 4 (USC Law School, Olin Research Paper No. 04-7, working paper, May 4, 2004), available at <http://ssrn.com/abstract=536963>.

difficult for them to compete in product and capital markets, potentially driving bad firms to seek to reduce the annual D&O fee by improving the quality of their corporate governance.<sup>212</sup> In this way, the annual cost of liability insurance would carry forward the deterrence function of corporate and securities law.

There is, of course, ample reason to doubt that this theoretical ideal works in practice. Most basically, D&O expenses may not be large enough to change corporate behavior, either because D&O expenses are an insignificant portion of a large corporation's total costs or because the marginal difference in D&O expense between good firms and bad firms may not be large enough for bad firms to change their ways. We deal below with each of these bases for skepticism.

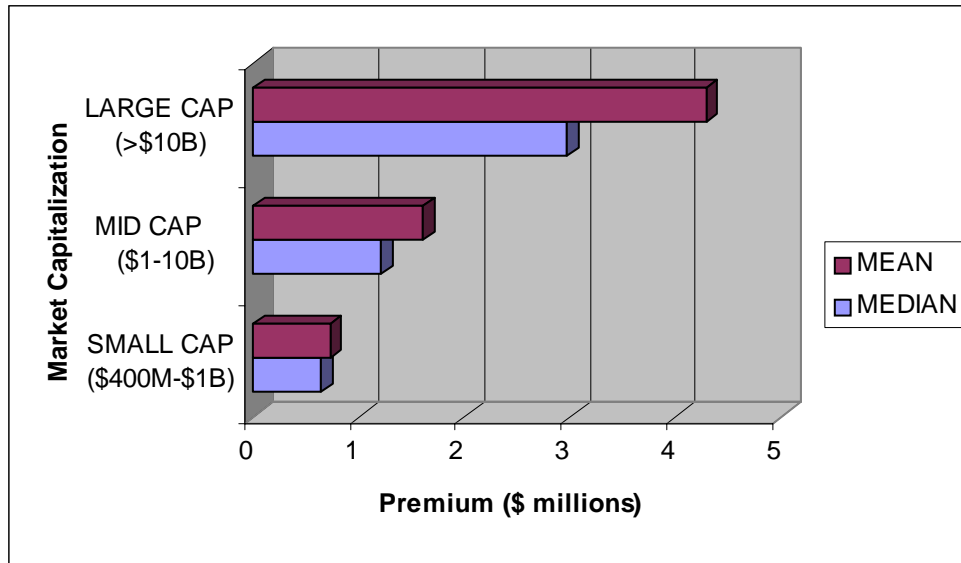
First, D&O insurance expenses might be so small, given a corporation's overall costs and cash-flows, that companies fail to take them into account as a significant source of cost-savings. Without firm-specific information, we cannot comment on whether D&O insurance costs are large enough, relative to market capitalization or cash flows, to affect firm behavior. We can, however, point out that D&O premiums are non-trivial. Average annual premiums are summarized in the table below. These costs may be large enough to affect the behavior of some firms.

**Figure 3:**  
**Annual Premiums By Market Capitalization Category**<sup>213</sup>

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<sup>212</sup> Higher costs must either reduce profit margins or be passed on to consumers. If profit margins are reduced, capital market participants will prefer the firm's higher profit rivals, leading to higher costs of capital for the worse governed firm. Conversely, if costs are passed on to consumers, the firm will be at a disadvantage in price competition with its rivals and may lose market share. Either way, a bad firm will face strong incentives to reduce annual D&O costs.

<sup>213</sup> 2005 DATA. Source: Tillinghast, 2006. We derived the "Mid-Cap" category as a weighted average of three market capitalization classes reported by Tillinghast. See *supra* note 79.



Second, even if D&O expenses are non-trivial and therefore noticeable to corporations, the difference between the premiums paid by good and bad firms may not be sufficiently large to force bad firms to improve. Good firms might pay too much while bad firms pay too little. This could be because underwriters make mistakes or the liability system makes mistakes or, as is most likely, both do. As a result, although there may be some difference in the prices charged to firms with differing corporate governance practices, good firms would cross-subsidize bad firms to some degree and deterrence would therefore be blunted.

Interestingly, liability insurers may play a part in the failings of the liability system by keeping the costs of shareholder litigation artificially *low*. If this seems counter-intuitive, recall that securities claims almost always settle within the limits of available insurance.<sup>214</sup> This, alone, is unsurprising since plaintiffs' lawyers typically prefer to be paid by an insurance company that is contractually obliged to pay them than to expend extra effort seeking recovery from individuals who will do everything they can do to protect their personal assets.<sup>215</sup> Now consider what happens if the real cost of securities litigation grows at a faster rate than insurance limits, which by some accounts at least, seems to have occurred in the 1990s when market capitalizations grew exponentially but D&O limits remained

<sup>214</sup> See *supra* note 3.

<sup>215</sup> See Baker, *Tort Regulation*, *supra* note 9 at 6-7 and *Tort Law in Action*, *supra* note 15.

relatively stable.<sup>216</sup> Because plaintiffs' lawyers would prefer to settle for insurance proceeds only, settlements will not reflect the real cost of liability but rather a lower amount—the growth rate of insurance limits.<sup>217</sup> In this situation, bad actors will pay significantly less in liability costs than the harm they cause. They will, in other words, be under-deterred. As importantly, damages will be effectively capped at typical policy limits.<sup>218</sup> And this compression of damages may lead to an inadequate spread between the liability costs of good and bad actors. When these liability costs are converted into an ex ante insurance premium, they will be similarly compressed, leading to further cross-subsidization of bad firms by good firms and therefore less deterrence.

If, as a result of any of these mechanisms, the liability fee falls too evenly on both good and bad firms, the deterrence objectives of the law can be expected to fail. All, however, is not lost. Our research supports the proposition that there is at least some deterrence value embedded in the D&O premium. Even if it is not large enough to affect the behavior of corporate insureds, it may be large enough to signal which firms are governed well and which firms are governed poorly.

As one of us has argued at length elsewhere, a corporation's D&O premium, if disclosed, would reveal valuable information about the corporation's governance quality to capital market participants.<sup>219</sup> Because underwriters seek to assess the risks posed by insureds and to charge an appropriate premium for different degrees of risk, the price of a firm's D&O policy represents the insurer's assessment of the governance quality of the insured, taking into account of course for the deductibles, limits and other terms of the policy (which also

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<sup>216</sup> See Miller et al., *supra* note 24, at 7 (providing data showing expected settlements have risen more slowly than investor losses).

<sup>217</sup> See James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence And Legal Implications Of The Failure Of Financial Institutions To Participate In Securities Class Action Settlements*, 58 STAN. L. REV. 411, 450 (2005) (“[W]e suspect that settlements are fixed... by the amount of available insurance or cash from the issuer”).

<sup>218</sup> As reported earlier, there are a small number of highly visible settlements in excess of the policy limits. See note 3. Cf. Baker, *Tort Regulation supra* note 9 at 6-7 (using Texas Department of Insurance commercial liability claim database to report “that there was a payment in excess of policy limits in only 31 out of 9723 [commercial] liability insurance claims paid in 2002 and that the total amount paid above the limits in those cases was \$9 million, as compared to \$1.8 billion in total [commercial] liability payments in Texas in 2002); Silver et al., *supra* note 15 (using Texas Department of Insurance medical liability claim data to report and even smaller ratio of above limit payments and that medical malpractice insurance settlements cluster at the policy limits).

<sup>219</sup> See Griffith, *Uncovering a Gatekeeper, supra* note 16.

would have to be disclosed).<sup>220</sup> Armed with this signal of governance quality, capital market participants may adjust their reservation values, discounting the share price of firms whose D&O premiums reveal low-quality corporate governance, thereby reintroducing the deterrence function of corporate and securities law.<sup>221</sup>

### B. Do The Merits Matter in Securities Litigation?

Corporate and securities law scholars have extensively debated the question of whether outcomes in shareholder litigation are related to the underlying merits of claims or whether such claims are, in fact, largely frivolous.<sup>222</sup> The principal argument is that shareholder litigation is driven by plaintiffs' lawyers whose incentives are so weakly correlated with shareholder interests that claims are both brought too often and settled too cheaply.<sup>223</sup> Supporting this argument, scholars have shown that shareholder claims have settled for relatively small amounts, often for attorneys' fees alone.<sup>224</sup> Others have sought to show that settlements tend to cluster around non-meritorious factors, such as a "going rate" demanded by

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<sup>220</sup> In order for the premium to have this signaling effect, market analysts would have to control for the financial and industry factors that predict the likelihood of investment loss generally. These adjustments would control for each of the factors in the base price algorithm, leaving only the governance variables. *See supra* note 190.

<sup>221</sup> It is worth pointing out again that what equity analysts are looking for (predictors of future performance) is not exactly the same as what D&O underwriters are screening for (predictors of future litigation). *See supra* note 131 (distinguishing D&O underwriting from equity analysis). However, litigation activity has a significant negative effect on shareholder returns. *See* Sanjai Bhagat, John Bizjak & Jeffrey L. Coles, *The Shareholder Wealth Implications of Corporate Lawsuits*, 27 FINANCIAL MANAGEMENT 5 (1998) (finding that corporate defendants lose nearly one percent of their value on the day a lawsuit is filed and almost three percent when the lawsuit alleges securities fraud). Equity analysts and other capital market participants therefore have strong incentives to take into account the information revealed by the D&O premium.

<sup>222</sup> *See* Marilyn F. Johnson, et al., *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, J.L. ECON. & ORG. (forthcoming 2006), available at <http://ssrn.com/abstract=883684>. *See also* Steven J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?* (NYU Law & Economics Paper No. 03-04, Feb. 2005) available at <http://ssrn.com/abstract=558285>.

<sup>223</sup> *See* John C. Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 L. & CONTEMP. PROB. 5 (1985). *See also* Kraakman, Park & Shavell, *Shareholder Suits*, *supra* note 5.

<sup>224</sup> *See* Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L. ECON. & ORG. 55, 61 (1991) (finding that although only half of the settlements in her sample resulted in any recovery to shareholders, 90% awarded attorneys' fees).

plaintiffs' lawyers to settle such claims.<sup>225</sup> These arguments were influential in the passage of the PSLRA in 1995.<sup>226</sup> Since then, research has shown that settlements have correlated more closely with evidence of fraud, such as accounting restatements and abnormal insider trading.<sup>227</sup> The merits, in other words, seem to matter more than they once did.<sup>228</sup> But the extent to which the merits matter in shareholder litigation remains an open question.

Our research supports the proposition that the merits *somewhat* matter. We found that D&O insurers do indeed inquire into a host of governance factors that are likely to be related to the merits of shareholder litigation.<sup>229</sup> We have been careful to emphasize that these are not the only factors that they examine, nor can we evaluate whether D&O insurers correctly weigh these factors in their risk-assessment. Nevertheless, D&O underwriters do report that they take merit-related factors into consideration. Because this is a revealed preference of D&O insurers—the party with the most to lose in the event that its risk-assessments are incorrect—our findings provide evidence that these factors do affect the risk of shareholder litigation.

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<sup>225</sup> See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements of Securities Class Actions*, 43 STAN. L. REV. 497, 500 (1991) (concluding that they do not). *But see* Cox, *supra* note 3, at 503-504 (disputing Alexander's conclusion by pointing out her failure to control for market events that may have explained some of her results); Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2084 (1995) (recalculating settlement amounts as a function of potential damages and finding that Alexander's 25% "going rate" can no longer be supported).

<sup>226</sup> See, e.g., *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs*, 103d Cong., 1st Sess. (1993); William S. Lerach, *Securities Class Action Litigation Under The Private Securities Litigation Reform Act's Brave New World*, 76 WASH. U. L. Q. 597 (1998) (stating that Congress "relied heavily upon Professor Janet Cooper Alexander's article" in enacting the PSLRA). On the PSLRA in general, see *supra* notes XX-YY and accompanying text.

<sup>227</sup> See Marilyn F. Johnson et al., *Merits Matter More*, *supra* note 147.

<sup>228</sup> See Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1498 (2004) ("[T]he existing literature on filings and settlements in the post-PSLRA time period provide[s] evidence that frivolous suits existed prior to the PSLRA and that a shift occurred in the post-PSLRA period toward more meritorious claims.").

<sup>229</sup> We are not seeking here to furnish a theory of what should count as "merit" in shareholder litigation. Because corporate governance and shareholder litigation are complements and well-governed firms ought therefore to be sued less often than poorly-governed firms, the conventional approach in the literature is to treat corporate governance variables as proxies for merit. See Choi, *supra* note 228 (summarizing this literature). That corporate governance variables weigh in the underwriter's assessment of D&O risk, therefore, provides indirect support for the proposition that the merits do matter.

### C. What Matters In Corporate Governance?

Similarly, corporate and securities law scholars have also long sought to determine which corporate governance variables are most important either in terms of firm performance or litigation risk. Numerous studies examine factors such as board independence,<sup>230</sup> committee composition,<sup>231</sup> executive compensation,<sup>232</sup> and management entrenchment<sup>233</sup> for their effects on firm performance or litigation risk. Scholars have also constructed various governance indices to test correlation of corporate governance variables and firm performance. Using their “Governance Index,” Gompers, Ishii, and Metrick found that firms with more pro-management governance terms perform significantly worse than firms with more pro-shareholder governance terms.<sup>234</sup> Seeking to discard noise variables,

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<sup>230</sup> See, e.g., Bernard S. Black & Sanjai Bhagat, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002) (finding that firms with more independent boards do not perform better than other firms); Eric Helland & Michael Sykuta, *Who’s Monitoring the Monitor? Do Outside Directors Protect Shareholders’ Interests?* 40 FIN. REV. 155 (2005) (finding that firms with more independent boards were less likely to be sued by their shareholders from 1988 to 2000). *But see* Marilyn F. Johnson et al., *Merits Matter More*, *supra* note 147, at 11, 23 (finding no greater ability to predict securities litigation on the basis of a handful of governance factors including: average board tenure, average number of additional directorships held by outside directors, percentage of outside directors, number of audit committee meetings, percentage of independent members of the audit committee, separation of the chief executive and board chair functions, whether the CEO was a firm founder, and whether the firm had a five percent or greater block-holder).

<sup>231</sup> See Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 48 J. LAW & ECON. 371 (2005) (finding that the probability of a restatement is lower for companies whose boards or audit committees have an independent director with financial expertise and higher for companies in which the chief executive officer belongs to the founding family).

<sup>232</sup> Talley & Johnsen, *supra* note 211, at 4 (finding a close relationship between incentive compensation and securities litigation and estimating that “each 1% increase in the fraction of a CEO’s contract devoted to medium- to long-term incentives... predicts a 0.3% increase in expected litigation and a \$3.4 million dollar increase in expected settlement costs”) (emphasis omitted). [FURTHER RESEARCH PENDING FROM TALLEY]

<sup>233</sup> See, e.g., K.J. Cremers & Vinay B. Nair, *Governance Mechanisms and Equity Prices* (Yale ICF Working Paper No. 03-15; NYU, Ctr. for Law and Bus. Res. Paper No. 03-09, working paper, April 2004), available at <http://papers.ssrn.com/abstract=412140>. (treating the Gompers, Ishii, Metrick index, discussed *infra*, as an entrenchment index to compare the interaction of internal versus external governance constraints).

<sup>234</sup> Paul A. Gompers, et al., *Corporate Governance and Equity Prices*, 118 Q. J. OF ECON. 107 (2003) (using the twenty-four corporate governance variables tracked by IRRC, most of which related to takeover preparedness to develop a governance rating system and comparing the performance of the most highly rated firms against the lowest scoring firms throughout the 1990s)

Bebchuk, Cohen, and Ferrell narrowed the Governance Index to a six factor “Entrenchment Index” and found these six factors in fact drove the results of the Governance Index.<sup>235</sup> Meanwhile, Brown and Caylor broadened the number of factors under consideration and found that a number of variables not included on other indices—including management compensation practices, meeting attendance, board independence, and committee composition—were significantly correlated with performance.<sup>236</sup>

Our findings suggest that these easily observable factors may be over-emphasized in the corporate and securities law literature. We found, instead, that D&O underwriters base a large amount of their risk assessment on the “deep governance” of a prospective insured, weighing both the “culture” of the firm (the system of incentives and constraints embedded within the firm) and the “character” of its management (their ability to rationalize their ways around rules and whether they are likely to be “risk-takers above the norm”).<sup>237</sup>

Culture and character do not make sense within a theory where the primary corporate governance concern is board entrenchment—a factor in which D&O underwriters are relatively uninterested.<sup>238</sup> They do, however, comport with a broader theory of corporate governance that recognizes aspects of organizational behavior. In recent years, several scholars have sought to erect this new framework of corporate governance.

For example, Don Langevoort has argued that in order to survive the corporate tournament-style promotion structure within firms, executives must cultivate traits such as “over-optimism, an inflated sense of self-efficacy and a deep capacity for ethical self-deception.”<sup>239</sup> Yet these very traits that enable executives to succeed

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<sup>235</sup> Bebchuk, et al., *What Matters in Corporate Governance?* (Harvard Law School John M. Olin Center Discussion Paper No. 491, Working paper, March 2005) available at [http://papers.ssrn.com/abstract\\_id=593423](http://papers.ssrn.com/abstract_id=593423). The six entrenchment factors were: (1) staggered boards, (2) limitations on shareholders’ ability to modify bylaws, (3) limitations on shareholders’ ability to modify the charter, (4) supermajority voting provisions, (5) golden parachutes, and (6) poison pills

<sup>236</sup> Lawrence D. Brown & Marcus L. Caylor, *Corporate Governance and Firm Performance*, (working paper, Dec. 7, 2004, available online at <http://ssrn.com/abstract=586423>, at 21-22).

<sup>237</sup> See *supra* Part III.C.1.&2.

<sup>238</sup> Underwriters acknowledged takeover protections as a relevant risk-assessment factor only when asked directly and, even then, did not emphasize them or discuss them at length. See *supra* note 168 and accompanying text.

<sup>239</sup> Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L. J. 285, 288 (2004) [hereinafter Langevoort, *Thermostat*]. Langevoort elaborates, noting that “the luckier risk-takers will outperform more risk-averse realists on average, and the positive feedback will enhance their self-efficacy.” *Id.* at 299.



also put the firms they manage at greater risk of fraud and failure, a dynamic exemplified by Enron itself:

Enron was filled with people who [were] optimistic, aggressive, and focused. The culture quickly identified itself as special and uniquely competent, believing that special skill rather than luck (or just being first) was responsible for the early victories. That self-definition then set a standard for how up-and-coming people acted out their roles: Enron was a place for winners. With this--and the stock market's positive feedback--the company's aspiration level rose.

This aspiration level required a high level of risk-taking by the firm.... [T]he compensation and promotion structure at Enron... harshly penalized the laggards at the firm, which, on average, tends to lead to herding behavior (risk aversion). To counteract this, the company had to magnify the reward structure considerably for those who ended up as stellar performers—a winner-take-all kind of tournament.<sup>240</sup>

Hyper-competition, in other words, exacerbates the familiar problem of the winner's curse, as executives must make more and greater promises—and take more and greater gambles to succeed.

This hyper-competitive culture breeds a certain kind of character—one with a tendency to equate what is self-serving with what is right, what Langevoort refers to as “ethical plasticity.”<sup>241</sup> In his words:

The person who most likely strikes the right competitive balance in a high-stakes promotion tournament is the one who best conceals from others the inclination to defect when necessary—extremely difficult in a corporate setting where one is being closely observed by subordinates, peers and superiors—yet does so nimbly. People who best deceive others are usually those who have deceived themselves, for they can operate in a cognitively unconflicted way. The Machiavellian with the best survival prospects in the corporate tournament is especially adept at rationalization:

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<sup>240</sup> Donald C. Langevoort, *The Organizational Psychology of Hyper-Competition: Corporate Irresponsibility and the Lessons of Enron*, 70 GEO. WASH. L. REV. 968, 973-74 (2002) [hereinafter Langevoort, *Hyper-Competition*].

<sup>241</sup> Langevoort, *Thermostat*, *supra* note 239 at 303. A reinsurance underwriter similarly observed:

I was looking up the other day “sociopath,” which changed to antisocial disorder or something like that, anyway, sociopath. And it turns out that in the American population, in the general population, the expectation is somewhere between 3-4% is sociopathic. Now, when you read the definition of sociopath, it reads pretty similar to senior corporate exec. So, my expectation is that as we go into the higher ranks of an organization, the distribution is actually going to be greater than the 3-4% that we would expect in the random population.

Underwriter #10, at 55.

convincing himself as well as others that what is self-serving is also right.<sup>242</sup>

Executives with this type of character in this kind of culture are among the most likely to lead their organizations into a spiral of ever greater risk-taking and, when their luck finally sours, to convert risk-taking into fraud.<sup>243</sup>

Other scholars make similar arguments. In seeking to predict which firms are most likely to restate their earnings, Stanford's William Beaver identified the following set of variables: (1) a company has experienced unusually high growth, (2) management attributes this growth to skill rather than luck, (3) management has made continued growth an integral part of corporate strategy, (4) management is arrogant or naïve about their prospects for sustaining such growth, and (5) management perceives the financial reporting and internal controls as a nuisance or subservient to entrepreneurial goals.<sup>244</sup> Similarly, Howard Schilit, a leading expert in forensic accounting, calls special attention to firms with weak internal controls, intense competition, and managers with questionable ethical judgment, sounding a particular alarm on high-growth companies whose growth is beginning to slow (Enron) and companies that are struggling to survive (WorldCom).<sup>245</sup> Finally, David Skeel has found

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<sup>242</sup> *Id.* (citation omitted).

<sup>243</sup> Langevoort, *Hyper-Competition*, *supra* note 240 at 974 (summarizing this cycle by noting that “overconfidence commits them to a high-risk strategy; once committed to it, they are trapped”).

<sup>244</sup> William H. Beaver, *What Have We Learned From The Recent Corporate Scandals That We Did Not Already Know?*, 8 STAN. J.L. BUS. & FIN. 155, 163 (2002) (further noting that “based upon the information disseminated in the financial press, the [corporate scandals] appear to fit these conditions quite well”). *See also* NASSIM NICHOLAS TALEB, *FOOLED BY RANDOMNESS: THE HIDDEN ROLE OF CHANCE IN LIFE AND IN THE MARKETS* (2005) (discussing the tendency to mistake luck for skill).

<sup>245</sup> HOWARD M. SCHILIT, *FINANCIAL SHENANIGANS: HOW TO DETECT ACCOUNTING GIMMICKS AND FRAUD IN FINANCIAL REPORTS*, 32 (2002). Management teams in this situation face a kind of final period problem, in which fraudulent risk-taking and possible success may appear preferable to truthful disclosure and certain failure, whether failure means termination of employment, takeover, or bankruptcy. *See, e.g.*, Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691 (1992). In the words of Arlen and Carney:

[A]n agent generally will not commit Fraud on the Market so long as his future employment seems assured. When the firm is ailing... an agent's expectations of future employment no longer serve as a constraint on behavior. In this situation a manager may view securities fraud as a positive net present value project. Aside from criminal liability, in a last period the expected costs of fraud (civil liability and job loss) are minimal, while the expected benefits of fraud may have increased. As remote as the prospects for success may seem, these benefits include possible preservation of employment as well as the value of the

evidence of this same pattern of destructive risk in a series of major corporate scandals going back over a century.<sup>246</sup>

D&O underwriters, it would seem, are screening for precisely these traits. Their unease with “risk takers above the norm,”<sup>247</sup> and managers who are “not sure how we are going to grow 20%, but ... we are going to grow 20%”<sup>248</sup> is based on suspicion of overoptimistic promises and over-committed managers. Similarly, disquiet concerning executives who rationalize their pollution issues by noting that “it was a small aquifer”<sup>249</sup> is consistent with Langevoort’s description of ethical plasticity and Beaver’s concern for those who view compliance with rules as subservient to entrepreneurial goals.

That underwriters screen for “deep governance,” again, is a revealed preference. We cannot say how important deep governance variables are in comparison with other aspects of corporate governance, nor can we evaluate whether underwriters are adept at measuring these variables.<sup>250</sup> But we can say that underwriters report that deep governance variables are an important part of assessing D&O risk. That these variables are largely missing from mainstream scholarship on corporate governance is, thus, a bit of a puzzle.<sup>251</sup> Our study thus suggests an important area of further research—specification and econometric testing of deep governance variables.

## CONCLUSION

Insurance companies transmit, via D&O premiums, the liability content of corporate and securities law to American corporations. This Article has described how D&O insurers evaluate risk in order to

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manager's assets related to the firm's stock, if by committing fraud he is able to buy sufficient time to turn the ailing firm around.

*Id.*, at 702-703.

<sup>246</sup> DAVID SKEEL, *ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM* (2005). See also Sean J. Griffith, *Daedalean Tinkering*, 104 U. MICH. L. REV. 1247 (2006) (reviewing Skeel).

<sup>247</sup> See *supra* note 175 and accompanying text.

<sup>248</sup> See *supra* note 177 and accompanying text.

<sup>249</sup> See *supra* note 174 and accompanying text.

<sup>250</sup> Underwriters do, however, have special access to information—direct access to top managers at the underwriters’ meeting—that might enhance their ability to make such determinations. See *supra* notes 118-120 and accompanying text.

<sup>251</sup> One explanation may be, to borrow from Archilochus, that economists are hedgehogs and the large data-set regression is their one big trick. See ANNE PIPPIN BURNETT, *THREE ARCHAIC POETS: ARCHILOCHUS, ALCAEUS, SAPPHO* (1983) (“The fox knows many tricks—the hedgehog, one big one.”).

arrive at that premium number. We found that, in addition to performing a basic financial analysis of the company, underwriters focus a large part of their efforts on understanding the corporate governance of the prospective insured, especially non-structural “deep governance” variables such as culture and character.

Our findings have significant implications for corporate and securities law. First, they suggest that underwriters, at least, believe that governance matters. This, by implication, suggests that the merits do matter in corporate and securities litigation. But, interestingly, our findings also suggest that what matters in corporate governance are not the structural governance variables most often tested in mainstream scholarship on corporate governance. Our findings thus suggest “deep governance” variables as a promising direction for future research.

Our research also contributes to the sociology of risk and insurance. Prior research in this area has largely addressed first party insurance sold to individuals—such as life, health, and property insurance—rather than organizations and, where it has addressed liability insurance, it typically has done so without adequate appreciation of the underlying institutions and individual dynamics that shape legal liabilities.<sup>252</sup> Moreover, with some important exceptions,<sup>253</sup> this literature has ignored the contributions of economic analysis.<sup>253</sup> Our research seeks to extend the sociology of risk and insurance into the liability realm and to integrate within it the insights of economic analysis and, at the same time, to apply the insights of the sociological approach to an area—corporate and securities law—that has too often been viewed through an exclusively economic lens.<sup>254</sup>

Finally, we contribute to the economic analysis of law by providing an insurance market case study that is both theoretically informed and thoroughly grounded. Such theoretically informed

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<sup>252</sup> See sources cited note 12, *supra*.

<sup>253</sup> But see CAROL HEIMER, *REACTIVE RISK AND RATIONAL ACTION: MANAGING MORAL HAZARD IN INSURANCE CONTRACTS* (1985) (studying corporate insurance in part and incorporating insights from economic analysis).

<sup>254</sup> Economic researchers are even more unlikely to be aware of or acknowledge the contributions of sociologists. The sociological literature has contributed significantly to problematizing mechanistic conceptions of insurance prevalent in both the legal and economics literatures. For example, the sociological approach has shown that “uncertainty,” rather than simple notions of “risk,” dominates the insurance field. See ERICSON & DOYLE, *UNCERTAIN BUSINESS*, *supra* note 121 (borrowing Frank Knight’s distinction between risk and uncertainty); PAT O’MALLEY, *RISK, UNCERTAINTY AND GOVERNMENT* (2004). It has also demonstrated that liability insurance institutions do not passively transmit tort and other liability signals, but rather actively transform them. See Ross, *supra* note 9; Baker, *supra* note 9.

qualitative research should serve to advance the economic understanding of how law works.<sup>255</sup> It provides a reality-check on the model-building and quantitative research methods on which law and economics scholars increasingly rely. Law, after all, is a social field, and a considerable amount of explanatory power may be lost in abstractions that fail to reflect how the world in fact works. Our alternative is to test the insights of economic research in its social context, to provide a thick description of the actors in a social field and their understanding of what they do and how and why they do it. Such research ought to play a large role in the design of economic models as well as their critique and ultimate improvement. In addition, qualitative methods allow researchers to explore questions for which there are no quantitative data available and to investigate fields that are not yet sufficiently understood to model. Our ultimate goal is thus not to replace economic modeling or quantitative research methods but rather to suggest a means of improving them.

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<sup>255</sup> Our approach to qualitative research, of course, is not without precursors. In this regard we follow in some large footsteps. *See, e.g.*, sources cited in note 14 *supra*. *See also* Gideon Parchomovsky & Peter Siegelman, *Selling Mayberry: Communities and Individuals in Law and Economics*, 92 CAL. L. REV. 75 (2004); Eric A. Feldman, *The Tuna Court: Law and Norms in the World's Premier Fish Market*, 94 CAL. L. REV. (forthcoming 2006).

# **The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer**

Tom Baker<sup>\*</sup>

Sean J. Griffith<sup>†</sup>

## Introduction

### I. D&O Insurance and Shareholder Litigation

### II. Empirical Findings: The Missing Monitors

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C. *Ex post*, D&O insurers manage settlements but not defense costs

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1. Traditional explanations

2. Market failure explanations

3. Agency cost explanations

C. The Comparative Advantage Puzzle

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2. Agency costs, again

## Conclusion

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The United States has a corporate governance problem. A series of scandals has made some companies—Enron and WorldCom, for example—synonymous with fraud and deceit,<sup>1</sup> and financial reporting has come to resemble a game of “artfully managed expectations.”<sup>2</sup> In case after case, managers recorded gains too quickly and failed to recognize losses; they shifted revenues and expenses forward and back across accounting periods to manage earnings; they boosted income with one-time gains, backdated options, and recorded revenues that did not exist.<sup>3</sup> Managers did these things and their boards of directors, their auditors and accountants, their inside and outside counsel all failed to stop them.<sup>4</sup>

This Article reports the results of qualitative empirical research on an institution that will be closely involved in any liability-based approach to addressing this problem: directors’ and officers’ liability insurance (“D&O insurance”). U.S. publicly traded corporations—virtually all of them—protect themselves against the costs associated with corporate and securities law liability by purchasing D&O insurance.<sup>5</sup> Significantly, D&O insurance protects corporate assets as well as the assets of the directors and officers of the corporation. Moreover, D&O insurance covers the full costs of the corporate and

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<sup>1</sup> See generally DAVID SKEEL, *ICARUS IN THE BOARDROOM* (2005) (placing the Enron and WorldCom scandals in historical context).

<sup>2</sup> Donald C. Langevoort, *Managing the “Expectations Gap” in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 58 *Vill. L. Rev.* 1139 (2003).

<sup>3</sup> See generally HOWARD SCHLIT, *FINANCIAL SHENANIGANS: HOW TO DETECT ACCOUNTING GIMMICKS & FRAUD IN FINANCIAL REPORTS* (2<sup>nd</sup> ed., 2002) (identifying each of these financial reporting techniques and providing examples of their use).

<sup>4</sup> See generally JOHN C. COFFEE, JR., *GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE* (2006) (attributing the recent corporate scandals to failures of various “Gatekeepers,” such as lawyers and accountants).

<sup>5</sup> See TILLINGHAST TOWERS PERRIN, *2005 DIRECTORS AND OFFICERS LIABILITY SURVEY 20*, fig. 21(2006) (reporting that 100% of public company respondents in both the U.S. and Canada purchased D&O insurance) (hereinafter *TILLINGHAST, 2005 SURVEY*). Prior surveys reported slightly smaller percentages of companies purchasing D&O insurance. The annual Tillinghast D&O survey is based on a non-random, self-selecting sample of companies. It is also the only systematic source of information on D&O insurance purchasing patterns in the U.S. We therefore draw upon it as a source of aggregate data in spite of its methodological weaknesses.

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individual liability, less a deductible, in all but a very few of the claims to which it applies.<sup>6</sup> As a result, the deterrence goals of corporate and securities law liability are achieved indirectly, through an insurance intermediary, if indeed they are achieved at all.<sup>7</sup>

D&O insurers have three ways of furthering the deterrence objectives of corporate and securities law liability and, at least in theory, ample incentive to do so. First, they can price their insurance based on their best assessment of the liability risk of each individual corporation, thereby providing an incentive for corporations to minimize that risk. Second, they can monitor and seek to improve the corporate governance practices of the corporations they insure, for the self-interested but socially beneficial reason that they stand to save money as a result. Third, they can manage the defense and settlement of corporate and securities lawsuits so that only meritorious claims are paid.

In a companion article we report the results of our investigation into the risk assessment and pricing practices of D&O insurers.<sup>8</sup> In brief, we find that D&O insurers do attempt to price on the basis of risk and that corporate governance does indeed play a role in that process. But the highly discretionary nature of the D&O insurance underwriting process and the competitive pressures of the insurance underwriting cycle limit the ability of corporate and securities law deterrence objectives to be fully reflected in the pricing of D&O insurance.

This Article is devoted to the second way that D&O insurers might further those goals: by monitoring corporations in order to

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<sup>6</sup> See, e.g., James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 512 (1997) (“[A]pproximately 96% of securities class action settlements are within the typical insurance coverage, with the insurance proceeds often being the sole source of settlement funds.”). Using U.S. data, Cornerstone reports that “over 65% of all [securities class action] settlements in 2004 were for less than \$10 million,” a figure within the policy limits of most publicly traded corporations, and that only 7 settlements were larger than \$100 million. See LAURA E. SIMMONS & ELLEN M. RYAN, POST-REFORM ACT SECURITIES SETTLEMENTS; UPDATED THROUGH DECEMBER 2004 (Cornerstone Research 2005).

<sup>7</sup> See generally Sean J. Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors’ and Officers’ Liability Insurance Policies*, 154 U. PA. L. REV. 1147 (2006) (pointing out the intermediary role of the D&O insurer and advocating disclosure of D&O premiums in order to preserve the deterrence function of shareholder litigation) [hereinafter, Griffith, *Uncovering a Gatekeeper*].

<sup>8</sup> See Tom Baker and Sean J. Griffith, *Predicting Governance Risk: Evidence From the Directors’ and Officers’ Liability Insurance Market*, --- CHI. L. REV.--- (forthcoming 2007).



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prevent the misrepresentations and other activities that lead to legally compensable losses. Insurers engage in such loss prevention practices in other insurance contexts—fire insurance companies, for example, often require smoke detectors and sprinkler systems,<sup>9</sup> and liability insurers require college fraternities to foreswear keg parties.<sup>10</sup> We investigate whether insurance companies engage in similar loss prevention activities in the D&O context as well.

Our approach is empirical. We interviewed over 40 people in the D&O insurance industry—including underwriters, actuaries, claims managers, brokers, lawyers, and corporate risk managers—and asked them to describe the relationship between D&O insurers and their public company insureds.<sup>11</sup> Do insurers offer loss prevention services to their corporate insureds? And, relatedly, do insurers monitor the corporate governance of their insureds? We found that the answer to both of these questions was “They don’t.” The participants in our study unanimously reported that D&O insurers do not offer real loss prevention services or otherwise monitor corporate governance.<sup>12</sup>

This finding raises substantial questions about the deterrent effect of corporate and securities law liability, providing further support for the claim that securities class actions, in particular, are not fulfilling

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<sup>9</sup> See Deere, 9 INT’L REV. L & ECON. 219 (1989).

<sup>10</sup> See Jonathan Simon, *In the Place of the Parent: Risk Management and the Government of Campus Life*, 3 SOCIAL & LEGAL STUDIES 14 (1994). Whether the insureds comply is, of course, another matter. On insurance and governance generally, see RICHARD V. ERICSON, AARON DOYLE & DEAN BARRY, *INSURANCE AS GOVERNANCE* (2003).

<sup>11</sup> We describe our qualitative research methods in our companion article. See Baker & Griffith, *Governance Risk*, *supra* note 6. In brief, we used a snowball recruitment technique and conducted semi-structured interviews with 21 underwriters from 14 companies, 3 D&O actuaries from 3 companies, 6 brokers from 6 brokerage houses, 4 risk managers employed by publicly traded corporations to purchase their insurance coverage, 3 lawyers who advise publicly traded corporations on the purchase of D&O insurance, and 4 professionals involved in the D&O claims process (2 claims managers, 1 monitoring counsel, and 1 claims specialist from a brokerage house). In addition, we attended 6 conferences for D&O professionals (participating as a moderator in two of them) and engaged in many informal conversations, supplementing our interviews with industry documents as well as regular reading of trade and industry publications. Because of the concentrated, highly networked nature of the D&O insurance market we are confident that we are reporting shared views despite the small number of interviews.

<sup>12</sup> Our interviews focused exclusively on publicly traded corporations. Our findings do not generalize to D&O insurance sold to private or non-profit corporations. Indeed, participants who are knowledgeable about the private and non-profit D&O insurance market report that D&O insurers provide considerably greater governance services – both *ex ante* and *ex post* – in those other markets. X-Ref

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their deterrence promise.<sup>13</sup> Indeed, if D&O insurance insulates corporations and their directors and officers from the financial impact of liability, and if D&O insurers do not provide other incentives to prevent the kinds of activities that lead to liability, then D&O insurance seems likely to *increase* the amount of shareholder losses due to securities law violations. This is the moral hazard of D&O insurance.<sup>14</sup>

In other contexts some increase in loss might be a tolerable or even a desirable result of liability insurance, because of the benefits that insurance provides to risk-averse individuals who might otherwise not engage in productive activities.<sup>15</sup> But public corporations do not need insurance for this purpose, because shareholders can spread the risk of corporate losses by holding a diversified portfolio.<sup>16</sup> Indeed, in the standard economic account, corporations buy insurance for seemingly ancillary services like loss

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<sup>13</sup> See John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, --- COLUM. L. REV. --- (forthcoming 2006) (arguing that, because the bulk of class action liability falls on corporations – and therefore innocent shareholders – securities class actions do not promote the deterrence goals of securities law).

<sup>14</sup> “Moral hazard” is the term economists and insurers alike use to describe “the effect of insurance on incentives,” namely, that insurance against loss reduces the incentive to take care to prevent loss. Kenneth Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 AM. ECON. REV. 941, 961 (1963). See also See also CAROL HEIMER, REACTIVE RISK AND RATIONAL ACTION (1985) (studying the use of insurance contract provisions to control moral hazard); Steven Shavell *On Moral Hazard and Insurance*, 93 Q. J. ECON. 541 (1979); Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996) (describing the evolution and uses of the term and discussing the empirical literature testing moral hazard). X-Ref

<sup>15</sup> Cf. Steven Shavell, *On Liability and Insurance*, 13 Bell J. Econ. 120, 121-2 (1982) (modeling relationship between liability and insurance and concluding “although the purchase of liability insurance changes the incentives created by liability rules, the terms of the insurance policies sold in a competitive setting would be such as to provide an appropriate substitute (but not necessarily equivalent) set of incentives to reduce accident risks”).

<sup>16</sup> As discussed in detail at *infra* TAN 118-24, entity-level D&O insurance spreads the risk of corporate and securities litigation, but shareholders do not necessarily benefit from this form of insurance since they can spread these risks costlessly themselves by holding a diversified portfolio of equity securities. See generally EDWIN J. ELTON, MARTIN J. GRUBER, STEPHEN J. BROWN, WILLIAM N. GOETZMAN, MODERN PORTFOLIO THEORY AND INVESTMENT ANALYSIS (6<sup>th</sup> ed. 2003). See also BURTON MALKIEL, A RANDOM WALK DOWN WALL STREET at 224 (2<sup>nd</sup> ed 2001) (including accounting fraud in a list of firm-specific risks that investors can reduce through diversification: “the whole point of portfolio theory is that, to the extent that stocks don’t move in tandem all the time, variations in the returns from any one security tend to be washed away or smoothed out by complementary variations in the returns from other securities”). See also Coffee, *supra* note 13 at – (illustrating how a diversified investment strategy spreads shareholder litigation costs).

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prevention and tax savings, not for the risk distribution that motivates individuals to buy insurance.<sup>17</sup>

Thus, our finding that D&O insurers are not engaged in loss prevention raises two obvious questions. If insurers don't offer loss prevention services, how do they control the moral hazard problem? And if corporations are not receiving extra monitoring, why do they buy entity-level D&O insurance, given that their shareholders do not need insurance to spread this risk? In addressing these questions, we draw upon our empirical findings to argue that the absence of monitoring is likely to be due, at least in part, to the agency problem in the corporate context. Corporate managers value their autonomy and therefore prefer to purchase D&O coverage without a strong monitoring component, even though the absence of that component likely increases the probability of loss (and, thus, makes the insurance on average more expensive). Moreover, although this D&O coverage may be inefficient from the shareholders' perspective, corporate managers buy it because it protects their compensation packages and partially insulates them from capital market scrutiny aroused by the payment of liabilities incurred in shareholder litigation.

Our analysis thus suggests that the existing form of corporate D&O insurance both results from and contributes to the relatively weak constraints on corporate managers. Corporate managers buy this form of coverage for self-serving reasons, and the coverage itself, because it has very limited means of controlling the problem of moral hazard, reduces the extent to which shareholder litigation aligns managers' and shareholders' incentives.

The Article proceeds as follows. Part I provides brief background on shareholder litigation and D&O insurance. Readers who are familiar with these topics may wish to skim or skip ahead. Part II reports our empirical findings: contrary to expectations, D&O insurers do not provide corporate governance monitoring or other loss prevention services *ex ante* or defense cost management services *ex post*. Part III explores this gap between theory and practice. We first

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<sup>17</sup> See, e.g., David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance*, 55 J. BUS. 281 (1982) ("[I]nsurance purchases by large corporations with diffuse ownership largely eliminates risk aversion as the source of the demand for insurance and allows us to highlight other incentives, such as the real-service efficiencies provided by the insurance companies.") *Id* at 294. See Clifford Holderness, *Liability Insurers as Corporate Monitors*, 10 INT. R. LAW & ECON. 115, 116 (1990) (claiming that D&O insurers provide monitoring services). For a detailed discussion of the reasons corporations buy insurance see TAN 134-53.

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explain why economic theory predicts that D&O insurers would provide monitoring services in order to control moral hazard and why corporations would demand these services even if insurers were not concerned about moral hazard. We then review a variety of explanations for why corporations might buy D&O insurance, and we argue that managerial agency costs provide the most compelling explanation for the nearly pure risk distribution form of D&O insurance that we observed. Other factors, particularly tax benefits and the costs of external capital, may in some cases provide good reasons for corporate insurance, but not for insurance that makes little or no attempt to manage loss costs, either *ex ante* or *ex post*. We conclude by arguing that, absent more forceful entry by D&O insurers into the “corporate governance industry,”<sup>18</sup> entity-level D&O insurance may not be in shareholders’ interest.

### I. D&O INSURANCE AND SHAREHOLDER LITIGATION

D&O insurance protects corporate officers and directors and the corporation itself from liabilities arising as a result of the conduct of directors and officers in their official capacity.<sup>19</sup> For public corporations, the dominant source of D&O risk, both in terms of claims brought and liability exposure, is shareholder litigation.<sup>20</sup> Shareholder litigation is a significant risk. Studies suggest that the average public company has a 2% chance of being sued in a

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<sup>18</sup> See Paul Rose, *The Corporate Governance Industry*, May 17, 2006 (available on SSRN).

<sup>19</sup> See, e.g., *AIG Specimen Policy 75011(2/00)* § 2.aa (providing coverage for “any actual breach of duty, neglect, error, misstatement, misleading statement, omission or act... by such Executive in his or her capacity as such or any matter claimed against such Executive solely by reason of his or her status as such...”) [hereinafter, *AIG Specimen Policy*]; *Chubb Specimen Policy 14-02-7303(Ed. 11/2002)* § 5.a, p. 7 (“Wrongful act means any other matter claimed against Insured Person solely by reason of his or her serving in an Insured Capacity.” [hereinafter, *Chubb Specimen Policy*, The Hartford, *Directors, Officers and Company Liability Policy, Specimen DO 00 R292 00 0696*, § IV.O. (defining coverage to include “any matter claimed against the Directors and Officers solely by reason of their serving in such capacity...”) [hereinafter, *Hartford Specimen Policy*].

<sup>20</sup> See TILLINGHAST 2004 DIRECTORS AND OFFICERS LIABILITY SURVEY, at 4 (2005) (reporting that “57% of the claims against [participating] public [companies] were brought by shareholders”).

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shareholder class action in any given year,<sup>21</sup> and average settlement values for such claims exceeded \$24 million in 2005.<sup>22</sup>

Most D&O policies include two basic types of coverage. First, individual-level coverage protects each individual officer or director against covered losses (“Side A” coverage).<sup>23</sup> Second, entity-level coverage protects the corporation itself from losses resulting from its indemnification obligations to individual directors and officers (“Side B” coverage)<sup>24</sup> or from losses incurred when the corporation itself is a defendant in a shareholder claim (“Side C” coverage).<sup>25</sup> Within the

<sup>21</sup> Cornerstone Research, *Securities Class Action Filings: 2005, A Year in Review* (2006) at 4 (estimating susceptibility to a federal securities class action for “companies listed on the NYSE, Nasdaq, and Amex” at the start of 2005 at 2.4%); Ronald I. Miller, et al., *Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, is Stabilization Ahead?* (NERA Economic Consulting, April 2006) at 3 (estimating susceptibility of all publicly traded corporations in 2005 at 1.9%). The exposure of some companies, of course, is higher than others. Larger companies are sued more often than small ones; certain industries are sued more often than others. Cornerstone, at 14.

<sup>22</sup> Miller, *et al.*, *supra* note 21, at 5. Median settlements, however, are considerably lower (\$7 million in 2005), demonstrating that average settlement is driven by a small number of very large settlements. *Id.*

<sup>23</sup> Basic coverage terms obligate an insurer to pay covered losses on behalf of individual directors and officers when the corporation itself cannot indemnify them. *See Hartford Specimen Policy, supra* note at § I.A. *See also Chubb Specimen Policy, supra* note 6, at § 1, p. 2; *AIG Specimen Policy, supra* note 6, at § 1.A.

<sup>24</sup> Typical policy language provides:

The Insurer will pay on behalf of the Company Losses for which the Company has, to the extent permitted or required by law, indemnified the Directors and Officers, and which the Directors and Officers have become legally obligated to pay as a result of a Claim ... against the Directors and Officers for a Wrongful Act....

*Hartford Specimen Policy, supra* note 6, at § I.B; *Chubb Specimen Policy, supra* note 6, at § 2, pg 2 (providing similar language); *AIG Specimen Policy, supra* note 6, at 1.B. Policies typically deem indemnification to be required in every situation where they it is legally permitted, thus preventing the corporation from opportunistically pushing the obligation to the insurer by simply refusing to indemnify its directors and officers. *See Hartford Specimen Policy, supra* note 6, at § VI.F (providing that if a corporation is legally permitted to indemnify its officers and directors, its organizational documents will be deemed to require it to do so). *See also Chubb Specimen Policy, supra* note 6, at § 13, p. 11; *AIG Specimen Policy, supra* note 6, at § 6.

<sup>25</sup> Typical policy language provides:

[T]he Insurer will pay on behalf of the Company Loss which the Company shall become legally obligated to pay as a result of a Securities Claim... against the Company for a Wrongful Act...

*Hartford Specimen Policy, §I.C; Chubb Specimen Policy, at § 3, p. 2; AIG Specimen Policy, at § 1.C.* A securities claim is defined in the policy to include claims by securities holders alleging a violation of the Securities Act of 1933 or the Securities Exchange Act of 1934 or rules and regulations promulgated pursuant to either act as well as similar state laws and includes claims “arising from the purchase or sale of, or offer to purchase or sell, any Security issued by the company” regardless of whether the transaction is with the company or over the open market. *Hartford*

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D&O insurance industry, only the latter, Side C, coverage typically is referred to as “entity coverage.” Yet, Side B coverage protecting the corporation against its indemnification obligations also provides coverage to the corporate entity. In order to avoid confusion with insurance industry terminology, we will use the term “entity-level coverage” when we mean to refer to both B and C side coverage, and we will not use the term “entity coverage” at all.

Side A, individual-level coverage obligates an insurer to pay covered losses on behalf of individual directors and officers only when the corporation itself cannot legally indemnify them.<sup>26</sup> This is a rare event,<sup>27</sup> and Side A coverage typically comes into play only when the corporation is bankrupt or insolvent,<sup>28</sup> or the amounts are paid to settle derivative litigation.<sup>29</sup> In general, the insurer’s payments, minus corporate retentions or co-insurance, are under Side B to reimburse the corporation for its indemnification payments or under Side C to cover the corporation’s own losses. Our participants confirmed that the vast majority of D&O insurance losses are incurred under Side B and C—that is entity-level —coverage.<sup>30</sup> Thus, to a very substantial extent, D&O insurance is corporate insurance.

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*Specimen Policy*, at IV.M; *Chubb Specimen Policy*, at § 5, p. 6; *AIG Specimen Policy*, at § 1.y. If the company purchases Side C coverage, the definitions of “claim,” “loss,” and “wrongful act” expand to include the company and not just the directors and officers.

<sup>26</sup> See *Hartford Specimen Policy*, at § I.A. See also *Chubb Specimen Policy*, at § 1, p. 2; *AIG Specimen Policy*, at § 1.A.

<sup>27</sup> Dan A. Bailey, Side-A Only Coverage (available online at <http://www.baileycavalieri.com>) (reporting that “the vast majority of Claims covered under a D&O Policy are indemnified by the Company”).

<sup>28</sup> Most policies contain a “financial insolvency” exception moving the insurer’s obligation to Side A of the policy when the corporation is financially unable to indemnify them. See *Hartford Specimen Policy* §VI.F. (providing Financial Insolvency exception); §IV.G. (defining financial insolvency as the status resulting from the appointment of a receiver, liquidator, or trustee to supervise or liquidate the company or the company becoming a debtor in possession). See also *Chubb Specimen Policy*, *supra* note, at § 14, p. 12 (financial impairment), § 3, p. 4; *AIG Specimen Policy*, *supra* note, at § 6 (crisis loss), Appendix B.

<sup>29</sup> See Del. Code Ann. tit. 8 §145(a) (2004) (permitting indemnification for judgments and settlements except for those actions “by or in right of the corporation”).

<sup>30</sup> See Underwriter 13, p. 16 (“Side A is predominantly a derivative action or an insolvency exposure[;] you have a very solvent company, and you are looking at derivative territory and derivative claims [that] for the most part have been contained in lower limits certainly relative to overall security claims.”); see also Underwriter 15, p. 40 (“I think A Side Towers has been viewed by the risk management community as a more inexpensive way or a more affordable way to buy D&O insurance, to give the directors the limits they need without spending as much for it...”).

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The shareholder suits covered by D&O insurance may include both corporate fiduciary duty claims, whether derivative or direct,<sup>31</sup> and securities law claims.<sup>32</sup> Of these, federal securities law claims represent by far the greatest liability risk.<sup>33</sup> The most important such cause of action is Rule 10b-5, under Section 10(b) of the Securities Exchange Act, which involves misstatements made in connection with a securities transaction.<sup>34</sup> Rule 10b-5 claims may be brought against a broad spectrum of defendants for any misrepresentation made “in connection with” the purchase or sale of a security.<sup>35</sup> In broad terms, Rule 10b-5 plaintiffs must prove an investment loss caused by a material false statement that the defendant knew or should have known was false (“scienter”).<sup>36</sup>

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<sup>31</sup> Derivative suits are corporate lawsuits initiated by shareholders on the corporation’s behalf. Direct suits are corporate lawsuits initiated by shareholders on their own behalf. See Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 137 (2004) (finding that approximately 80% of all fiduciary duty claims filed in Delaware Chancery Court in 1999 and 2000 were class actions challenging board conduct in an acquisition and that only 14% of fiduciary duty claims over the same period were derivative suits).

<sup>32</sup> The possible grounds for shareholder complaint are many. See, e.g., WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS, 7<sup>th</sup> ed., at §17.02 (listing 170 possible grounds for liability in shareholder litigation). The basic concern underlying all of these, however, is the problem of divergence between managerial concerns and shareholder welfare—i.e., “agency costs.” See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (identifying the divergence in interests between shareholder principals and manager agents as a central feature of the corporate form).

<sup>33</sup> See Counsel #1, p. 11 (“The big exposure to D&O, as I am sure you know, is that No. 1 head and shoulders above everything else is securities class actions...”). See also Counsel #3, p. 5 (“[S]ecurities litigation outweighs derivative litigation by far.”). These arise under the Securities Act of 1933, see 15 USCA §§ 77a-77aa (1997 and Sup 2005) (hereinafter “Securities Act”), and the Securities Exchange Act of 1934, 15 USCA §§ 78a-78mm (1997 and Sup 2005) (hereinafter “Exchange Act”).

<sup>34</sup> 15 U.S.C. s 77 i; 17 C.F.R. s 240.10b-5 (1995). Sections 11 and 12(2) of the Securities Act are a distant second and third, respectively. In 2005, 93% percent of securities class actions alleged violations of Rule 10b-5. Only 9% alleged a Section 11 violation, and only 5% alleged a Section 12(2) claim. See Cornerstone, *supra* note 21, at 16-17.

<sup>35</sup> See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 753-55 (1975).

<sup>36</sup> See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (discussing elements of a 10b-5 claim and establishing presumption of reliance on basis of “fraud-on-the-market” theory). 15 U.S.C. §§ 77k, 77l. In recent years, securities class actions have increasingly been dominated by claims involving fraud in financial reporting. See Coffee, *supra* note – at – (“although it would be an overstatement to say that the

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Covered losses under a D&O policy include compensatory damages, settlement amounts, and legal fees incurred in the defense of claims arising as a result of the official acts of directors and officers.<sup>37</sup> Shareholder litigation almost always challenges the official acts of the directors and officers. As a result, the D&O insurer typically pays *all* the costs associated with the defense and settlement of shareholder litigation, above a deductible (as long as the corporation has purchased enough insurance, which is typically the case).<sup>38</sup>

Although there are a number of important exclusions in the D&O insurance policy, D&O insurance professionals report that none of these exclusions have a significant practical impact on D&O insurers' overall responsibility to pay for shareholder litigation.<sup>39</sup> The principal exclusions are for claims involving fraud or personal enrichment,<sup>40</sup> claims either noticed or pending prior to the commencement of the policy period,<sup>41</sup> and claims between insured persons.<sup>42</sup> Significantly, the Fraud exclusion is commonly subject to a "final adjudication" condition that obligates the insurer to fund the criminal and civil defense of directors or officers unless and until the fraud is finally adjudicated in the proceeding for which coverage is sought.<sup>43</sup> Because shareholder litigation almost always is settled (and, therefore, not adjudicated in the proceeding for which coverage

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securities class action exclusively polices fraud in financial reporting, this seems to be its primary role").

<sup>37</sup> *Hartford Specimen Policy*, *supra* note 6, at § IV.J. (including compensatory damages, settlement amounts, and legal fees). *See also Chubb Specimen Policy*, *supra* note 6, at § 3.a, pg 5; *AIG Specimen Policy*, *supra* note 6, at § 1.p.

<sup>38</sup> Deductibles are discussed in note 109 *infra*.

<sup>39</sup> *See* Monitoring Counsel #1, p. 13 ("[It] tends to be only in extremely unusual cases [that] the corporation has to kick in its own money because of the application of some exclusion.")

<sup>40</sup> This is the so-called "Fraud" exclusion. *See* *AIG Specimen Policy*, §§ 4.b.-c.; *Chubb Specimen Policy*, §§ 7-8; *Hartford Specimen Policy*, § V.J.

<sup>41</sup> This is the "Prior Claims" exclusion. *See* *AIG Specimen Policy*, §§ 4.h., 1.; *Chubb Specimen Policy*, §§ 6.a.-b.; *Hartford Specimen Policy*, § V.C.

<sup>42</sup> This is the "Insured versus Insured" exclusion. *See* *AIG Specimen Policy*, §§ 4.i., j.; *Chubb Specimen Policy*, § 6.c.; *Hartford Specimen Policy*, § V.D.

<sup>43</sup> *See* John H. Mathias, Jr., Timothy W. Burns, Matthew M. Meumeier, Jerry J. Burgdoerfer, *Directors and Officers Liability: Prevention, Insurance and Indemnification* at 8-14 (2003) (collecting cases holding that "if the exclusion requires a final adjudication, that adjudication must take place in the underlying action for which coverage is sought"). *See Little v. MGIC Indem. Corp.*, 836 F.2d 789, 794 (Final adjudication language requires insurance company to "pay loss as the insured incurs legal obligation for such loss, subject to the requirement that the insured reimburse any monies received if it is subsequently determined in a judicial proceeding that he engaged in active and deliberate dishonesty.")



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is sought), the Fraud exclusion does not have the impact that a simple reading of the D&O insurance policy might suggest.<sup>44</sup>

The Prior Claims exclusion carves out any claims noticed or pending prior to the commencement of the current policy. Ordinarily the prior claims would be covered under a prior policy, so the exclusion simply shifts the obligation to the earlier insurer. Finally, the Insured v. Insured exclusion does not apply to derivative actions maintained independent of the board—as, for example, when demand has been excused.<sup>45</sup> The other common exclusions simply remove peripheral claims—such as environmental claims,<sup>46</sup> ERISA claims,<sup>47</sup> claims alleging bodily injury or emotional distress,<sup>48</sup> and claims arising from service to other organizations<sup>49</sup>—from the scope of coverage, leaving shareholder litigation as the principal covered risk.<sup>50</sup>

Almost all shareholder litigation settles within the limits of the available D&O insurance.<sup>51</sup> Tillinghast reports that in 2005, small cap companies—defined here as those with market capitalizations between \$400 million and \$1 billion—purchased an average of \$28.25 million in D&O coverage limits.<sup>52</sup> Mid cap companies—

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<sup>44</sup> Mathias et al, *supra* note 43 at 8-15 (noting that the application of the final adjudication provision “drastically diminishes the force and effect of the [actual fraud] exclusion.”). Some more recent policies contain broader fraud exclusions, but these exclusions have not yet been tested. *Id.*

<sup>45</sup> Corporate fiduciary duty claims must often be brought as shareholder derivative actions. Derivative suit procedures require that shareholder plaintiffs first demand that the corporation’s board of directors pursue the claim on their behalf and, if the board elects not to do so, also bind the shareholders to the board’s decision. Only if the board itself is conflicted will demand be excused, thus allowing shareholders to pursue the suit without consent of the board. *See generally* [citation needed] Derivative suits proceeding without the consent of the board are carved out of the Insured v. Insured exclusion.

<sup>46</sup> See AIG Specimen Policy, § 4.k.; Chubb Specimen Policy, § 6.d.; Hartford Specimen Policy, § V.E.

<sup>47</sup> See AIG Specimen Policy, § 4.m.; Chubb Specimen Policy, § 6.f.; Hartford Specimen Policy, § V.G.

<sup>48</sup> See AIG Specimen Policy, § 4.h., l.; Chubb Specimen Policy, § 6.e.; Hartford Specimen Policy, § V.A.

<sup>49</sup> See AIG Specimen Policy, § 4.f., g.; Chubb Specimen Policy, § 6.g., h.; Hartford Specimen Policy, § V.F.

<sup>50</sup> Each of these types of peripheral claims is covered by another form of liability insurance.

<sup>51</sup> See Elaine Buckberg, Todd Foster, Ronald I Miller, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: ARE WORLD COM AND ENRON THE NEW STANDARD? 1 (NERA 2005) (“[S]ettlements on behalf of directors are typically wholly paid by D & O insurers...”).

<sup>52</sup> Tillinghast, 2005 Directors and Officers Liability Survey, *supra* note at 29, tbl. 17C.

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market capitalization \$1-10 billion—purchased an average of \$64 million in limits.<sup>53</sup> And large cap companies—market capitalization in excess of \$10 billion—purchased an average of \$157.69 million in D&O coverage.<sup>54</sup> According to the participants in our study, the largest available coverage limit is \$300 million.<sup>55</sup> In recent years some highly publicized cases have settled for very large amounts substantially in excess of the D&O insurance policy,<sup>56</sup> but 65% of all class action settlements in 2004 were for less than \$10 million.<sup>57</sup> This is an amount well within the insurance limits of even small cap companies.

## II. EMPIRICAL FINDINGS: THE MISSING MONITOR<sup>58</sup>

Our research question was very simple: “What do D&O insurance companies do to reduce either the frequency or severity of shareholder litigation filed against the corporations they insure?” We set out to investigate this question because (a) economic theory asserts that liability insurance companies should work to prevent and manage insured losses,<sup>59</sup> (b) prior sociological research demonstrates that insurance companies do prevent and manage insured losses in

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<sup>53</sup> Tillinghast reports mid-cap limits in three categories. The first, companies with market capitalizations between \$1 billion and \$2 billion, purchased mean limits of \$44.88 million and median limits of \$30 million. The second, companies with market capitalizations between \$2 billion and \$5 billion, purchased mean limits of \$83.2 million and median limits of \$75 million. Finally, the third group, companies with market capitalizations between \$5 billion and \$10 billion, purchased mean limits of \$79.4 million and median limits of \$65 million. *See id.* The number reported in the text is an average of these three categories, weighted for the number of observations in the Tillinghast sample.

<sup>54</sup> *See id.* The median reported for companies with market capitalizations in excess of \$10 billion was \$125 million.

<sup>55</sup> Risk Manager #3, p. 6 (“[T]he most that we could purchase for the corporate side was in the 200 to absolute maximum 300 million available.”). *See also* Underwriter #13, pp. 37-38.

<sup>56</sup> *Id.*

<sup>57</sup> See Laura E. Simmons & Ellen M. Ryan, *POST-REFORM ACT SECURITIES SETTLEMENTS; UPDATED THROUGH DECEMBER 2004* (Cornerstone Research 2005).

<sup>58</sup> Our research methods are described in our companion Article. Baker & Griffith, *Governance Risk*, *supra* note 8. For a brief description, see note 9, *supra*.

<sup>59</sup> See, e.g., Shavell, *Liability and Insurance*, *supra* note 13 (standard account); George M. Cohen, *Legal Malpractice Insurance and Loss Prevention: A Comparative Analysis*, 4 Conn. Ins. L. J. 305 (1997-98) (institutionalist account).

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some other contexts,<sup>60</sup> and (c) some work has claimed that D&O insurance companies do so as well.<sup>61</sup> In part because this latter work was not adequately supported,<sup>62</sup> we engaged in intensive qualitative research to investigate what D&O insurers do to prevent or manage shareholder litigation losses.

When we began this research, we expected to find corporations that treated D&O insurance companies as trusted suppliers of loss prevention services, D&O insurance premiums that provided significant loss prevention incentives, and D&O insurers that conditioned coverage on loss prevention behavior. It did not take very many interviews to learn that we were wrong. In practice, D&O

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<sup>60</sup> See, e.g., RICHARD ERICSON & AARON DOYLE, *UNCERTAIN BUSINESS: RISK, INSURANCE AND THE LIMITS OF KNOWLEDGE* (2004); Simon, *supra* note --; Elizabeth O. Hubbard; 1996-1997. *When Worlds Collide: The Intersection of Insurance and Motion Pictures*, 3 CONN. INS. L.J. 267 (1997-98); Pat O'Malley, *Legal Networks and Domestic Security*, 11 STUD. L., POL'Y & SOC'Y 171 (1991). See also Tom Baker, *Insurance, Risk and the Social Construction of Responsibility*, in *EMBRACING RISK: THE CHANGING CULTURE OF INSURANCE AND RESPONSIBILITY* (Tom Baker & Jonathan Simon, eds., 2002). [Need to add reference to North Sea drilling rigs literature.]

<sup>61</sup> Holderness asserts:

Insurance companies monitor their customers directors and top managers in a number of ways. When it decides to issue a policy, the insurer investigates the firm's past actions, occasionally requires changes in the board, and sets conditions for directors and officers to observe. When allegations of misconduct arise, the insurer through its defense efforts can serve as an independent external investigator of not only the accused official but the entire board and management team.

Holderness, *Liability Insurers as Corporate Monitors*, 10 Int. R. Law & Econ. 115, 116 (1990). In 1997 O'Sullivan reported that he had supported Holderness's monitoring thesis in the U.K. (which, unlike the U.S., mandates disclosure of D&O insurance) by finding a correlation between the number of outside directors and the likelihood that the corporation purchased D&O insurance, reasoning that inside directors are better able to monitor the corporation and, thus, do not need the D&O insurer to serve that role. See Noel O'Sullivan, *Insuring the Agents: The Role of Directors' and Officers' Insurance in Corporate Governance*, 64 J. R. & Ins. 545 (1997).

<sup>62</sup> Holderness, *supra* note 6-, did not provide any empirical evidence in support of the monitoring assertion. O'Sullivan's correlation between the number of outside directors and the purchase of D&O insurance does not confirm Holderness's hypothesis. See O'Sullivan *supra* note 61. That correlation is more likely to reflect the outside directors' demand for risk distribution services to protect themselves than their demand for monitoring to protect shareholders (especially because, as we report, the insurance that the corporation does buy does not provide monitoring). The only other reported research on D&O insurance monitoring found that English D&O insurers were not providing monitoring services in the early 1990s. See Vanessa Finch, *Personal Accountability and Corporate Control: The Role of Directors' and Officers' Liability Insurance*, 57 Mod. L. Rev. 880, 908 (1994) ("United Kingdom insurers have not to date, however, developed systems that routinely give attention to individual directors.")

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insurers do little to monitor the public corporations they insure. D&O insurers do not condition the sale of insurance on compliance with loss prevention requirements in any systematic way. Although D&O insurers do provide some loss prevention advice, underwriters report, and brokers and risk managers confirm, that this advice is not highly valued by public corporations, nor does it appear to affect corporate management behavior. Finally, in sharp contrast to the liability insurance norm, D&O insurers do not manage defense costs. In the sections that follow, we report these findings.

A. D&O INSURERS DO NOT PROVIDE LOSS PREVENTION SERVICES

With only one exception that we discuss in detail below, none of the underwriters or brokers we interviewed could tell us about a single situation in which a publicly traded corporation changed a business practice in response to a governance concern from a D&O insurer. In fact, the consensus was that this rarely, if ever, occurred. One underwriter described his view in more vivid terms than the rest, but his basic point represents the common understanding of the people we interviewed:

You had asked me on the phone whether companies changed their behavior for the benefit of their D&O insurers. I don't think they are. I think the brokers sometimes can put lipstick on the pig, but that is a marketing feature. And it seems to me that however high D&O premiums climb, they are not going to climb high enough to get the companies to really, really pay attention.<sup>63</sup>

Qualitative research cannot prove that something *never* takes place. Nevertheless, it does provide access to the common understandings and practices of the field under investigation. As the exception that we discuss indicates, a public corporation may well, on very rare occasions, have changed its disclosure practices, board composition, or insider trading policies because of something that a D&O insurance company did, but our participants uniformly and unequivocally reported that this kind of loss prevention impact is not the norm.<sup>64</sup>

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<sup>63</sup> Underwriter #5, p. 30.

<sup>64</sup> By contrast, loss prevention conditions and advice are frequently provided in the private and non-profit D&O insurance market. In that market, D&O insurance is sold as part of package policy that also insures against employment liability risks. Employment liability is the more significant risk in that market and the main subject

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The underwriters reported that they could well understand why we might think that they would be actively involved in corporate governance. Some even reported that they had tried. For example, the assistant D&O product manager for a leading insurer reported:

At one point we wanted to go in with accountants and governance experts and have them do a rigorous review, an interview with management and everything else in exchange for, assuming the report comes back positive, in exchange for much better terms and/or price, and we started to try to do this and send out feelers probably in early '03 when the hard market was still, you know, roaring along, thinking clients will be open to this, if they can get significant reductions in their D&O prices, and they were very, *very* reluctant, I should say. In other words, a brick wall let you through to do that, and that is still very much the case for two reasons I think. One, the companies don't want you in there and two, the brokers don't want you in there because they feel part of their value proposition is giving the customer some risk insights on that front, so you are kind of conflicting with their value proposition.<sup>65</sup>

The time period here is quite important. Liability insurance is a cyclical business with recognizable periods of tight supply, high prices, and other factors that demonstrate that insurance sellers have the upper hand; this is the “hard market” to which the manager referred.<sup>66</sup> If D&O insurers cannot introduce serious loss prevention during a hard market, they are most unlikely to do so during the later “soft market” when insurance buyers gradually gain the upper hand. More precisely, they cannot do so unless the buyers demand those services, and we found no evidence that contradicted our participants' claim that public companies are not demanding those services from their D&O insurers.

A few of the insurance companies do have D&O loss prevention booklets and newsletters, but underwriters and brokers uniformly described that literature as a marketing material with no discernible impact on their clients' business practices. The statement from this underwriter from a major insurer is typical:

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of the insurers' loss prevention efforts. See, e.g., Nancy Van der Veer, Note, *Employment Practices Liability Insurance: Are EPLI Policies a License to Discriminate? Or Are They a Necessary Reality Check For Employers?*, 12 CONN. INS. L.J. 173 (2005-2006).

<sup>65</sup> Underwriter #8, p. 50.

<sup>66</sup> See Tom Baker, *Medical Malpractice and the Insurance Underwriting Cycle*, 54 DEPAUL L. REV. 393 (2005) (reviewing literature on the liability insurance underwriting cycle). See also Baker & Griffith, *Governance Risk*, *supra* note 8 (addressing the cycle in D&O underwriting specifically).

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We have a newsletter, but it doesn't really ... say, "Look, if you do this, you'll get a better price." What we do [say] is, "Look, here are some issues." ... It goes in one ear and out the other. ...<sup>67</sup>

Some D&O insurers do support good governance projects and even, to a very limited extent, research into what constitutes good governance. For example, the product manager of a leading D&O insurer reported:

We produce publications on good governance, and we subscribe and participate in best practices conferences with directors, directors' conferences and things like that. We sponsor things that are best practices and we publish stuff.<sup>68</sup>

But, he also reported, his company does not condition coverage on any governance practices, provide governance or related loss prevention audits, or even provide identifiable discounts for adopting what he regards as good corporate governance practices for publicly traded companies. Insurer support for best practices certainly is welcome to those engaged in such efforts, but this support is a long way from the bundled package of monitoring and risk distribution services that theory suggests.

We eventually learned of one specialized insurance company that had developed a reputation in the market for emphasizing loss prevention. So we set out to talk to people from this company and, eventually, interviewed a senior official in the company. He confirmed that, in the past, the company did have a business plan that focused on loss prevention:

We felt strongly that there were certain things that, if the companies did them, would reduce their likelihood of being named in a securities class action lawsuit, and those would be things like controlling insider trading, controlling your disclosure and corporate reporting, having policies and procedures in place in advance in case they have to report bad news. If they do so, they do it in a controlled way that does not exacerbate the situation and wind up in and of itself causing the source of the class action lawsuit. When we first started it, what we were telling people was, "And if you do these things, we will give you a discount."<sup>69</sup>

He shared with us their loss prevention guide, which was prepared in the mid 1990s. The guide addressed a variety of topics:

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<sup>67</sup> Underwriter #5, p. 29.

<sup>68</sup> Underwriter #7, p. 11. The product manager is the individual with overall responsibility for the profitability of a particular line of business in a company with multiple business areas.

<sup>69</sup> Underwriter #4, p. 15.

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analyst communications, insider trading, bad news disclosure, and the mechanics of the protections provided by the then recently enacted Private Securities Litigation Reform Act. For each topic, the guide provides what appears to be sensible background explanation and concrete procedures, forms and practices for companies to use to reduce the likelihood of securities litigation. The guide was much longer, more detailed, and appeared to us to be far more practical and useful than any of the other loss prevention materials we obtained from other D&O insurance companies or brokers.

The guide had received substantial attention among D&O insurers and brokers and was one reason the company had developed the loss prevention reputation. The problem was, however, that this loss prevention effort did not work. As he described, “It was a lesson in both directions.” From the customer side, what he learned was: “We don’t value your message enough.” And, from the insurance company side:

We couldn’t show the discount .... We had to learn the value of humility, too. I still think they are good practices. I still think they work, too. I think what it will do – if you have a lawsuit, it will make it more defensible. ...<sup>70</sup>

Companies were occasionally receptive to the insurer’s offer to help them adopt disclosure practices and other corporate governance guidelines. But when this advice came with a higher price, competitors undercut these premiums and even marketed against the advice—“as in look [that company] will make you jump through a bunch of hoops; we can get the insurance for you cheaper... without all the fuss and bother.”<sup>71</sup> As a result, the company was forced to drop its loss prevention program. “It was costly to maintain, and it was not economically supported. There was no premium, if you will.”<sup>72</sup> Subsequently, the company left the D&O insurance business entirely.

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<sup>70</sup> *Id.*

<sup>71</sup> E-mail from D&O Product Manager to Tom Baker, dated July 31, 2006.

<sup>72</sup> *Id.* at 16. It is worth noting that the fact that this insurer found it more expensive to sell insurance with loss prevention services does not indicate that the cost of the loss prevention services exceeded the benefits. As reported in our companion Article, D&O insurance programs consist of layers of insurance policies, typically sold by different insurance companies. See Baker & Griffith, *supra* note --. The value of the loss prevention services accrues to all of the insurers in the program (as well as the insured corporation); it is to be expected that the insurer in the program that is providing the loss prevention services will expect to be paid more than the other insurers. The more serious problem with the strategy of this insurer relates to the public good nature of the best practices type advice it was providing, as we discuss *infra* note --.

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While we have no reason to believe that the failure of the loss prevention experiment explains this decision, nevertheless this experience cannot provide much encouragement for future efforts to adopt a D&O business model emphasizing loss prevention services.

Having run that loss prevention story to the ground, we then investigated whether brokers provide meaningful loss prevention services, mindful of the statement from the D&O product manager we reported earlier: that providing loss prevention advice was part of the “value proposition” of the broker. The brokers reported that they do, in fact, sometimes provide such advice, but only in the context of putting the clients’ best foot forward to insurance companies. For example, one broker from a major brokerage house reported:

There have definitely been points, whether it is governance or, you know, it could be anything, where we would say to our clients, “This is going to be a negative from the underwriter’s perspective,” and why. But I guess I would say, we really don’t have the authority or position to turn around and say to them, “You need to change this.” I think it is really up to them and, frankly, their board and audit committee as to what they end up doing, but we definitely point out what we would view to be a negative.<sup>73</sup>

A D&O product manager with close ties to the brokerage community confirmed that when brokers have tried to provide loss prevention advice:

It has generally been pretty poorly received. So I would tell you, it is very invasive, for a broker, an insurance broker to get in there and say, “Let me have 8 hours from your board.” It is just not taken particularly well.<sup>74</sup>

Like D&O insurers, brokers provide little in the way of loss prevention services, and the loss prevention services they do provide did not appear to be highly valued. Brokers provide other, very highly valued services, but these services all relate to risk distribution: negotiating favorable terms, putting together a program with quality insurers and adequate limits, and, in the event of a claim, using their market power to put pressure on insurers to resolve that claim.

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<sup>73</sup> Broker #1, p.7. The D&O product manager of yet another leading D&O insurer explained his understanding of this situation as follows:

You’re dealing with, generally, a lot of times the CEO, the general counsel, and these guys have egos to fill this room. You’re a 30 or 40 year old underwriter in the insurance business, and although your policy is very important to them and has been the last couple of years, since they’ve all been kind of crucified, you’re going to have a hard time saying, you know, “You need one more outside director.”

Actuary #2, p. 27 (joint interview with chief actuary and D&O product manager).

<sup>74</sup> Underwriter #7, p. 11.



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As noted above, our research cannot prove definitively that D&O insurers never condition the sale of insurance on specific loss prevention measures or that corporations always ignore the limited loss prevention advice that D&O insurers and brokers do provide. What we can report, however, is that all the people in the D&O insurance business we interviewed said this is the case. Moreover, we made a concerted effort to identify D&O insurance companies that went against this grain. Given the number of underwriters and brokers that we interviewed and the high concentration of the D&O insurance market, we are confident that we are reporting the common practice and the conventional understanding.

B. D&O INSURANCE PRICING PROVIDES ONLY A DIFFUSE LOSS  
PREVENTION INCENTIVE

Although D&O insurers do not require corporations to adopt specific loss prevention measures, the insurers do price on the basis of risk. As we reported in our companion Article, firms within industries with more shareholder litigation pay more than firms in industries with less litigation; large cap companies pay more than small cap companies; and companies with more volatile stock prices pay more than firms with less volatile stock prices.<sup>75</sup> These factors, of course, have nothing to do with corporate governance. Corporate governance is also a factor, albeit a secondary one, and other things being equal, our participants reported that they attempt to charge poorly governed corporations more for D&O insurance than better-governed corporations.<sup>76</sup>

Conceivably, this risk based pricing could lead to loss prevention monitoring in the following manner: Insurer X might grant Corporation Y a discount for adopting a particular governance practice, such as majority board independence, and then “monitor” Y’s commitment to that practice by making it a condition for coverage in the event of a claim. Yet our participants reported that this commitment mechanism does not occur in practice. The most that can be said about D&O insurance pricing and loss prevention is

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<sup>75</sup> See Baker & Griffith, *supra* note 8.

<sup>76</sup> *Id.* While we cannot evaluate whether this claim is correct, we can observe that insurers have a strong incentive to price in this manner and they regularly receive feedback on how well they are doing.

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that claims experience matters and, thus, a corporation that incurs shareholder litigation will pay more for insurance in the future.

C. *EX POST*, D&O INSURERS MANAGE SETTLEMENTS BUT NOT  
DEFENSE COSTS

So far, we have focused exclusively on the potential for D&O insurance to monitor and motivate corporations *ex ante* to prevent the kinds of investment losses that lead to shareholder litigation. Arguably, the causes of investment loss in general, let alone the narrow category of investment losses that are legally compensable, are so complicated and so difficult to sort out that there is nothing that D&O insurers could do to prevent them. Alternatively, it is possible that securities lawsuits are random events that are unrelated to corporate governance. Even if one or both of these were entirely true (possibilities that we discuss in the penultimate section of this Article), D&O insurers nevertheless could reduce the overall cost of those losses through loss cost management *ex post* (i.e. after the insured-against event takes place).

Indeed, as George Cohen observed in his insightful analysis of legal malpractice insurance, “after diversification, the risk reduction method most used by legal malpractice insurers, as well as by other liability insurers, is *ex post* loss reduction.”<sup>77</sup> From the beginning of liability insurance in England in the 1880s, liability insurers routinely have provided this *ex post* loss reduction through their control over the settlement and defense of covered claims.<sup>78</sup> Liability insurers negotiate preferred rates, monitor counsel to reduce unnecessary discovery or motion practice, and generally manage the litigation to minimize the sum of defense and settlement (or judgment) expenses. This is the norm in automobile insurance, malpractice insurance, and the general liability insurance that constitutes the main liability insurance protection for most individuals and businesses in the U.S.<sup>79</sup>

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<sup>77</sup> See Cohen, *supra* note 59.. See also Mayers & Smith, *Corporate Demand*, at 285 (noting that “insurance firms develop a comparative expertise in processing claims because of economies of scale and specialization”).

<sup>78</sup> See KENNETH S. ABRAHAM, *THE LIABILITY CENTURY* (forthcoming 2007); cf. Tom Baker, *Liability Insurance Conflicts and Defense Lawyers: From Triangles to Tetrahedrons*, 4 *Conn. Ins. L. J.* 101 (1998)

<sup>79</sup> For individuals, this coverage is provided as part of the homeowners or renters insurance package policies. For small businesses, this coverage is provided as part

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This norm makes economic sense, because of the *ex post* moral hazard that would otherwise result.<sup>80</sup>

D&O insurance sold to public corporations is very different. Rather than providing and controlling the defense, D&O insurers reimburse their policyholders' defense costs.<sup>81</sup> D&O insurance contracts give policyholders the right to choose defense counsel and manage their own defense, at the insurer's expense, subject only to the dollar limits of the policy and the requirement that defense costs be reasonable.<sup>82</sup> This defense arrangement substantially constrains D&O insurers' ability to provide *ex post* loss reduction. D&O insurers do have formal authority over settlement, as long as the claim can be settled within the limits of the D&O insurance program (which, as noted above, is typically the case).<sup>83</sup> But they must exercise that authority without the benefit of the close relationship with defense counsel that comes from controlling the defense.

Our investigation of the claims side of the D&O insurance business is not complete.<sup>84</sup> The evidence that we have collected so far, however, indicates that the results are what the economics of insurance would predict, based on the defense cost reimbursement structure of the D&O insurance contract.<sup>85</sup> The predictable effects are, first, D&O insurers are unable to control the costs of defending claims and, second, as long as the settlements are within the D&O policy limits, corporations pressure D&O insurers to settle claims sooner and at greater expense than an insurer in full control of defense and settlement would allow.<sup>86</sup>

As an initial matter, it is important to emphasize that the defense cost component of D&O insurance coverage is substantial. There are

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of the business owners or farmers package policies. For larger businesses, this coverage is purchased separately as commercial general liability insurance.

<sup>80</sup> See Baker, *Insurance Conflicts*, *supra* note 78 at 107-8 (explaining why "a rational prospective insured would prefer a liability insurance contract giving the company [control over the defense] ... [o]therwise the insured would demand at the point of claim a level of defense that he would not be willing to pay for at the time of purchasing the policy")

<sup>81</sup> See note 37, *supra*.

<sup>82</sup> *Id.*

<sup>83</sup> See TAN note 51, *supra*.

<sup>84</sup> See Tom Baker & Sean J. Griffith, *Directors' and Officers' Insurance in the Defense and Settlement of Shareholder Litigation* (work in progress) (studying the role of D&O insurance in the defense and settlement of shareholder litigation).

<sup>85</sup> See, e.g., Mark V. Pauly, *The Economics of Moral Hazard: Comment*, 58 AM. ECON. REV. 531 (1968). See generally, Baker, *Moral Hazard*, *supra* note 14.

<sup>86</sup> For a structural analysis of the dynamics of settlements within limits, see Baker, *Insurance Conflicts*, *supra* note 78.

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no definitive, publicly available defense cost data comparable to the publicly reported data for auto insurance, medical malpractice insurance, and other kinds of duty-to-defend insurance.<sup>87</sup> Nevertheless, the Tillinghast survey that forms the basis of much of what is known about D&O insurance purchasing patterns includes questions about defense costs, and the survey results separately identify defense costs for shareholder/investor claims (which is a reasonable proxy for defense costs for public corporation D&O insurance). Excluding claims that were closed with no payment to the claimant, Tillinghast reports that the median and mean defense costs were \$538,150 and \$1,965,079 per claim.<sup>88</sup> Compared to the median and mean settlement amounts reported in the same survey (\$5 million and \$27 million<sup>89</sup>) this suggests that defense costs typically are about eleven percent of the costs of paid claims, declining in percentage terms as the settlement amount increases.<sup>90</sup>

The head of the claims department of a leading D&O insurance company described the defense cost situation as follows:

We don't have a high level of control. Our policy suggests that we will pay for reasonable and necessary defense costs. The case law on that is pretty funky and is not positive to insurers. So the situations where you can absolutely reject it - the behavior has to be incredibly egregious behavior.<sup>91</sup>

The D&O product manager at another leading D&O insurance company described the incentives somewhat more bitterly as follows:

On the defense side, and again, this is not an accident, this was totally predicted, with the insureds not having an economic participation, they don't really care, and so it is no accident that the rates for securities firms have gone from \$400 and \$500 per hour to \$750 per hour in the last 5 years.

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<sup>87</sup> See, e.g., A.M. BEST CO, *AGGREGATES AND AVERAGES PROPERTY/CASUALTY* (2005 ed.).

<sup>88</sup> Tillinghast, 2005 *DIRECTORS AND OFFICERS LIABILITY SURVEY* at 112, table 107.

<sup>89</sup> Id. at 111, table 103.

<sup>90</sup> This is a conservative estimate. At a D&O industry conference, one senior underwriter reported that defense costs commonly were twenty five to thirty five percent of the settlement amount and sometimes as high as fifty percent. New York Seminar No. 1, p. 7 (“We are seeing some abuses but, even where you don't have abuses, we are seeing defense costs not just 25 to 35% of the settlement, [name omitted], as you commented, but sometimes 50% or 100% of the settlement”).

<sup>91</sup> Claims Manager 1 interview at p. 10. See Willy E. Rice, *Insurance Contracts and Judicial Discord Over Whether Liability Insurers Must Defend Insureds' Allegedly Intentional and Immoral Conduct: A Historical and Empirical Review of Federal and State Courts' Declaratory Judgments – 1900-1997*, 47 AM. U. L. REV. 1131, 1147-1148 (1998). See also *Okada v. MGIC Indemnity Corp.*, 823 F.2d 276 (9th Cir. 1986).

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That is not photocopy inflation, okay. That is the fact that they can charge that amount and that the companies will pay it. Increasingly, we get boxes of bills, so to speak, you know, “Here, sort it through and pay it.” So, you know, the inflation on the defense cost side is huge, probably much faster than the overall settlement as a whole, but nobody has really studied it. ... I just think that it is a function of, “You get what you can,” and I think the defense firms can charge \$750 per hour because nobody cares. I mean, it is staggering to me.<sup>92</sup>

The same product manager provided an example that, although not using the term *ex post* moral hazard, clearly illustrated his economic understanding of the situation:

I will give you two customers, both Fortune 500 companies, both in 10b-5 securities class actions. One customer spent \$75 million in the course of 18 months, and another one spent \$3.5 [million], and the difference was the deductible. In one case it was our money, and in the other case it wasn't, it was their money. And the difference was how they watch-dogged it, how they went through the bills, how they leaned on these guys and pushed back. In the case of the \$70 million bill, they had a \$250,000 deductible, and the insured stopped caring a long time ago and, literally, it boiled down to us opening boxes, you know, exercise bicycles, things in hotel rooms, I mean, you couldn't believe the stuff that was in that box, but it was all billable, it was all defense expenses. On the other case, they had a \$20 million deductible, and they were pounding on that law firm in terms of the bill. Think about that difference, though. I mean, that's a huge exponential difference in the cost of the case.<sup>93</sup>

Of course we cannot evaluate on the basis of qualitative research whether all of the securities litigation defense cost increases are the result of this *ex post* service-provider moral hazard.<sup>94</sup> We can report, however, that D&O insurance underwriters believe that a substantial part of the defense cost escalation is attributable to their inability to control defense costs.

Two of the leading D&O insurance companies have tried to address defense costs by developing lists of “panel counsel” from which all or some of their insureds are supposed to pick a firm to handle litigation covered by their D&O insurance policies. In other lines of insurance the use of panel counsel is believed to lower

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<sup>92</sup> CT D&O insurance seminar 1 at p. 9.

<sup>93</sup> *Id.*

<sup>94</sup> Indeed, at least some of the increased costs are likely to be a rational response to the increased damage claims.

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defense costs and facilitate insurer loss management.<sup>95</sup> But neither company appears to have been successful in using panel counsel to reduce defense costs of D&O claims.

We interviewed brokers and lawyers knowledgeable about the operation of both panels, and we obtained copies of panel counsel lists. The panel lists did not include all of the leading securities defense firms with which we are familiar, but it did include most of them. We recognized many of the firms on the lists as either the large national firms or more specialized litigation firms that also have reputations as “top dollar” firms.<sup>96</sup> In addition, brokers reported to us that D&O insurance buyers can and often do insist that their preferred firm be added as approved counsel if it is not already on the panel list.<sup>97</sup> Very senior, very knowledgeable participants informed us that the two leading insurance companies sometimes require defense counsel to provide litigation budgets but that there is little else done to control defense costs.

Generally speaking the way this works is that the defense firms that are picked by the insureds are people that are qualified to represent the insureds in these sorts of cases and don’t have conflicts. There are repeat players, and we see them over and over again, and we don’t object to their retention, and we consent ultimately to incurring defense costs.<sup>98</sup>

At the margin the companies might argue about whether certain activities fall within the scope of the defense. But, as one participant reported, “Insurance companies are known for negotiating lower rates and not letting people fly first class. Well, that is not the case here. Now the lawyers are selected by the policyholders, and they fly first class.”<sup>99</sup>

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<sup>95</sup> See Douglas R. Richmond, *The Business and Ethics of Liability Insurers’ Efforts to Manage Legal Care*, 28 U. MEM. L. REV. 57, 79 (1997) (“By establishing relationships with select firms, insurers can negotiate reduced hourly fees and special fee arrangements in exchange for continuing business. Controlling the defense also allows an insurer to participate in strategic decisions and to seize settlement opportunities”).

<sup>96</sup> The first list that we obtained contains 552 law firms, of which 257 are multiple offices of the same national firms. The second list we obtained contains 182 firms, of which 77 are multiple offices. Of note, both lists contain prominent New York firms such as Sullivan & Cromwell and Cravath Swaine & Moore.

<sup>97</sup> See also Christopher W. Martin, *Directors and Officers Insurance*, 41 Houston Lawyer 38 (2004) (reporting “the corporate policyholder may be able to negotiate with the insurer to add the insured’s preferred firm”).

<sup>98</sup> Claims Manager 2 interview at p 20.

<sup>99</sup> Monitoring Counsel 1 interview at p. 11

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III. ANALYSIS: A PROBLEM AND TWO PUZZLES

As we have seen, D&O insurers do not provide the monitoring that economic theory predicts. They do not provide loss prevention services *ex ante*, and they do not provide the defense cost management services *ex post* that routinely are provided in other lines of liability insurance. In this Part we explore a problem and two puzzles that arise from this gap between theory and practice.

The problem is moral hazard: the D&O insurance that we observed seems likely to reduce the deterrent effect of shareholder litigation and to increase both the amount of losses and the price of D&O insurance. The first puzzle is closely related to this moral hazard problem. Why do corporations buy this form of D&O insurance when shareholders do not appear to need the risk distribution that it provides?

The second puzzle is the inability of D&O insurers to capitalize on what would seem to be an obvious comparative advantage in the market for loss prevention services. Corporations pay law firms, management consultants, accounting firms, and a growing “corporate governance industry” for corporate governance loss prevention advice.<sup>100</sup> Yet, alone among all the potential suppliers of these loss prevention services, D&O insurers promise to pay the losses that result if their advice does not work. In other words, they bond their advice not only with their reputation,<sup>101</sup> but also with a promise to

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<sup>100</sup> Paul Rose, the Corporate Governance Industry, May 17, 2006 (available on SSRN).

<sup>101</sup> As discussed in the gatekeeper literature, accounting firms, law firms and other “reputational intermediaries” bond their services through their reputation. *See, e.g.*, John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 308 (2004); Assaf Hamdami, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53, 93 n.94 (2003-04) (“It is commonly assumed, for example, that underwriters’ concern for their reputation would make them investigate the quality of prospective issuers in the absence of liability.”); John C. Coffee, Jr. *Understanding Enron: “It’s about the Gatekeepers, Stupid,”* 57 Bus. Law. 1403, 1405 (2001-02) (“[Reputational gatekeepers] relative credibility [stem] from the fact that it is in effect pledging its reputational capital that it has built up over many years of performing similar services for numerous clients.”); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L. Q. 491, 495 (2001) (“The arguments in favor of gatekeeper liability assume that when it is too costly for the issuer to bond itself..., one or more third party intermediaries will be able to step in and offer their reputation as a

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pay for their customers' losses. Thus, D&O insurers have the best incentive to get that advice right and should have a comparative advantage over other suppliers of loss prevention advice for this reason.<sup>102</sup> Yet, their advice is so undervalued that they no longer invest real resources in providing it. Why?

A. THE MORAL HAZARD PROBLEM

The term “moral hazard” refers to the tendency of insurance to reduce an insured’s incentive to take care to avoid loss and, thereby, to increase loss.<sup>103</sup> The economic analysis of insurance teaches that insurance increases loss whenever the following conditions are met: (1) money compensates for loss; (2) the decision-makers are rational loss minimizers; (3) taking care requires effort; (4) taking care is effective; (5) the beneficiaries of the insurance have control over the care-taking activity; and (6) insurance payments are not conditioned on a given level of care.<sup>104</sup> Especially in the liability insurance context, it is important to keep in mind that the “loss” includes not only the harm that leads to the claim, but also all the financial costs of the claim. Therefore, claims management is part of the care-taking activity.<sup>105</sup>

In some other contexts there are good reasons to doubt that insurance poses a real moral hazard problem – because one or more of these conditions are not satisfied.<sup>106</sup> By contrast, D&O insurance meets *all* of these conditions. First, unlike health insurance, all of the losses are monetary, and money surely compensates for money. Second, whether corporate executives always behave as rational loss minimizers can be debated, but corporate decisions conventionally are

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replacement for the issuer’s bond.”); Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. L. REV. 916, 942 (1997-98) (“To avoid the collapse of the certification market due to certifier infidelity, certifiers may bond themselves to remaining faithful in their screening role”). We are inclined to doubt that this form of bonding is as complete in the loss prevention context as that of D&O insurers. Among other reasons, D&O insurers also have reputational interests that exceed the amount at stake in any particular transaction. Moreover, the consumer of loss prevention services is the corporate client itself, not the shareholders and other outside constituencies addressed in the gatekeeper literature.

<sup>102</sup> Griffith, *supra* note 7.

<sup>103</sup> See sources cited in note 14 *supra*

<sup>104</sup> Baker, *supra* note 14 at 276.

<sup>105</sup> *Id.*, at 276 n. 186.

<sup>106</sup> *Id.* at 283-89.



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regarded as rational and the incentive effects of liability are based on that assumption.<sup>107</sup> Third, implementing corporate governance controls, complying with securities laws, managing loss costs, and other aspects of care taking require effort. Fourth, these efforts help prevent loss. Good governance and compliance cannot guarantee that the stock price will not drop and that the shareholders will not sue, but both corporate and securities law are based on the assumption that such efforts will reduce fraud and other bad acts. Fifth, the directors and officers who most directly benefit from the insurance are in charge of the corporation and, thus, they do control the care-taking activity. Finally, as we have reported, D&O insurers do not condition their coverage on the level of care.<sup>108</sup>

Are we reporting that D&O insurers do *nothing* to protect against moral hazard? No. D&O insurers do three things. First, they leave some of the risk on the corporation. B and C Side coverages have deductibles,<sup>109</sup> and corporations do face residual liability in the rare event that the settlement amount exceeds the limits of the coverage. As a result of these deductibles and limits, the insurance protection is incomplete, maintaining at least some incentive to prevent loss.<sup>110</sup>

Second, the D&O policy contains a moral hazard exclusion: the Fraud exclusion against liability based on a “dishonest, fraudulent, criminal act or omission or willful violation of any statute, rule or law.”<sup>111</sup> But, as we described earlier, the D&O policy typically provides that this exclusion only applies if there has been a final

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<sup>107</sup> See Marc Galanter, *Planet of the APs: Reflections on the Scale of Law to its Users*, 53 BUFF. L. REV. 1369, 1373 (2006) (reviewing literature supporting the claim that, “To a far greater extent than natural persons, [corporations] may be capable of acting in the purposeful, rational, calculating fashion that the legal system prefers to ascribe to actors”).

<sup>108</sup> See TAN 63-76.

<sup>109</sup> See TILLINGHAST, 2005 DIRECTORS & OFFICERS LIABILITY SURVEY 59, tbl. 47 (2006). The most recent Tillinghast D&O survey contains information on the deductibles for B and C side coverage organized by asset size of the survey respondents. Corporations with \$50-100 million assets reported median and mean deductibles of approximately \$300,000 and \$500,000, respectively. By contrast, corporations with over \$10 billion assets reported median and mean deductibles of \$5 million and \$8.9 million. See *id.* at 112, table 107.

<sup>110</sup> See Shavell, *Moral Hazard*, *supra* note 14 at 541 (noting that incomplete coverage is a partial solution to the problem of moral hazard).

<sup>111</sup> Executive Risk Indemnity, Inc., Executive Liability Policy, III.A.1. Similar language appears in both the AIG, Chubb, and Hartford policies. See *supra* note. A related exclusion prevents insurers from making payments to indemnify an insured person against unjust enrichment claims, thus preventing the insured from retaining any such gains. See AIG Specimen Policy, § 4.a.; Chubb Specimen Policy, §§ 7-8; Hartford Specimen Policy, § V.I.

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adjudication of actual wrongdoing by the insured in the proceeding for which coverage is sought.<sup>112</sup> Moreover, for any officer or director subject to such final adjudication, there almost always are others who do not come within the scope of the exclusion yet had an opportunity to prevent or reduce the impact of the fraud.<sup>113</sup> As a result, our participants report that the Fraud exclusion almost never allows a D&O insurer to avoid coverage for a claim.<sup>114</sup>

Third, D&O insurance companies have some control over settlements, with the result that the corporation cannot simply hand money to plaintiffs to make them go away. But, strikingly, D&O insurers give public corporations and their directors and officers essentially a blank checkbook to cover the costs of defense. Defense costs do count against the limits of the insurance – thereby reducing the amount available to settle the claim – but the fact that most claims settle well within the total limits of the D&O insurance program<sup>115</sup> suggests that this “defense within limits” feature does not constrain defense costs in most cases.

What all this suggests is that the existing form of D&O insurance does not simply distribute the risk of legally compensable investment losses. Instead, that form of D&O insurance likely increases those losses and, because of the comparatively unmanaged *ex post* moral hazard, almost certainly increases the overall cost of those losses.

## B. THE CORPORATE INSURANCE PUZZLE

As described earlier, most D&O policies offer two kinds of protection—individual coverage for directors and officers and entity-level coverage for the corporation itself—and the vast majority of

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<sup>112</sup> See TAN 43, *supra*.

<sup>113</sup> See Claims Manager #2, p. 39:

You have got issues that will sometimes arise, not frequently, but will sometimes arise is whether the conduct of the individuals is such that it triggers a coverage issue with respect to those individuals or whether the conduct of the people who applied for the insurance with knowledge of that wrongdoing gives rise to a right to rescind the policy altogether.

Note that there is not good research on the frequency of out of pocket payments by insiders; this is a topic addressed in our ongoing D&O insurance claims research.

<sup>114</sup> For example, the D&O insurers for Enron paid notwithstanding the eventual criminal convictions of corporate officers. Indeed, the Washington Post reported that the D&O insurance payments included \$17 million to Jeffrey Skilling’s criminal defense lawyers. See Carrie Johnson, *After the Enron Trial, Defense Firm is Stuck with the Tab*, WASHINGTON POST, June 16, 2006 D1.

<sup>115</sup> See TAN 51, *supra*.

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corporations purchase both. Individual coverage is easy to understand. Directors and officers, because they are risk-averse and eager to protect their personal assets, will not serve without individual-level coverage.<sup>116</sup> They could, of course, purchase the coverage themselves, but the managerial labor market appears to have allocated the expense of individual D&O coverage, like any other executive perquisite, to the corporation itself.<sup>117</sup> In any event, the explanation for the individual coverage is a simple one, based upon individual risk-aversion and labor market dynamics.

Corporate coverage, however, presents a puzzle. The entity protection aspect of D&O insurance spreads the risk of shareholder litigation from the corporation itself to a third party insurer. The insurer, of course, does not do this for free but rather charges the insured a premium that represents an actuarially determined probability of loss plus a loading fee.<sup>118</sup> This loading fee, representing the insurer's costs and profits, compensates the insurer for its efforts.<sup>119</sup> Loading fees mean that the cost of buying insurance always exceeds the actuarial probability of loss (otherwise the insurer would be driven out of business).<sup>120</sup>

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<sup>116</sup> See, e.g., Randy Parr, *Directors and Officers Insurance*, in D & O LIABILITY INSURANCE 2004: DIRECTORS AND OFFICERS UNDER FIRE 13 (PLI 2004). See also Finch, *supra* note 62.

<sup>117</sup> Coverage for individual directors and officers was recognized as an aspect of compensation early in the evolution of D&O insurance. See, e.g., Joseph F. Johnston, Jr., *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993, 2013 (1978) (stating that the fact that the corporation paid D&O premiums “was nothing more than another form of compensation for the executives and another way of attracting capable managers”). Interestingly, the first D&O policies allocated a portion of the premium, usually 10%, to the individual insured. See Wallace, *More on Sitting Ducks: (Officers and Directors, That Is)*, INSURANCE, April 16, 1966, 32, 36 (describing then-typical “ration of 90% of the premium to the corporation and 10% to the officers and directors”). This aspect of the policy has been discontinued, presumably because individual directors and officers asked for and received corporate payment of the full premium.

<sup>118</sup> KARL BORCH, *ECONOMICS OF INSURANCE* 13-15, 163 (1990) (describing the insurance premium as the sum of the expected claim payment under the insurance contract, the administrative expenses of the insurance company and the reward to the insurer for bearing the risk, later referring to the difference between expected claims payments and the insurance premium as the “loading” of the contract).

<sup>119</sup> Due to the limits of publicly available data, these loading costs cannot be computed with precision, but they are reported to be somewhere between twenty and thirty percent. Marc Siegel, *The Dilemmas in the D&O Market: Where Do We Go from Here?* Presentation at 2006 D&O Symposium of the Professional Liability Underwriting Society, February 1, 2006 (available at [http://www.plusweb.org/Downloads/Events/Dilemmas\\_in\\_The\\_DO\\_Market.ppt](http://www.plusweb.org/Downloads/Events/Dilemmas_in_The_DO_Market.ppt)).

<sup>120</sup> As a result, individuals ought to purchase insurance only against large potential losses that, if incurred, would significantly diminish their quality of life and not

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Insurance nevertheless may be a wise investment for those with no other means of spreading the risk of loss. But the owners of corporations—the shareholders—have another, cheaper way to spread the risk of loss. The basic lesson of modern portfolio theory is that shareholders can eliminate idiosyncratic risk—that is, firm-specific losses not simultaneously experienced by most firms in the market—by holding a diversified portfolio of equity securities.<sup>121</sup> Because the risk of shareholder litigation is largely idiosyncratic, attaching to a specific firm and not the market generally, it is one of the risks that can be managed through diversification.<sup>122</sup> The B and C sides of D&O insurance, in other words, are unnecessary to spread the risk of shareholder litigation because investors can spread the risk themselves by holding a diversified portfolio.

But perhaps it is necessary to protect undiversified investors? After all, not all investors hold the market portfolio. Those that do not might prefer the protection offered by D&O coverage. Perhaps, but it is a tortured interpretation of fiduciary duty that would have directors seeking to maximize shareholder welfare by purchasing high-cost insurance against a risk that some of shareholders have already eliminated in their own portfolios and that all shareholders easily *could* eliminate. Those that do not eliminate the risk either have chosen not to (and why subsidize them?<sup>123</sup>) or are too

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against small losses—though extended consumer warranties, for example—that one could easily bear oneself. See ROBERT I. MEHR & EMERSON CAMMACK, *PRINCIPLES OF INSURANCE* 35 (1976) (“Insurance for small losses which can be absorbed is uneconomical because the insurance premium includes not only the loss cost but also an expense margin.”).

<sup>121</sup> See generally EDWIN J. ELTON, MARTIN J. GRUBER, STEPHEN J. BROWN, WILLIAM N. GOETZMAN, *MODERN PORTFOLIO THEORY AND INVESTMENT ANALYSIS* (6<sup>th</sup> ed. 2003).

<sup>122</sup> Some portion of securities fraud surely is systemic. For one thing, securities fraud losses are likely to be biased in one direction – i.e., the losses typically are incurred when an artificiality inflated price deflates. In addition, asset bubbles may increase the likelihood of securities violations, and the bursting of a bubble surely increases the likelihood that violations will be detected, suggesting not only that the losses are biased in one direction, but also that they are correlated to at least some degree. Nevertheless, unless there is reason to believe that D&O insurance can spread these systemic risks better than holding a diversified portfolio (we can think of no such reason), the systemic aspect of securities fraud does not provide a justification for D&O insurance.

<sup>123</sup> A recent article by Zohar Goshen and Gideon Parchamovsky, *The Essential Role of Securities Regulation*, 55 *DUKE L. J.* 711 (2006), argues that “information traders” should be regarded as the primary beneficiaries of securities regulation, including the disclosure and liability rules that provide the legal basis for securities class actions. Information traders are systematically exposed to securities misinformation risk and, thus, they represent a potentially appealing class of non-

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unsophisticated to recognize the choice. It is laudable to seek to help unsophisticated investors, but imposing this partial, inefficient and narrowly targeted cross-subsidy on the rest of the market seems an inappropriate way of doing so.<sup>124</sup>

Why, then, do so many corporations buy corporate coverage? Unless insurance offers some benefit other than mere risk-spreading, the purchase of entity-level D&O coverage would appear to be a negative net present value transaction.<sup>125</sup>

Some corporations, we should note at the outset, do purchase only Side A coverage in their D&O packages.<sup>126</sup> In fact, one risk manager reported that his corporation's approach to D&O coverage has "evolved from protecting our balance sheet to protecting the individual D&O balance sheet."<sup>127</sup> After a long history with traditional A, B, C coverage, his corporation now purchases only Side A coverage.<sup>128</sup>

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diversified investors who may benefit from D&O insurance. Whether pure risk distribution D&O insurance provides sufficient benefits to information traders to justify the costs to other, diversified shareholders is an empirical question that we leave for later work. We note here only that the potential for the risk distribution aspect of D&O insurance to benefit information to benefit information traders provides an additional reason to require public corporations to disclose all the terms and conditions of D&O insurance insurance policies. See Griffith, *supra* note – (justifying public disclosure on other grounds).

<sup>124</sup> Cf., Tom Baker, Securities Misinformation Insurance: Report to the Task Force for Financial Modernization, Investment Dealers Assn. of Canada (2006) (evaluating a proposal for first party insurance against misinformation losses and rejecting the compensation justification even for non-diversified investors); Sean J. Griffith, *Daedalean Tinkering*, 104 U. Mich. L. Rev. 1247, ---- (2006) (critiquing proposals for an investor insurance scheme).

<sup>125</sup> We do not address in this Article forms of insurance other than D&O insurance, but it is clear that some of these same concerns apply to all corporate insurance. Our intuition is that D&O insurance differs from most other traditional forms of corporate insurance in terms of the moral hazard that is presented, because the behavior that leads to securities class actions is more likely to be the behavior of the senior executives than the behavior that leads to many other large insured losses, such as factory fires or mass tort actions.

<sup>126</sup> See Dan A. Bailey, Side-A Only Coverage (available online at <http://www.baileycavalieri.com>) (reporting that Side A coverage is becoming more prevalent). *But see* TILLINGHAST, 2005 DIRECTORS & OFFICERS LIABILITY SURVEY 47 (2006) (Reporting that about 2% of all insured participants purchased side A coverage only).

<sup>127</sup> Risk Manager #3, p. 3.

<sup>128</sup> The transition took place within the last five years. In his words: [T]here is probably 25% or maybe even less of the large corporate buyers have evolved to [Side-A-only coverage]. And again, this is a relatively recent occurrence for us. If you look in the rearview mirror, four years ago we were buying insurance similar to the way a lot of our peers still buy it, which is A, B, C coverages. Risk Manager #3, p. 4.

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In the ensuing conversation with him, we pursued the reasons for this change. He offered several, including the erosion of the value of the coverage through bad actors and the reappearance of allocation issues as well as the inability of his (very large) corporation to purchase limits adequate to cover its possible exposure.<sup>129</sup> In his words:

What precipitated this? Enron, WorldCom, ... all the D&O things that were going on. If you go back and you look in the press and you talk to people in the industry, what was the value of the insurance that was being purchased, and how was it being eroded? It was being... eroded by bad guys and the potential for corporate indemnification. You know, it became an issue as to who was first in the door looking to have their claims paid. So the bad guys were getting their claims paid because they had defense costs by outside insurers. There were quite a few bad guys that were eroding the good guys' insurance, and then there was the idea, you know, coming out of some of those major financial meltdowns that the judges could potentially go after in bankruptcy proceedings [on the theory that] these policies are assets of the corporation, when in fact the original intent of D&O insurance was to protect directors and officers, not the corporation. ... We basically said we are going to go back to its original purpose.<sup>130</sup>

Price, in other words, was not a principal consideration in this corporation's decision. As the risk manager further described the issues then under consideration:

There were certainly pricing pressures, and when we review our coverages up with the board and the finance committee of the board, you know, we do have price in there, but I don't think it was a price issue. I really think we went back to, what's the intention of the purchase of this insurance product? Who is it protecting? And how do we get the most value out of it for those individuals?<sup>131</sup>

As alluded to by this risk manager, the purchase of only Side A coverage offers at least three tangible benefits to directors and officers. First, because most D&O claims are indemnifiable and Side A coverage only responds to non-indemnifiable losses, the insurance

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<sup>129</sup> On this last point, he said: "the value of the B and C coverage was not nearly as great [as the value of the A coverage], because... the size of the limits we were purchasing didn't really protect our balance sheet adequately." *Id.* at 5. See also *supra* note XX (quoting this interview).

<sup>130</sup> Risk Manager #3, pp 7-8.

<sup>131</sup> *Id.* at 9.

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for the individual insureds will not be eroded by corporate losses.<sup>132</sup> Second, because there is no corporate benefit from Side A coverage, there is no bankruptcy allocation issue.<sup>133</sup> And finally, insurers may offer Side A coverage without the same carve-outs and exclusions as traditional A-B-C coverage.<sup>134</sup>

It is thus somewhat strange that more companies do not purchase Side-A-only coverage. The sections that follow seek to offer explanations for this puzzle and for the fact the D&O insurance that is purchased does not provide the monitoring services that economic theory predicts.

1. TRADITIONAL SOLUTIONS TO THE CORPORATE INSURANCE  
PUZZLE

The availability of risk spreading through investment diversification has prompted several economists, starting with Mayers and Smith, to seek to solve the puzzle of corporate insurance.<sup>135</sup> Their explanations include: (1) tax benefits,<sup>136</sup> (2) bankruptcy transaction costs,<sup>137</sup> (3) credit costs,<sup>138</sup> (4) the cost of external capital

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<sup>132</sup> See Dan A. Bailey, *Side-A Only Coverage*, at 7, available online at <http://www.baileycavalieri.com> (describing a recent case where a corporation settled its securities claim for the limits of its traditional D&O policy, leaving the directors and officers potentially exposed to an unsettled derivative claim).

<sup>133</sup> See *Louisiana World Exposition v. Federal Ins. Co.*, 832 F.2d 1391 (5th Cir. 1987). See also *In re First Central Financial Corp.*, 238 B.R. 9 (Bankr. E.D.N.Y. 1999).

<sup>134</sup> Bailey, *supra* note 132, at 4 (“Since the vast majority of Claims covered under a D&O policy are indemnified by the Company, a Side-A only Policy allows Insurers to afford much broader coverage terms than reasonably possible under a Side-B policy.”).

<sup>135</sup> Mayers and Smith addressed this puzzle in a series of articles. See generally David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance*, 55 J. BUS. 281 (1982); David Mayers & Clifford W. Smith, Jr., *Corporate Insurance and the Underinvestment Problem*, 54 J. RISK & INS. 45 (1987); David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance: Evidence from the Reinsurance Market*, 63 J. Bus. 19 (1990). See also Richard MacMinn & James Garven, *On Corporate Insurance*, in HANDBOOK OF INSURANCE 541.

<sup>136</sup> See Mayers & Smith, *Demand*, *supra* note 135, at 289-91, 294-95 (describing and modeling tax incentives for corporate insurance purchases); MacMinn & Garven, *Corporate Insurance*, *supra* note 135, at 557-60 (same).

<sup>137</sup> See Mayers & Smith, *Demand*, *supra* note 135, at 284-85; MacMinn & Garven, *Corporate Insurance*, *supra* note 135, at 548-505

<sup>138</sup> See Mayers & Smith, *Demand*, *supra* note 135, at 287 (noting that “[b]ond indentures frequently contain covenants requiring the firm to maintain certain types of insurance coverage”); MacMinn & Garven, *Corporate Insurance*, *supra* note

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relative to internal capital,<sup>139</sup> and (5) monitoring services that benefit the corporation directly or are demanded by other stakeholders.<sup>140</sup> As we will demonstrate, these rationales may explain the corporate purchase of some forms of insurance, but they cannot adequately explain the pattern of pure risk distribution D&O insurance that we observed.

*Tax.* The tax benefits of corporate insurance turn on the favorable treatment of market insurance over self-insurance. An insurance premium is a deductible business expense. By contrast, funds put into a reserve are not deductible, and the income earned on those funds is taxable. Losses that actually occur also are deductible business expenses,<sup>141</sup> but these losses are uncertain and in the future. The tax benefits of deducting an insurance premium today are greater than those of deducting an uncertain amount of similar expected value in the future.<sup>142</sup> Moreover, funds that the insurance company puts into reserves are deductible business expenses; as a result the insurance company can accumulate funds more cheaply than a corporation. These benefits make the insurance cheaper than it otherwise would be, but they do not make the insurance free.<sup>143</sup> The “insurance” provided by a diversified portfolio is essentially free. Moreover, the tax benefits cannot explain the preference for a form of insurance that makes little or no effort to control loss costs either *ex ante* or *ex post*.

*Bankruptcy.* The bankruptcy explanation turns on the fact that bankruptcy risk leads a corporation’s contracting partners to increase their prices. Measures that reduce the risk of bankruptcy therefore have cost saving benefits across a wide range of corporate activity.<sup>144</sup> Bankruptcy costs are unlikely to explain the corporate protection

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135, at 550-57 (modeling corporate insurance as a means to mitigate agency problems between corporate managers and bondholders).

<sup>139</sup> See generally, Kenneth A. Froot, David S. Scharfstein, & Jeremy C. Stein, *Risk Management: Coordinating Corporate Investment and Financing Policies*, 48 J. Fin. 1629 (1993).

<sup>140</sup> See Mayers & Smith, *Demand*, supra note 135 at 285-86. See also Mayers & Smith, *Underinvestment*, supra note 135 at 46 (summarizing the monitoring services).

<sup>141</sup> See Rev. Rul. 80-211 (1980)) (concluding that even “Amounts paid as punitive damages incurred by the taxpayer in the ordinary conduct of its business operations are deductible as an ordinary and necessary business expense under section 162 of the Code”).

<sup>142</sup> See MacMinn and Garven, supra note 135 at --.

<sup>143</sup> See John Core, *On the Corporate Demand for Directors’ and Officers’ Insurance*, 64 J. Risk & Ins. 63, 68 n. 10 (1997) (arguing that “any tax effects are at most second-order in magnitude”).

<sup>144</sup> See MacMinn and Garven, supra note 135 at --.



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aspect of D&O insurance, however, because the D&O insurance programs we observed cannot credibly make the difference between a firm going bankrupt and not. A corporation seeking bankruptcy protection would have high limits, because it is only the very rare massive claim that threatens most corporations' solvency, not the more routine (albeit still sizeable) securities class action. By contrast, D&O insurance programs have low limits relative to worst-case exposure.<sup>145</sup> It thus appears, from this structure of coverage, that corporate managers are not buying D&O insurance to protect shareholders from bankruptcy costs. Even if they were, however, bankruptcy transaction costs cannot explain the demand for a pure risk distribution form of insurance.

*Credit costs.* It is obvious why a secured creditor would demand that a corporation purchase insurance covering the asset pledged as security. But it is equally obvious that this example cannot explain D&O insurance, because D&O insurance does not protect particular assets. The only contracting parties in a position to demand D&O insurance are the directors and officers themselves, and their needs can be met by Side-A-only coverage.

Mayers and Smith demonstrated theoretically, however, that even unsecured creditors should prefer to lend to an insured corporation. While the economics are technical, the basic intuition is that a serious, uninsured loss destroys equity and therefore increases the debt to equity ratio of the firm. In some circumstances this leads to a conflict of interest between shareholders and bondholders that Mayers and Smith called the "underinvestment problem."<sup>146</sup> In that situation new investment would benefit bondholders but not shareholders. Since the shareholders are in charge, the corporation does not make the investment, even if the investment has a positive net present value. Insurance solves that problem because it reduces the impact of the loss on the debt to equity ratio of the firm. As a result, even unsecured creditors will grant better terms to a corporation with insurance, especially if that corporation is highly leveraged. These

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<sup>145</sup> See note 109, *supra* (summarizing relationship between deductibles and asset size). See Risk Manager #3, p. 6 ("[T]he most we could purchase for the corporate side was in the 200 to absolute maximum 300 million available. I mean our balance sheet is billions of dollars.... [E]xcess of 300 million or whatever insurance we could buy, we were self-assuming that."). By contrast, insurance limits of \$1 billion or more are relatively common in the property and general liability insurance programs of large corporations.

<sup>146</sup> Mayers & Smith, *Underinvestment*, *supra* note 135 at 51-52.

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reduced credit costs may offset insurance loading costs in some highly leveraged corporations. But, once again, these benefits cannot explain the preference for D&O insurance that makes little or no effort to control loss costs either *ex ante* or *ex post*.

*Costs of external capital.* Froot, Scharfstein and Stein observed that public corporations engage in a variety of hedging transactions despite the ability of investors to diversify.<sup>147</sup> Insurance is one strategy for hedging losses; thus, their analysis is directly relevant to the corporate insurance puzzle. They identified one important additional reason to hedge beyond those identified by Myers & Smith in the corporate insurance literature, namely the additional costs of raising external capital. For a variety of reasons that include transaction costs and information asymmetries between managers and investors, Froot, Scharstein and Stein posit that going out to the market to raise capital is more expensive than generating the same amount of capital internally.<sup>148</sup> But a firm's ability to generate capital internally is limited by its cash flow, so many corporations cannot self-fund capital shocks (particularly, we note, low frequency, high severity events like securities litigation or, for that matter, some other typically insured losses). Hedging transactions allow firms to reduce the likelihood of a mismatch between cash flow and investment needs. Thus, to the extent that the cost of a hedging transaction is less than the additional costs of raising capital externally, the transaction adds value to the corporation.

Along with the tax explanation, we find this cost of capital explanation the most compelling of the traditional explanations, for the following reason. Consider that a firm that is in the midst of shareholder litigation is in a disadvantageous position for raising capital. Traditional methods of raising capital—from equity investors or creditors—may not be available in the midst of a large shareholder claim or, if capital is available, it may only be available on sub-optimal terms. The cost of external capital, in other words, is likely to be higher than usual in the midst of shareholder litigation.

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<sup>147</sup> Froot et al, *supra* note 139, at 1631.

<sup>148</sup> Froot et al also observed that hedging also can provide private benefits to managers and, thus, managers may act as if the cost of external capital is more costly than it is. *Id* at 1634. We regard this as an example of an agency cost, an explanation that we address more fully *infra*, TAN 164-74.

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The obvious means of avoiding this situation is to set up reserves and to fund losses from shareholder litigation.<sup>149</sup> But for an operating company, reserving has the disadvantage of diverting capital when it might be used more efficiently elsewhere within the firm. This will be especially true for companies that fuel growth by reinvesting cash flows into the business. Moreover, as explained earlier, tax law discourages reserving. What a firm in this situation needs is a commitment from a creditor to make capital available at a time when traditional means of raising capital are unavailable or prohibitively expensive. This is precisely what D&O insurers do through Side B and C coverage. Seeing the coverage through this lens thus makes the D&O premium seem analogous to capital commitment fees paid to lenders for a commitment to make funds available upon the occurrence of a specified event, such as a successful takeover offer.<sup>150</sup> The D&O insurer essentially commits to make funds available in the event that the insured incurs losses through shareholder litigation.

Viewed in this way, the purpose of entity-level coverage is to protect the corporation from borrowing on disadvantageous terms once a claim has arisen. Instead, the funds are promised from an insurer on a clear day when there is no loss on the horizon. The cost of the premium will be worth incurring when it is less costly to the firm than other forms of contingent financing. It is therefore conceivable that some form of D&O insurance might in fact be the low cost form of contingent financing. Once again however, that form of D&O insurance seems quite unlikely to be pure risk distribution D&O insurance – because of the moral hazard problem.

*Monitoring.* Economists have also theorized that shareholders or other corporate stakeholders might want the corporation to

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<sup>149</sup> For present purposes it is immaterial whether the corporation sets up an internal reserve or, instead, sets up a captive insurance company or a trust. All three options receive essentially the same tax treatment. See generally Richard M. Cieri & Michael J. Riela, *Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DEPAUL BUS. & COMM. L. J. 295 (Observing the taxable comparability of these three mechanisms). However, “captured” insurance companies may not be classified as being in the business of insurance if they are wholly owned by one corporation. This is due largely to the absence of risk-spreading. As a consequence, unrelated corporations have begun to pool their assets to create group captured insurance companies that would side-step this particular limitation. *Id.*

<sup>150</sup> See Richard L. Shockley & Anjan V. Thakor, *Bank Loan Commitment Contracts: Data, Theory and Tests*, 29 J. MONEY, CREDIT AND BANKING 517 (1997).

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purchase insurance because the corporation may not have the economy of scale needed to develop loss prevention or loss management expertise. Mayers and Smith refer to this as the “real service efficiencies” of insurance.<sup>151</sup> Monitoring is the key to these efficiencies. Shareholders may demand monitoring services from an insurer to counteract tendencies within the firm to underinvest in loss prevention technologies.<sup>152</sup> Similarly, other corporate constituencies, such as employees or bondholders may demand insurance-based monitoring to control managers’ post-loss opportunistic behavior.<sup>153</sup> Mayers and Smith refer to this as the “bonding” benefit of insurance.<sup>154</sup>

Nevertheless, hypotheses explaining D&O insurance as a function of the value added by an active insurer-monitor must be rejected when confronted with our basic empirical finding that insurers in fact provide no monitoring. Our basic finding is that D&O insurers fail to monitor the corporations they underwrite. Demand for monitoring cannot explain the purchase of insurance that in fact provides no monitoring.

## 2. MARKET FAILURE EXPLANATIONS

Our participants provided two insurance market failure explanations for the pattern of D&O insurance that we observed. First, some participants reported that corporations do not buy Side-A-only policies because those policies are too expensive relative to the protection that is provided, and the additional cost of purchasing Side B and C coverage is less than the marginal benefit of entity-level coverage. Second, other participants reported that corporations do not buy D&O policies that manage defense costs because insurance companies cannot be trusted to manage the defense in the corporation’s best interest.

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<sup>151</sup> Mayers and Smith refer to this as the “real service efficiencies” of insurance. See *Demand*, *supra* note 135 at 285.

<sup>152</sup> Mayers and Smith use the example of property insurers that require the installation of sprinkler systems to reduce the risk of fire. *Id.* at 286.

<sup>153</sup> *Id.* at 287-88.

<sup>154</sup> *Id.* See also MacMinn & Garven, *supra* note 135 (supporting these arguments as sound theoretical bases for corporate insurance).

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*a. Mispricing of Side-A-only policies*

Several of the participants in our study suggested that the discount for purchasing Side-A-only coverage is not large enough. Following the numerical example offered by one of the risk managers we interviewed: if 85% of claims paid are under Sides B and C of a traditional insurance policy, the price for equal limits under a Side-A-only policy should be approximately 15% of the cost of a traditional A-B-C package.<sup>155</sup> Side-A-only coverage, however, is not offered at this discounted price. Indeed, our respondents reported that the discount offered for Side-A-only coverage does not compensate the corporation for the foregone coverage.<sup>156</sup>

Most of the risk managers in our study supported this explanation. When asked why his firm purchases Side B and C coverage, one responded:

We evaluate it every year. But I would say that ... maybe 70-80% of large companies still do the A, B and C. We have heard of a few companies just going out and doing a Side A, bankruptcy protection. ... But we haven't seen it done, because when it all comes down to it, you know, you really are protecting the assets of the corporation. ... You could [buy Side-A-only]. I am not arguing against that. It is a decision you truly go through each year. ... And you think about it, but there is no patent answer for that. It depends on the price.<sup>157</sup>

Another replied:

[F]rom my perspective as a risk manager, the reason why I buy Side C coverage or I recommend that we buy it here is because I feel that it would be negligent not to buy it. ... There is not enough credit for excluding it out of the policy. If there was, we would probably [not buy] it because philosophically we don't agree with the coverage.<sup>158</sup>

These answers support a view that the value of balance sheet protection to the corporation is greater than the cost of the coverage, at least when compared to the discount offered for buying a Side-A only policy.

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<sup>155</sup> Risk Manager #1, pp. 33-34.

<sup>156</sup> *Id.*, at 34 (concluding that “the knock I have heard in panel discussions, things like that, is that the credit that you get for dropping [B and C Side coverage] is not worth what you are actually getting if you are losing coverage”). Complicating this analysis is the fact that Side-A-only policies may offer broader protection for the directors and officers. See TAN 134, *supra*.

<sup>157</sup> Risk Manager #2, p. 33.

<sup>158</sup> Risk Manager #4, p. 15.

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Nevertheless, this is an odd explanation since it suggests that there is a failure in the market for Side-A-only coverage. If it is true that the discount for purchasing Side-A-only coverage is not commensurate with the insurer's reduced risk, why don't insurers sell Side-A-only coverage for less? Is it because they want to discourage this line of coverage to maximize premium dollars? But that would seem to be a losing strategy since there is nothing to prevent another insurer from appropriately pricing Side A coverage and thereby gaining market share.

Moreover, given that shareholders can spread these risks costlessly (or nearly so) simply by holding a diversified portfolio, Side B and C policies are really only a bargain if the insurer is essentially giving them away. Do insurance companies always get the pricing right? Clearly not.<sup>159</sup> But if insurance companies *always* underpriced the product, one would expect losses to drive them to abandon the product. Thus, although our data do not permit us to conclusively reject this explanation, we view it as a particularly weak explanation for entity-level coverage because it depends upon persistently irrational pricing by sophisticated companies in a competitive business with low barriers to entry. Moreover, even if there were persistent underpricing of entity-level coverage, that mispricing would not explain the pure risk distribution form of that protection that we observed.

*b. Untrustworthy insurance claims services*

Our investigation of the D&O insurance claims process is ongoing and thus, a full explanation of that process awaits later work. Nevertheless we address here the assertion by some of our participants that corporations demand defense cost reimbursement coverage (as opposed to the duty-to-defend coverage more typical in liability insurance contexts) because D&O insurance companies cannot be trusted to act in the insured corporation's best interests in claims defense.

As Kenneth Abraham has described, corporate policyholders have had poor claims experiences with the liability insurance industry

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<sup>159</sup> See Sean M. Fitzpatrick, *Fear is the Key: A Behavioral Guide to Underwriting Cycles*, 10 CONN. INS. L. J. 255 (2004).

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over the last twenty-five years.<sup>160</sup> Liability insurance coverage disputes routinely follow in the wake of any significant environmental or product liability claim, with the result that litigation with customers has become an acceptable, normal state of business relationships for the major commercial insurance companies that also sell D&O insurance. This history has had a corrosive effect on the perceived trustworthiness of insurance companies. A senior lawyer in the general counsel's office of a Fortune 100 company pointedly asked us after describing his company's experience with general liability insurance claims, "Would you trust an insurance company to defend you in a securities claim?"<sup>161</sup> He clearly thought that the obvious answer to the question was "No."

Nevertheless, we are inclined to doubt this market failure explanation as well. First, D&O insurance claims are very different from the environmental and product liability claims that led to the reduction in trust. The environmental and products liability claims arose under policies sold years and even decades before the claims arose, at a time when no underwriter could have predicted either their frequency or severity, and, thus, insurance company leaders may have had some justification for thinking that it was reasonable to contest their companies' responsibility for these claims. By contrast, D&O insurance claims typically relate to recent behavior of a kind that D&O insurance underwriters cannot claim to be a surprise.<sup>162</sup> Second, D&O insurance companies have demonstrated that they are responsive to the market demands of the very sophisticated corporate purchasers of D&O insurance. If corporate buyers wanted D&O insurance that managed the defense costs of shareholder litigation, D&O insurance programs could be restructured to do so.<sup>163</sup> Moreover, these buyers could exert market discipline over insurers that earned a reputation for providing an inadequate defense.

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<sup>160</sup> Kenneth Abraham, *The Rise and Fall of Commercial Liability Insurance*, 87 Va. L. Rev. 85 (2001).

<sup>161</sup> Associate General Counsel #1.

<sup>162</sup> D&O insurance policies are "claims made" policies, meaning that they apply to claims made during the policy period regardless when the underlying injury took place. By contrast, the commercial general liability insurance policies typically apply to injury during the policy period, regardless when the claim eventually is made. See generally, Bob Works, *Excusing Nonoccurrence of Insurance Policy Conditions in Order to Avoid Disproportionate Forfeiture: Claims-Made Formats as a Test Case*, 5 Conn. Ins. L. J. 505 (1998-99).

<sup>163</sup> See TAN 181-82 *infra*.

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3. AGENCY COST EXPLANATIONS

If the existing form of Side B and C coverage represents a negative net present value investment from the shareholders' point of view, there may nevertheless be some within the firm who would prefer, for their own reasons, to make the investment. This divergence between the interests of the firm's managers and its owners is an example of agency costs.<sup>164</sup> In this context, there may be two types of agency costs: (a) risk manager agency costs, and (b) executive agency costs. Unlike any of the other explanations we have explored, agency costs do explain the pure risk distribution form of D&O insurance that we observed.

*a. Risk Manager Agency Costs*

Risk manager agency costs exist if the corporation's risk manager has an incentive to purchase D&O insurance notwithstanding the fact that such insurance may be a negative net present value investment from the shareholders' point of view. The basis for this divergence in incentive is obvious—the risk manager may suffer adverse career consequences if she did not buy insurance against a loss that *ex post* seems costly to the firm. One of the risk managers in our study candidly suggested this explanation:

I guarantee you that no matter what anybody says or anybody tells you, a big loss comes in to a company and it is 100, 200 [million]. You say what? “I have bankruptcy protection over there, but this 200 million thing against the company, I don't have anything for it.” Yeah. You would be [in trouble]. ... So there is an element of making sure there is comprehensive protection.<sup>165</sup>

From a strictly *ex post* point of view, insurance against a significant loss may seem like a good idea even if the *ex ante* value of the insurance is less than its cost. If her superiors will tend to view loss from an *ex post* point of view, a risk manager may purchase D&O insurance in order to protect her own career regardless of the shareholders' preferences. This incentive is compounded if there are

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<sup>164</sup> See generally Jensen & Meckling, *supra* note XX (describing agency costs as the divergence in interests between shareholder principals and manager agents).

<sup>165</sup> Risk Manager #2, pp. 34-35.



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also executive agency costs within the organization that favor the purchase of comprehensive D&O coverage.

This *ex post* perspective and compounded incentives help explain nearly pure risk distribution form of existing D&O insurance, especially the absence of defense cost management. Managers and directors facing securities litigation apparently prefer the maximum autonomy, blank checkbook approach to D&O insurance coverage, and they are not going to be pleased with a risk manager who agreed in advance to hand over the defense to an insurance company, even if that decision might have made sense from an *ex ante* perspective. The following excerpt from an interview with the head of the claims department in a leading D&O insurer illustrates this point:

They got a D&O policy to pay for it, and the general counsel, the last g-d damn thing that he wants to do - excuse my language - is to walk into the CEO's office and say, "Oh, I cut their bill in half." The CEO is going to say, "Wait a second. In other words, I am not getting the best possible defense because you are pissing them off? Oh, I don't think so. You know, I've got a huge house in Greenwich. I want to keep that huge house. I've got the mistress. I've got the Mercedes. ... Why the hell are we doing this?"<sup>166</sup>

*b. Executive Agency Costs*

Executives, unlike shareholders, are not able to avoid the idiosyncratic business risks generated by the firm they manage since they have a more personal stake—their jobs and their pay packages—in that firm.<sup>167</sup> D&O losses threaten executives in two ways. First, large losses may push the firm towards insolvency (and lead to job loss) or, short of actual insolvency, may make the firm a takeover target (and lead to job loss). Second, even if the losses are not large enough to threaten the financial stability of the firm, losses may have a significant impact on accounting measures of performance and compensation packages tied to those performance measures.<sup>168</sup>

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<sup>166</sup> CM #1, p. 27.

<sup>167</sup> The investment of human capital, in other words, is not easily diversified. See Mayers & Smith, *Corporate Demand*, *supra* note 135.

<sup>168</sup> See generally LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004) (detailing defects in the design of executive compensation packages that lead to similarly distorted incentives).

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Entity-level D&O insurance helps executives avoid both of these threats.

According to this explanation, executives may be motivated to purchase B and C Side coverage to protect their own positions and pay packages in spite of the fact that it may be a negative net present value investment from the shareholders' perspective.<sup>169</sup> In this way, entity-level D&O insurance is essentially a form of earnings management, allowing managers to avoid shocks to the firm's accounting statements in exchange for an annual premium, paid out of corporate funds. Because managers have a personal incentive to incur this annual expense when their shareholders would prefer that they did not, it is a form of agency cost.<sup>170</sup>

Moreover, when the managers select D&O insurance, the insurance they select does not provide monitoring. This, too, represents an agency cost. Buying D&O insurance without monitoring increases the freedom of managers to take risks that improve accounting measures of performance and, hence, their compensation, but not the long term value of the firm. If these risks lead to shareholder litigation, D&O insurers step in to pay the claim.

Econometric research on D&O purchasing patterns supports the managerial agency costs explanation. Chalmers et al studied the relationship between the amount of D&O insurance purchased in connection with an initial public offering and the later price of the stock that was offered, investigating the hypothesis that managers are willing to buy large amounts of D&O coverage at high premiums because they receive all of the benefits of the coverage but bear the costs only in proportion to their fractional ownership of the firm's equity.<sup>171</sup> They found a significant negative correlation between the three-year post IPO stock price performance of the company and the amount of insurance that the company purchased just before issuing the IPO. They concluded "managers choos[e] abnormally high D&O insurance coverage based on their belief that their shares are priced too high."<sup>172</sup>

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<sup>169</sup> See Griffith, *Uncovering a Gatekeeper*, supra note 7.

<sup>170</sup> Cf., Froot et al, supra note 139 at 1634 (describing potential private benefits to hedging). It is possible that investors may (irrationally) prefer such costly income smoothing, even though it would reduce their long-term investment returns.

<sup>171</sup> John M. Chalmers, Larry Y. Dann, Jarrad Haford, *Management Opportunism? Evidence from Directors and Officers Insurance Policies*, 57 J. Finance 609 (2002).

<sup>172</sup> *Id* at --.

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Similarly, Core studied the relationship between director pay and D&O insurance limits in Canadian firms, investigating the hypothesis that more entrenched managers are more likely to purchase D&O insurance.<sup>173</sup> (Unlike U.S. firms, Canadian firms are legally required to disclose their D&O insurance limits.) He found that “firms with higher excess director pay... are more likely to carry D&O insurance coverage and purchase higher limits,” suggesting that managers bundle compensation and insurance because they do not internalize the cost of either.<sup>174</sup>

C. THE COMPARATIVE ADVANTAGE PUZZLE

D&O insurers provide no monitoring services to public corporations *ex ante* and they do not monitor defense costs *ex post*. To us, this means that their customers prefer D&O insurance in a nearly pure risk distribution form, notwithstanding the resulting moral hazard. D&O insurance is sold in a highly competitive market. A D&O insurer that demanded *ex ante* or *ex post* loss prevention when competitors did not would quickly lose market share. Indeed, although one example does not constitute definitive proof, the one company that tried to market itself as a loss prevention specialist went out of business.

Nevertheless, even if D&O insurers could not insist on bundling monitoring and risk distribution, they might still be trusted suppliers of loss prevention services. Alone among all possible providers of loss prevention services, insurers fund the losses. They are bonded to their services. As Cohen explains,

[L]oss prevention services by an insurance company come with a stronger guarantee than loss prevention services by lawyers. The insurance company bonds its appraisal by agreeing to indemnify the insured for losses that occur; lawyers guarantee only nonnegligent appraisals.<sup>175</sup>

In addition, insurance companies are less subject to co-optation by the client than fee-for-service professionals because the insurer is less dependent on any one client for business.<sup>176</sup> As reported in our

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<sup>173</sup> Core, *supra* note 143, at 81.

<sup>174</sup> *Id.* at --.

<sup>175</sup> Cohen, TAN 134 (citing Mayers & Smith)

<sup>176</sup> *Id.* As Rose explains, some of the corporate governance rating firms have conflicts of interest because they provide consulting services to corporations. *See*

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companion Article, no single D&O insurer is willing to sell very high limits to any single corporation, with the result that D&O insurers hold a large portfolio of D&O risks.<sup>177</sup> Moreover, as the one ultimately on the hook for losses, insurers are likely less susceptible to the ideological biases of “corporate governance entrepreneurs.”<sup>178</sup> Finally, because insurance companies already assess corporate governance in the underwriting process, the insurer has a transaction cost advantage over at least some other competing service providers.<sup>179</sup>

Yet, according to our sources, corporations largely ignore D&O insurers’ loss prevention advice, and they do not look to D&O insurers for corporate governance audits, appraisals or other, more intrusive, monitoring services. This is the comparative advantage puzzle. To analyze that puzzle we first consider some potential institutional barriers to insurance monitoring and then return to agency costs.

1. INSTITUTIONAL BARRIERS TO INSURANCE MONITORING

As we have described, there are three main theoretical reasons why we expect to find monitoring bundled with loss distribution in the corporate insurance context: monitoring provides insurers with a way to manage moral hazard; monitoring provides benefits to shareholders who might not otherwise need risk distribution; and the “bonding” provided by risk distribution gives insurers a comparative advantage in monitoring. But of course the world does not always work as theory would suggest, in many cases because of institutional

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Rose, *supra* note – at – (referring to Institutional Shareholder Services and Governance Metrics International).

<sup>177</sup> See Baker & Griffith, *supra* note 8 at – (reporting \$50 million as the largest limit available from any one insurer and noting that in the recent hard market, no insurance company offered a policy larger than \$25 million, with most policy limits set at \$10 million or less).

<sup>178</sup> See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L J 1521, 1560 (2005). As described by Romano, corporate governance entrepreneurs have advocated governance innovations that make little or no difference in a corporation’s susceptibility to risk. Because the insurer ultimately bears corporate governance risk, it is unlikely to be fooled by merely cosmetic governance features.

<sup>179</sup> A corporation’s existing law firm and accounting firm would have a similar (and perhaps even superior) transaction cost advantage.

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barriers. In this section we consider the following potential barriers to bundling risk distribution and loss prevention services:

- The layered structure of D&O insurance programs,
- Underwriter knowledge and experience,
- The public good nature of best practices advice,
- Characteristics of securities misinformation losses that may make monitoring futile or prohibitively costly,
- The insurance underwriting cycle, and
- D&O insurers' own liability concerns.

As we will explain, these institutional barriers provide only a partial explanation for the missing monitor.

*The layered, excess-of-loss structure of D&O insurance programs.* D&O insurance programs consist of layers of insurance coverage provided by different insurance companies on an “excess of loss” basis (meaning that each insurer becomes responsible for a claim only after all of the lower layers of insurance are exhausted).<sup>180</sup>

This structure raises concerns about the fidelity of insurers' interests to those of the policyholder at the point of claim. If the insurer with the first layer at risk bears the entire defense burden, then the policyholder may be concerned that the insurer will shirk in the defense of the claim (because all that insurer has at risk is the limits of the policy it sold to the policyholder).<sup>181</sup>

There is an alternative way to structure an insurance program that would alleviate this concern: the “quota share” structure. In a quota share structure, each insurer is responsible for a percentage of the total insurance program limits, and one insurer (or claims management company) manages claims on behalf of all of the insurers in the program. This structure aligns the interests of each insurer with those of the total program and, subject to the risk of liability excess of the total limits, more closely aligns the insurers' interests with those of the policyholder. The existence of this alternative structure means that corporations' choice to employ the layered, excess of loss D&O insurance arrangement is a revealed preference, indicating that managers do not want D&O insurers taking a more active role in the management of defense costs or litigation.

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<sup>180</sup> See Baker & Griffith, *supra* note 8 at --.

<sup>181</sup> See Baker, *Liability Insurance Conflicts*, *supra* note 78 at – (explaining the low limits conflict).

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The excess of loss structure might similarly be misunderstood to be an obstacle to monitoring *ex ante*, because, as in the *ex post* situation, the benefits of the monitoring would accrue to the insurance program as a whole while the costs would be likely to be imposed on a single monitoring insurer (most likely the insurer first on the risk). Yet, *ex ante* monitoring costs would be predictably incurred in all cases, so the insurer responsible for monitoring can demand a larger share of the total D&O insurance program premium commensurate with that obligation.<sup>182</sup> Moreover, in contrast to the *ex post* situation, there is little or no opportunity for the *ex ante* monitoring insurer to attempt an opportunistic breach, because that insurer can easily be replaced. (The *ex post* situation presents an opportunity for opportunistic breach because, after a loss, it is too late to replace the misbehaving insurer.<sup>183</sup>)

*Underwriter knowledge and experience.* Perhaps an obvious explanation for the D&O insurer's failure to engage in *ex ante* monitoring is the claim that D&O insurance companies cannot competently monitor because they do not employ people with the necessary knowledge and experience. While we tend to agree that most current D&O insurance personnel currently lack the requisite skill set to be competent monitors of corporate governance (and believe that the insurance professionals we interviewed would agree as well), we feel that this explanation inverts cause and effect. Unless monitoring is futile or prohibitively costly (possibilities that we discuss shortly), then there are people who do have the knowledge and experience, and they could go to work for insurance companies – if there was a demand for bundled monitoring and risk distribution.

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<sup>182</sup> The same result would be possible in a quota share arrangement and, unless there were efficiencies to having the same organization provide the *ex ante* and *ex post* monitoring services, there is no reason that the same insurer (or management company) would be expected to provide both sets of services. It is worth noting that the need to provide additional compensation to the monitoring insurer provides an answer to the objection that the example of the D&O insurer that went out of business undercuts our argument about bundling loss prevention and risk distribution. Recall that the senior executive from this insurer reported that they abandoned their loss prevention effort because of the cost. See TAN – *supra*. It might be argued that this demonstrates that monitoring would not be effective in reducing losses. As we discuss below, it is empirically possible that monitoring would be futile or prohibitively costly. But this example does not provide strong evidence of this possibility because the monitoring insurer in a multi-insurer D&O insurance program can be expected to have higher costs than the other insurers even if monitoring is effective.

<sup>183</sup> See Works, *supra* note 162, at – (discussing opportunistic breach).

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Accounting firms, law firms, outside directors, and consulting firms are all presently selling compliance and other securities loss prevention services to public corporations. At least some of those professionals would be willing to work for D&O insurers, provided that they were adequately compensated. If there are in fact efficiencies to bundling risk distribution and loss prevention, then a D&O insurer should be able to provide these professionals adequate compensation. Like the current structure of D&O insurance programs, the current knowledge and experience of D&O insurance personnel seems more likely to represent a revealed preference of the managers buying D&O insurance policies than a real institutional barrier to bundling risk distribution and monitoring.

*The public good nature of best practices advice.* Some loss prevention advice comes in the form of information about best practices. The loss prevention guide we described in the empirical section of this Article is a good example.<sup>184</sup> Recall that the guide contained information about the Private Securities Liability Reform Act, analyst communications, insider trading and bad news disclosure, among other topics. Best practices information of this sort is a public good, with the result that an insurance company that invests in developing this information cannot capture the full return from that investment.<sup>185</sup> For this reason, individual insurers are not the best institutions to develop and disseminate best practices information. An individual insurers' comparative advantage comes in intrusive, detailed monitoring that is specific to the particular corporation and that cannot be duplicated without corporation-specific investments.

*The futility of insurance monitoring.* Perhaps D&O insurers do not provide such corporation-specific monitoring because it would not be cost effective, either because securities claims are random events or because getting sufficiently inside the corporation to provide effective monitoring would be prohibitively expensive. These are empirical assertions that we cannot answer definitively. Nevertheless, we offer the following observations on the basis of our research:

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<sup>184</sup> See TAN 69-72, *supra*.

<sup>185</sup> A public good will not assure its own supply because individuals fail to contribute to its production. Lighthouses are the classic example. Because one person's consumption of the light does not reduce the resource available for others and the light cannot be parsed and given only to those who pay, an individual may reason that he harms no one by making use of the light without paying for it. See generally R.H. Coase, *The Lighthouse in Economics*, 17 J.L. & ECON. 357 (1974).

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First, the idea that securities lawsuits are random events is a variation on the idea that the merits don't matter in securities litigation.<sup>186</sup> We summarized that debate in our companion Article and we hope to contribute to that debate when we report the results of our ongoing research into the securities litigation process. For present purposes we simply note that the continued existence of the private cause of action for securities law violations is predicated on the idea that the merits do matter, D&O insurance underwriters act as if the merits matter, and there is some empirical research suggesting that they do matter.<sup>187</sup>

Second, with regard to the expense of getting sufficiently inside the corporation to do effective monitoring, we observe that accounting firms are already deep inside the corporation. For that reason, the most cost-effective way to bundle monitoring and risk distribution may involve a combination of accounting and insurance functions. One possible approach is the Financial Statements Insurance concept suggested by Joshua Ronen and elaborated by Lawrence Cunningham.<sup>188</sup> Their idea is for insurance companies to offer financial statements insurance that would guarantee the accuracy of financial statements. There has been considerable resistance to

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<sup>186</sup> See, e.g., Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements of Securities Class Actions*, 43 STAN. L. REV. 497, 500 (1991) (arguing that the merits of securities claims do not drive outcomes in settlement); James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 503-504 (1997) (critiquing Alexander's methodology and conclusions); William S. Lerach, *Securities Class Action Litigation Under The Private Securities Litigation Reform Act's Brave New World*, 76 WASH. U. L. Q. 597 (1998) (stating that Congress "relied heavily upon Professor Janet Cooper Alexander's article" in its 1995 reform of the securities laws); Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2084 (1995) (disconfirming Alexander's basic finding of a non-meritorious 25% "going rate" in settlement).

<sup>187</sup> See, e.g., Marilyn F. Johnson, et al., *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, J.L. ECON. & ORG. (forthcoming), available at <http://ssrn.com/abstract=883684> (finding "a significantly greater correlation between litigation and both earnings restatements and insider trading after the PSLRA.") See also Baker & Griffith, *supra* note – (explaining that the use of corporate governance factors in D&O insurance risk based pricing suggests that the merits matter); Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465 (2004) (summarizing recent empirical work on the question of whether the merits matter).

<sup>188</sup> See Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance alternative to Accountant Liability*, 52 UCLA L. REV. 413 (2004); Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance and GAAP Revisited*, 8 STAN. J. L. & BUS. & FIN. 39 (2002).



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their concept, at least in part because they have emphasized its novelty and the legal and institutional change required for implementation, and they have predicted that FSI would lead to dramatic improvements in the accuracy of financial statements. In our view, the concept of bundling monitoring and risk distribution is simpler and less novel than they suggest. At least since Mayers and Smith, economists have understood that monitoring can be an important benefit of that corporate insurance provides to shareholders, and the obvious candidates to perform monitoring in the D&O insurance context are the accountants who are already deep inside the corporation. Accounting firms already provide a limited amount of “insurance” (in the form of professional liability), and D&O insurance companies already provide a limited guarantee of the financial statements (in the form of coverage for securities violations related to inaccuracies in the statements). The challenge is to identify incremental ways to bring these two functions closer together, without the need for legal reform or dramatic changes in existing institutions.

*The insurance underwriting cycle.* The insurance underwriting cycle provides one possible explanation for the fact that monitoring and risk distribution are not provided as a bundled product. To explain we begin with a quote from a participant from a leading reinsurance company whom we asked to read our companion Article to verify that we had accurately described the D&O insurance underwriting process. He said that we had, but added the following observation:

This is all theater around a price list. And what is the price list? At one moment there is a Happy Hour and everything is half price.<sup>189</sup>

In other words, although insurers may attempt to price on the basis of risk, there are market realities that can lead to dramatic price cuts that have little or nothing to do with the risk of the particular corporation. The underwriting cycle is one reason for such “Happy Hours.”<sup>190</sup>

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<sup>189</sup> Email to Sean Griffith, June 22, 2006.

<sup>190</sup> See Baker, *Underwriting Cycle*; Fitzpatrick, *Underwriting Cycle* (note that this author was at the time the Chief Underwriter for Chubb’s specialty lines insurance business, one of the leading providers of D&O insurance); Matthew Dolan, *Repeating the Sins of Market Cycles*, Insights, Oct. 2003, available at [http://www.onebeaconpro.com/insights/insights\\_vol2\\_sp.pdf](http://www.onebeaconpro.com/insights/insights_vol2_sp.pdf) (note that this author was a former Chubb underwriter and, at the time, the CEO of specialty lines insurer active in the D&O business).

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The insurance underwriting cycle affects many aspects of the insurance relationship, not just price. In soft market conditions, insurers not only compete on price, they also compete on contract terms, underwriting speed, and other aspects of the insurance buying process that make them easy to deal with.<sup>191</sup> Reducing the intrusiveness of their monitoring could become a competitive tool, reducing the ability of D&O insurers to serve as trusted monitors, but again, if lesser monitors earned a reputation as such, one might expect market discipline to limit departures from an industry standard of monitoring.

*D&O insurers' potential liability for negligent monitoring.* A final institutional barrier to bundled monitoring and risk distribution is speculative for the moment, but nevertheless worth considering. This is the concern that an insurer that offered monitoring services might become liable to shareholders, much as accounting firms, law firms, and other gatekeepers can become liable to shareholders.<sup>192</sup> Although courts have held that insurance companies' risk assessment activities do not create legal duties to the policyholder or third parties,<sup>193</sup> courts may be willing to revisit the issue if risk assessment and monitoring were to become an explicit feature of the insurance relationship. For this reason, we believe that the bundling of risk distribution and monitoring might ultimately involve a combination of insurance with accounting or other professional firms already bearing this liability risk.<sup>194</sup>

## 2. AGENCY COSTS AGAIN

As the preceding discussion makes clear there is some logic and a great deal of experience, that suggests it would be difficult for D&O insurers to bundle risk distribution and monitoring services. Nevertheless, we remain convinced that agency costs are, at the very least, an important part of the explanation. When an accounting firm, a law firm, an outside director, or a consulting firm provides securities loss prevention advice, the downside is the potential for a loss that, in

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<sup>191</sup> See Baker, *Underwriting Cycle*, *supra* note --.

<sup>192</sup> See generally, Coffee, *supra* note 4.

<sup>193</sup> For example, life insurance companies do not have a common law duty to accurately test for the HIV virus when underwriting a life insurance policy.

<sup>194</sup> See *supra* note 188 and accompanying text (describing Cunningham's and Ronen's proposals for a merger of auditing and insurance).

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the vast majority of cases, will be insured. When that advice is provided as part of a bundled package of monitoring and risk distribution services, however, the downside is much bigger: ignoring that advice could lead to an *uninsured* loss for the corporation.<sup>195</sup> If taking the advice is likely to have no impact, or a positive impact, on share prices, then a manager whose compensation is linked to those share prices should be willing to take it. But in at least some circumstances the advice will be bad tasting medicine – a disclosure, a revenue recognition decision, or some other accounting judgment that means that the company will not “make the numbers” for this quarter and, thus, share prices will decline. In that case, the manager may prefer not to take the advice. Linking that advice to D&O insurance protection – so that ignoring the advice means that there is no insurance for any resulting loss – would significantly constrain the manager’s autonomy. Who wants that? The answer, we have argued, is the shareholders.

## CONCLUSION

In order for shareholders to benefit from entity-level D&O coverage, there must be some benefit to the coverage other than pure risk distribution, which shareholders could accomplish more efficiently through portfolio diversification. Although some plausible explanations have been suggested—including offsetting tax advantages and the benefits of low cost contingent financing—each such explanation is only partial and is unlikely to fully justify the extent of corporate protection D&O insurance that presently is purchased. None of these explanations accounts for the pure risk distribution form of D&O insurance that we observed. Any benefit offered by, for example, low-cost contingent financing thus must overcome not only the insurer’s loading fees but also the cost of moral hazard associated with this form of pure risk distribution.

We are therefore left with only one satisfactory explanation for the form of D&O insurance that we observed: agency costs.<sup>196</sup>

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<sup>195</sup> We are not suggesting that Side A coverage be tightly linked to monitoring services. Individual loss aversion provides sufficient justification for Side A coverage; obligating individual directors and officers to follow the insurance company’s loss prevention advice, on pain of losing their insurance coverage, could well lead to behavior that was too cautious from the shareholders’ perspective.

<sup>196</sup> Habit may also be an explanation, but the profit motive would likely change this habit absent the agency cost problem. See, e.g., M. Martin Boyer, *Is the Demand*

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Managers do not want insurers monitoring their decisions *ex ante* and they do not want them managing their defense *ex post*. Both monitoring and defense management would reduce managers' autonomy and, relatedly, their ability to profit at the shareholders' expense.

Even if, as we doubt, shareholder litigation were a purely random event, unrelated to corporate governance and therefore impossible for an insurer to minimize through *ex ante* loss prevention efforts, insurers could still reduce the costs of shareholder litigation through *ex post* loss minimization efforts. Our research reveals not only that they fail to do so, but also that D&O insurance, as currently structured, affords little opportunity to do so. Thus, our research strongly suggests that the prevailing form of D&O insurance benefits management at the shareholders' expense. Only firms that purchase Side-A-only coverage, a relatively rare coverage package, are not susceptible to this charge.

The "missing monitor" in directors' and officers' insurance stands in contrast to insurers' loss prevention and management activities in many other lines of insurance. Sociological research has documented "insurance as governance" in a wide variety of contexts,<sup>197</sup> and D&O underwriters and brokers who are familiar with the non-profit and private company D&O market reported to us that insurers regularly engage in loss prevention and loss management. Thus, our research suggests that there is a structured inequality across fields of insurance.<sup>198</sup>

While we are reluctant to create a general theory for this inequality based on the investigation of a single insurance field, to us the obvious explanation here lies in corporate officials' control over corporate resources. Top executives in public corporations are able to purchase income-smoothing insurance without ceding any governance authority to insurers because this purchase, like all such decisions, is insulated from shareholder challenge by the business judgment rule. Insurers are willing to sell this coverage because, in most markets, they can do so profitably; they cannot be blamed for providing a product that customers are eager to buy. Most basically, corporate

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*for Corporate Insurance a Habit? Evidence of Organizational Inertia from Directors' and Officers' Insurance*, CIRANO Working Papers 2004s-33 (2004).

<sup>197</sup> See, e.g., Ericson and Doyle, *supra* note 60 and Ericson, Doyle and Barry, *supra* note 10.

<sup>198</sup> Thank you to Richard Ericson for bringing this point to our attention.

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governance arrangements that cannot place reasonable limits on CEO compensation can hardly be expected to place reasonable limits on a far less visible (and less expensive) insurance product that is not widely understood.

With that said, investors and outside directors that wish to rein in agency costs should consider turning their attention to entity level D&O insurance. With their attention thus focused, the choice is plain. Unless and until they can demonstrate that entity level coverage provides the cheapest form of contingent financing for securities liability losses – and that such contingent financing is in their shareholders' interests – public corporations should purchase only Side A coverage. And they should push for the creation of a bundled package of monitoring and risk distribution services that D&O insurers may be uniquely positioned to provide.