Ensuring Corporate Misconduct
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How Liability Insurance Undermines Shareholder Litigation

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CHAPTER ONE

Introduction

Financial crises present opportunities for introspection. Beyond the initial concern over what happened and why, they present an opportunity to reflect on the regulatory framework as a whole and to consider the effectiveness of each element of the law affecting business, to ask what aspects of the regulatory structure work well and what aspects may benefit from some correction. In this book, we take the opportunity afforded by the recent financial crisis to reflect on the effectiveness of shareholder litigation in regulating corporate conduct.

Shareholder litigation forms an important part of the structure of law and regulation affecting American business. Because public regulators cannot oversee every company at every moment and cannot anticipate or even respond to every report of a potential wrong, a variety of remedies are left in the hands of shareholders themselves. Shareholders who have suffered at the hands of a corporation in which they have invested can sue—either as a class or on behalf of the company itself—to right these wrongs. They thus assume, with their counsel, the role of “private attorneys general,” with strong personal incentives to detect and prosecute corporate wrongdoing. The lawsuits they bring fill an important gap in the regulatory framework affecting American business.

Shareholder litigation exerts its regulatory effect through the mechanism of deterrence. That is, prospective wrongdoers realize, through the threat of litigation, that they will be made to account for whatever harms they cause and, thus internalizing the cost of their conduct, forswear bad
acts. This basic mechanism of deterrence explains much civil litigation. Corporate officers and directors, understanding that they may be held liable to their investors for the harms they cause, refrain from engaging in conduct that will harm investors and induce them to sue. In this way, shareholder litigation regulates corporate conduct.

The problem with this story in the corporate context is that officers and directors are typically covered under a form of insurance, known as “Directors’ and Officers’ Liability Insurance” or “D&O insurance,” that insulates them from personal liability in the event of shareholder litigation. D&O insurance also protects the corporation itself from liabilities it may have in connection with shareholder litigation. This insurance disrupts the deterrence mechanism by transferring the obligations of the prospective bad actor (the officer, director, or the corporation itself) to a third-party payer (the insurer). An actor that is no longer forced to internalize the costs of its actions is no longer deterred from engaging in harmful conduct—managers who are no longer personally at risk for investor losses are less likely to take care in avoiding them, and corporations that are no longer at risk from shareholder litigation are less likely to monitor the conduct of their managers—and the regulatory effect of shareholder litigation is diminished, distorted, or destroyed.

Unless, that is, the insurer does something to prevent this outcome. The introduction of D&O insurance essentially establishes the D&O insurer as a third-party intermediary in the regulatory dynamic. If shareholder litigation is to deter bad corporate acts, it must be through the intermediary agency of D&O insurers who will have an opportunity to influence corporate conduct through the insurance relationship. Because they are the ones ultimately paying for the harms caused by their corporate insureds, insurers have ample incentive to exert this sort of constraining influence, and they have the means to do so. We identify three ways in which the insurance relationship may influence corporate conduct—through underwriting, monitoring, and the settlement of claims. The question thus becomes what influence D&O insurers do in fact exert through this relationship and whether this influence is sufficient to reintroduce the deterrence mechanism, thus preserving the effectiveness of shareholder litigation as a regulatory device.

There is a lot riding on this question. Indeed, if D&O insurers fail to preserve the deterrence mechanism, then shareholder litigation would seem to have little chance of regulating corporate conduct and thus would appear to be, as critics have long contended, mere waste, a tax on business
that supports an unnecessary plaintiffs' bar. In order to answer this question then, we must examine corporate and securities law through the lens of liability insurance.

That is precisely what this book seeks to do. In the pages that follow, we examine shareholder litigation through the lens of liability insurance in order to evaluate whether shareholder litigation accomplishes its regulatory objective. Through extensive interviews with professionals working in this area, we analyze each of these three ways in which insurers may preserve the deterrence function of shareholder litigation and we evaluate how well each works in achieving that end. The short answer, unfortunately, is not very well. As it is currently structured, D&O insurance significantly erodes the deterrent effect of shareholder litigation, thereby undermining its effectiveness as a form of regulation. The situation is not without hope, however, and we end by offering three narrowly tailored corrections that a rule maker such as the Securities and Exchange Commission (SEC) might enact to rehabilitate the deterrent effect of shareholder litigation, notwithstanding the presence of liability insurance.

But this brief preview of the analysis to come has taken much for granted. From this point onward we will be more careful. In the remainder of this chapter, we explain our assumptions and define some of the terms that we will use throughout the book. We also describe our empirical methodology and lay out, in some detail, the questions that we will confront in each chapter. Finally, we preview our policy prescriptions, recommending relatively simple reforms of SEC rules in order to prevent D&O insurance from subverting the deterrence function of securities litigation.

### Shareholder Litigation

Throughout this book, we use the term “shareholder litigation” to encompass all civil actions brought by current or former shareholders of a corporation against the corporation or its managers for losses the shareholders have suffered as a result of actions taken by the corporation or its managers. This definition excludes criminal actions brought by prosecutors or other public authorities as well as enforcement actions brought by regulatory agencies, such as the SEC. It includes, principally, claims brought by shareholders under either federal securities law or state corporate law.

Among these claims, securities class actions represent, by far, the largest potential source of liability. Shareholders filed 210 federal securities class
actions in 2008, thirty-three more than they had filed in 2007 and eighteen more than the average number of class actions filed per year from 1997 through 2007. Allegations in 94 percent of these claims were centered on misrepresentations in financial statements. In 2008, 2.23 percent of all companies listed on the NYSE, Nasdaq, and Amex at the beginning of the year became defendants in securities class actions filed later that year, down from 2.32 percent the year before and in line with the 2.24 percent average going back to 1997. These numbers are somewhat higher for Standard and Poor’s 500 companies, 9.2 percent of which were sued in a securities class action in 2008, up from 5.2 percent in 2007 and the highest since 12.0 percent were sued in 2002.

In securities class actions, current or former shareholders are given the right to sue the corporation collectively for misrepresentations that allegedly induced the shareholders to trade. The allegations underlying such claims typically revolve around misrepresentations in financial documents or in the company’s projections concerning future results. Shareholders who trade on the basis of this false information suffer losses when the market price of the security reverts to its “true” underlying value—that is, the price at which a trade might have occurred had it not been for the false information released by the defendants. Securities law thus gives investors the right to sue for this difference in price, which can grow to extremely large amounts once aggregated over the total number of shares transacted during the period of the misrepresentation.

In addition to federal securities class actions, shareholder claims can be brought against corporate defendants under state corporate law. These actions may be representative in form, as when a class of shareholders is deprived of a right, such as voting, that the shareholders possess in common, or they may take the form of shareholder derivative suits when the underlying harm is suffered primarily by the corporation itself and only derivatively by the shareholders, such as when a manager is vastly overcompensated or otherwise wastes corporate funds. Individual or representative claims brought under state corporate law often seek injunctive relief—for example, an order enjoining an unfair reorganization or requiring the board of directors to solicit additional bids in a merger transaction. Derivative suits, by contrast, are most often brought seeking damages. The damages in derivative suits, however, are limited to losses caused by the underlying misconduct—the amount of loss suffered by the corporation, for example, in overpaying its managers or in wasting assets in a particular transaction—not to losses measured by share price fluc-
tuations. Therefore, damages in derivative suits typically do not grow to
the size of losses alleged in securities litigation. Additionally, a number
of substantive rules and procedural requirements operate as barriers to
recovery in derivative suits. As a result, state corporate law litigation is
often viewed as secondary to securities law claims. Indeed the phenome-
non of the “tagalong derivative suit,” discussed in chapter 2, illustrates the
way in which state corporate law claims often follow in the wake of more
significant federal claims.

Regardless of how state corporate law and federal securities law claims
compare in terms of relative importance, for purposes of this research
we treat the two basic types of claims together under the rubric of share-
holder litigation. Both types of claims feature shareholders seeking relief
from the corporation or its managers for investment loss. Both types of
claims principally involve monetary damages, not administrative sanctions
or criminal penalties. And both types of claims focus on misconduct by
the corporation or its managers leading to losses suffered by shareholders.
Not all aspects of these claims are identical, and going forward we will
be careful to make the distinction when an argument or line of analysis
applies to one but not the other. Nevertheless, the claims seem to share
the same basic functions, of both compensating shareholders for losses
suffered at the hands of the corporation's managers and deterring conduct
that might cause such losses in the first place.

This leads us to consider the regulatory function of shareholder litiga-
tion. What, in the larger picture, is shareholder litigation meant to accom-
plish? Two possibilities present themselves. The basic goal of shareholder
litigation may be to compensate shareholders, to make them whole for
losses suffered at the hands of the corporation and its managers. Alter-
nately, the purpose of shareholder litigation may be to deter bad acts
in the first place, to create incentives for corporations and managers to
avoid claims. The perspective we choose on this question will have impor-
tant implications for our policy analysis. So, which is it, compensation or
deterrence?

Compensation or Deterrence?

Like other forms of civil litigation, shareholder litigation may be sup-
ported by either of two public policy justifications: compensation or de-
terrence. According to the compensation rationale, shareholder litigation
is meant to make shareholders whole for losses they suffer at the hands of the corporation and its managers. Alternately, according to the deterrence rationale, shareholder litigation is meant to create incentives for the corporation and its managers to prevent conduct leading to certain kinds of loss. These two rationales are independent—the success or failure of one does not depend upon the other—so one or both or neither may in fact apply to justify shareholder litigation. Let us take a moment to examine each, starting with the compensation rationale.

Although the compensation rationale makes a great deal of intuitive sense, an emerging consensus among most corporate and securities law scholars rejects compensation as a justification for shareholder litigation. Three forceful critiques of the compensation rationale compel this conclusion. First, shareholder litigation often involves mere “pocket shifting” since many plaintiffs are also shareholders of the corporate defendant and the corporate defendant, directly or indirectly, funds most settlements. Second and related, over time, diversified shareholders generally will not benefit from the most common form of shareholder litigation—the prototypical 10b-5 class action involving a nontrading corporation and alleging fraud on the market—because the plaintiffs’ losses will be offset by gains to other groups of investors, which may, in the long run, include the plaintiffs themselves. Third, most shareholder litigation recovers only a small fraction of total shareholder loss and does so at very high transaction costs, suggesting that it is at best a very inefficient means of providing compensation for investors who have been harmed.

The first critique—that settlements and damages paid in shareholder litigation typically amount to pocket shifting and are therefore of no economic value—focuses on the fact that many plaintiffs are also shareholders. This is so in the context of many securities law claims, especially those for which the plaintiff class consists of those who purchased shares at a price allegedly inflated by fraud and who remain shareholders through the bringing of the suit. But it also applies to those 10b-5 claims for which the plaintiff class consists of those who sold shares at an allegedly deflated price as long as the plaintiffs do not sell all of their shares and thus remain invested in the corporate defendant, as will often be the case for fund holders and other long-term diversified shareholders. In these cases, the plaintiffs are essentially suing themselves and, if they “win,” merely moving dollars from one pocket to another, minus very substantial litigation costs.

The pocket-shifting critique applies not only to many securities claims but also to many state corporate law claims, especially derivative suits for damages. In fact, as we shall describe in greater detail in chapter 2, state
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law forbids indemnification of derivative suit settlements precisely because of pocket-shifting concerns (since the indemnification would essentially amount to a payment from the corporation to make whole a manager defendant who had just paid a settlement to the corporation). Nevertheless, as we shall see, state law permits such settlements to be insured, and, as a result, corporations now fund the settlements indirectly (through the insurance premium), even if they cannot fund them directly (through indemnification). This kind of circular wealth transfer is pocket shifting in the extreme. It is the type of transaction from which no one benefits, at least in compensation terms, except perhaps attorneys, who, on the plaintiff’s side, receive a portion of the settlement and, on the defendant’s side, receive hourly fees. From the actual plaintiff’s perspective, however, this is not a good deal. Plaintiffs clearly do not benefit from compensation when they effectively pay it themselves minus whatever portion they pay out in attorneys’ fees and other costs.

The second critique—that there is no real economic gain to diversified shareholders from being compensated for their losses in a typical 10b-5 claim—turns on the law of large numbers and the likelihood that, over time, a diversified shareholder will gain as often as he or she loses from mispricing in the market. All market transactions, obviously, involve buyers and sellers. Sometimes buyers will gain from mispricing due to faulty corporate disclosure—specifically, when the disclosure has the effect of unjustifiably deflating securities prices at the time of their purchase—and sometimes sellers will gain—that is, when the disclosure has the effect of unjustifiably inflating securities prices at the time of their sale. Over time, however, diversified investors are as likely to be on one side of the transaction as on the other, and their losses from some mispricing are likely to be offset by their gains in others. Systematically, therefore, they lose nothing at all under the facts of a typical 10b-5 claim. And, of course, if nothing at all is lost, then there is nothing at all to compensate. A diversified shareholder thus would not favor a rule that, in the words of two eminent commentators, “force[d] his winning half to compensate his losing half over and over.” Moreover, when the compensation system is as costly as the system of shareholder litigation in fact is—involving large payments to attorneys and other professionals on both sides, costs that from the perspective of a diversified shareholder are pure waste (unless there is a deterrent benefit, which we address separately)—rational investors would clearly prefer to forgo such compensation altogether.

Finally, the third critique—that the compensation offered by shareholder litigation is inefficient and wasteful because it returns a very small
portion of shareholder losses at very high transaction costs—focuses directly on the costs and benefits of the current system from a compensation perspective. Settlement values in 10b-5 claims are a tiny fraction of investor loss. In 2008, the median settlement was only 2.7 percent of total investor loss, a percentage that has been fairly consistent for a number of years—2.3 percent in 2007, 2.2 percent in 2006, and 3.2 percent in 2005. The obvious implication of these statistics is that investors are not well compensated for their losses. If we imagine that shareholder litigation makes investors whole for market losses surrounding a corporate misrepresentation, then that is just what we are doing—imagining it. Shareholder litigation, in fact, compensates only pennies on the dollar of total investment loss (although, as we describe in chapter 8, investor loss is at best a crude proxy for losses from securities fraud). Moreover, the transaction costs associated with this compensation scheme—the plaintiffs’ attorneys’ commission and the defense lawyers’ hourly rates—further reduce the benefit ultimately received by shareholders. Simply stated, the system is so costly and inefficient that it is difficult to believe that it provides meaningful compensation to investors.

As forceful as each of these critiques is on its own, taking all three of them together effectively destroys the compensation rationale as a justification for most shareholder litigation. We say “most” here because each of these critiques applies most clearly to the most common form of shareholder litigation—the prototypical 10b-5 claim. They do not apply as well to securities claims involving market manipulation or insider trading, but, as we describe in chapter 2, the vast majority of class actions under the federal securities laws do indeed center on what we are calling the prototypical 10b-5 claim—involving, essentially, a nontrading corporate defendant and allegations of fraud on the market. These critiques thus speak to the vast majority of securities claims. Moreover, they apply with equal force to much state corporate law litigation, especially the typical shareholder derivative suit. However, direct shareholder actions under state law, especially those challenging the fairness of corporate acquisitions and seeking additional compensation in the transaction, are not affected by these critiques and therefore may offer the best case for the applicability of the compensation rationale. We will therefore treat this type of claim as an exception to the rule that the compensation rationale does not supply a credible justification for shareholder claims. Nevertheless, having effectively dispensed with compensation as a possible justification for the bulk of shareholder litigation, we are left with the deterrence rationale,
for which there is considerably more support, both within the academic literature and in the courts.

Deterrence works when a prospective wrongdoer, recognizing that he or she will be forced to pay the full cost of any harm he or she causes (and more, perhaps, to account for a less than perfect likelihood of detection), therefore forswears the harmful conduct.\(^8\) Widely recognized as a basic purpose of much civil litigation, deterrence essentially makes plaintiffs—or more accurately, plaintiffs’ lawyers—into private attorneys general who serve a public purpose in bringing private claims. Each acts on the basis of his or her private incentives by bringing claims but in doing so creates a public good—namely, the \textit{in terrorem} effect, basically inducing potential defendants to be good in order to avoid the liabilities associated with being bad. The deterrence justification for shareholder litigation thus focuses on the value it creates by preventing corporate managers from engaging in conduct leading to investor loss. The deterrence rationale is not without controversy, with much of the academic debate focusing on the incentives of the plaintiffs’ attorneys and the related question of whether the deterrence effect of shareholder litigation is set at the optimal level or whether there is too much deterrence or not enough.\(^9\) Deterrence is nevertheless widely accepted as the fundamental purpose of shareholder litigation by courts and commentators alike. The U.S. Supreme Court, for example, has long viewed the deterrence effect of private shareholder litigation as “a necessary supplement to [Securities and Exchange] Commission action.”\(^10\)

The deterrence function of shareholder litigation connects it to corporate governance. “Corporate governance” is a broad concept that much of the legal literature has given a narrow definition. Scholars discuss it most often in the context of specific regulatory reforms or in terms of charter provisions and other structural characteristics of firms. But corporate governance may refer more broadly to any system of incentives and constraints operating within a firm. Corporate governance is designed to constrain bad acts on the part of corporations and their managers. Insofar as these are the same acts that will lead to liability in shareholder litigation, corporate governance and shareholder litigation pursue similar ends—both seek to make managers better serve the interests of their shareholders. Good corporate governance ought to lead to less shareholder litigation, and the risk of shareholder litigation ought to lead prospective defendants to improve their corporate governance.

If we are thus to take deterrence as the basic rationale behind shareholder litigation, supplying it with its underlying purpose and justifying its
existence, we are left primarily with questions about how well shareholder litigation in fact accomplishes the end of deterrence. If shareholder litigation systematically fails to deter, it would fail to accomplish its underlying purpose and would have no reason to exist. Indeed, if shareholder litigation fails to deter, radical reform would seem to be appropriate, either to correct the defects of shareholder litigation or to abolish it altogether. These possibilities are presented most starkly when the underlying risks are covered by insurance.

**Introducing Insurance**

D&O insurance funds shareholder litigation. Almost every publicly traded corporation in the United States purchases D&O insurance to cover the risk of shareholder litigation. And most shareholder litigation settles within the limits of these policies. D&O insurance transfers shareholder litigation risk away from individual directors and officers and the corporations they manage to third-party insurers.

This risk transfer is not complete. There have been approximately twenty so-called mega settlements over the past ten years that have significantly exceeded the value of existing D&O insurance policies, and there have been more cases in which corporate defendants paid a significant amount of corporate funds on top of the available insurance. It is difficult to know precisely how often or how much corporate defendants contribute to settlement because corporations are required to disclose neither D&O insurance limits nor how settlements are funded. Nevertheless, using the information on class action settlements available at the Stanford Class Action Clearinghouse Web site, we estimate that approximately 15 percent of class action settlements include a payment by the defendant in addition to the available insurance. In most of these cases, the amount of the corporation's contribution was substantially less than the amount paid by the corporation’s D&O insurers, and, in some cases, the payment may have been part of satisfying an insurance deductible. Michael Klausner and Jason Hegland, who run the Clearinghouse, recently looked carefully at a sample of cases in their database and concluded that corporations paid more frequently in their sample than we estimate, but they concluded, nevertheless, that “corporations’ payments into settlements, on average, constitute relatively small portions of total settlements.” Thus, as far as we can tell on the basis of publicly available information, the risk
transfer from the insured to the insurer is not quite complete, but it is very nearly so.

This creates a problem for deterrence. With liability risk transferred to a third-party insurer, prospective defendants are no longer forced to internalize the full cost of their actions. With little or nothing at risk, in other words, they are unlikely to be deterred from the sorts of actions that may lead to shareholder litigation. Worse, once the reins of deterrence are loosened, prospective defendants may be more likely to engage in conduct leading to losses, thus creating a moral hazard problem in which the effect of insurance, paradoxically, is to increase loss. This is the insurance-deterrence trade-off analyzed so elegantly in economists’ formal models, explored empirically in connection with personal injury litigation, and largely ignored in corporate and securities law scholarship.\(^\text{14}\)

Even from the perspective of compensation, D&O insurance is problematic. D&O insurance serves to guarantee investors that they will be compensated for losses stemming from shareholder litigation. But if D&O insurance merely performs this compensatory function, then it is not a good investment from the shareholders’ perspective, because the price of an insurance contract is always greater than the expected payout under the contract—insurance companies, after all, do not sell their products for free. And the same protection against loss could be obtained by shareholders for free (or very nearly so) simply by holding a diversified portfolio of investments, since the effect of diversification is essentially to cancel the risk of unexpected events (like shareholder litigation) that is associated with any one holding. Because diversification provides shareholders with essentially the same protection against loss as insurance and does so at a lower cost, rationalizing D&O insurance from the compensation perspective turns out to be as problematic as justifying shareholder litigation on the basis of the compensation rationale.

Insurance thus poses a challenge to the aims and ends of shareholder litigation. Indeed, to the extent that insurance weakens deterrence, it undermines the basic justification for shareholder litigation. Nevertheless, it would be leaping to conclusions to assume, without more, either that insurance necessarily destroys the basic rationale of shareholder litigation or that the purchase of D&O insurance cannot be justified. Insurers, after all, have both the incentive and the influence to design mechanisms to control the risk of loss, and in seeking to control their own losses under the policy, insurers may reintroduce the deterrence function of shareholder litigation. Our basic question then is, Do they? What do insurers do to
control losses and thereby reintroduce the deterrence function of shareholder litigation?

**Corporate and Securities Law through the Lens of Liability Insurance**

Insurance has recently been revealed as a shadowy force shaping many aspects of public policy. Who can think about the current health care debate without thinking almost immediately about health insurance or about the current rash of bank failures without thinking of the Federal Deposit Insurance that dampens their effect? Similarly, public policy debates link automobile accidents with automobile insurance, hurricanes with property insurance, death with life insurance, aging with social security and long-term care insurance, medical malpractice with medical malpractice insurance, and tort litigation more generally with liability insurance. Insurance, to paraphrase sociologist Richard Ericson, is a form of governance.

Yet, to a large extent, this understanding of insurance as governance has extended only to insurance that addresses (or fails to address) the needs and problems of individuals and families. Within law and policy, the attention to insurance similarly extends primarily to fields that address these same problems, such as health, tort, and elder law and policy. With few exceptions, the focus is on insurance for individuals and the only large organizations that come into this picture are insurance organizations, the insurance companies, other private risk pooling organizations, and government agencies engaged in spreading the risks of life and death.

But large organizations and, especially, large corporations buy insurance too, as evidenced by the size of the commercial insurance market. To date, this corporate insurance market has not figured prominently in academic analysis or public debate in the corporate law and finance field. In the academic literature the only strong research thread addresses the question of why publicly traded corporations buy insurance at all, given that their shareholders can spread risk simply by holding a diversified portfolio. But this literature has been largely theoretical, and it has not been followed up by research into what corporations do with the insurance that they buy and what that insurance does to them. Corporate and securities law academics, moreover, have largely ignored D&O insurance.

Our research aims at uncovering the relationship between D&O insurance and corporate governance because, as we have already described,
The question of the effectiveness of shareholder litigation as a regulatory device depends upon it. D&O insurance has the potential to insulate corporations and their managers from the consequences of liability rules that are expressly designed to penalize bad governance and encourage good governance. As a result, the D&O insurer thus assumes a pivotal role in the analysis. The question thus becomes, Does the D&O insurer have some means of passing along the deterrent effect of shareholder litigation or does the fact of D&O litigation distort or destroy the accountability mechanisms built into shareholder litigation? In other words, what do D&O insurers do to deter bad acts on the part of their insureds? Since, after all, the insurers are the ones ultimately footing the bill for shareholder claims, they would seem to have ample incentive to control the conduct that might lead to claims.

We hypothesized three ways that the D&O insurer might seek to control the risks posed by its insureds, each with different implications for the effectiveness of shareholder litigation as a regulatory device. 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. 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.

We set out to investigate our hypotheses and, more broadly, to understand the effects of insurance and shareholder litigation empirically by talking to people in the field, asking questions and listening to their stories. We would very much have liked to test our hypotheses quantitatively—for example, comparing premiums against governance terms or the impact of limits on settlements—but the data necessary to study these questions simply are not available. We therefore set out to gather data however we could, applying the qualitative research methods described below.

**Research Method**

We have used the research tools of qualitative interviews and participant observation that have been employed most effectively in recent years by
social scientists outside economics to study the relationship between insurance and shareholder litigation. Following in the footsteps of recent work by sociologists—Richard Ericson, Aaron Doyle, and Dean Barry and earlier work by Carol Heimer—we have sought to illuminate the governance function of insurance, gathering data by interviewing D&O insurance specialists and also by observing and participating in industry conferences on the subject. Our goals were to test our hypotheses about insurance and deterrence as well as simply to learn as much as possible about the role of D&O insurance in shareholder litigation.

From 2005 through 2007, we conducted in-depth interviews with over one hundred people working in and around the interconnected fields of D&O insurance and securities litigation. Our interviews were semi-structured, by which we mean we followed a loosely organized research protocol, which set forth a list of topics to explore with each interviewee. However, our interviews were not designed as cross-examinations. We did not set out in advance to elicit yes or no answers to a predetermined set of questions. Rather, our interviews were designed to engage our interviewees and get them talking about their area of expertise and, from their observations, to begin to compile relevant material on our research questions.

We identified prospective interviewees by beginning with references from leaders of the Professional Liability Underwriting Society, a professional association including underwriters, brokers, claims managers, consultants, and other specialists on professional liability lines of insurance. From these initial interviews, we then proceeded outward to references from our interviewees, thus expanding our set of prospective interviewees with each interview. By the time we were finished, we conducted recorded interviews with

- twenty-one underwriters from fourteen companies, including primary, excess, and reinsurance underwriters;
- twelve claims managers from ten D&O insurance companies;
- twelve lawyers who specialize on the defense side of shareholder litigation;
- eleven lawyers who specialize in bringing shareholder litigation on behalf of shareholders;
- ten lawyers who specialize in representing D&O insurance companies in the monitoring and settlement of shareholder litigation (typically called “monitoring counsel”);
- six brokers from six brokerage houses;
- four risk managers employed by publicly traded corporations to purchase their insurance coverage;
three D&O actuaries from three companies, two of whom were the chief professional lines actuaries in their firms;
- five policyholder coverage counsel;
- three mediators who were among the small group of mediators most actively involved in the settlement of shareholder litigation during the period of our interviews;
- two experts who assist parties in assessing the damages in shareholder litigation; and
- two claims advisors from two brokerage houses.

In addition, we have participated in numerous industry conferences and discussions involving both industry professionals and academic experts, several of which gave us the opportunity to present our work and thus to receive additional comments from our participants on early drafts of our findings.

This method of identifying participants cannot produce a random sample, and some bias may creep into our results from the simple fact that not all potential respondents were equally likely to participate. Nevertheless, in spite of the self-selecting and self-referential nature of this sample, we can describe the interaction of insurance and shareholder litigation with some confidence because the top firms in each part of the field are relatively few and densely connected. As one of our participants said to us, “It’s a really small sandbox. You don’t want to pee in it.”19 The same is true of the plaintiffs’ and defense lawyers working in this area, as one such lawyer described:

Because the bar is so small, your personal reputation counts. Integrity counts. Saying you are going to do a deal means something. You know, double-crossing someone, maybe you can pull it off once, but you are going to be caught. So there is that, that you trust people within this circle, and of course you do have all the due diligence and documentation and settlement agreements that are a million pages long, but there is some level of trust, some level of candor.20

The relevant numbers bear these statements out. The universe of players on the plaintiffs’ side has remained small and relatively stable, with the top eight plaintiffs’ firms accounting for 75 percent of total securities class action settlement collections.21 The defense bar is less concentrated than the plaintiffs’ class action bar, but the panel counsel lists maintained by the top D&O insurance carriers provide a good guide to that bar, and, perhaps not surprisingly, the top New York and national firms are well
represented. D&O insurance, moreover, is a highly concentrated market, clustering around two dominant primary insurers—AIG and Chubb—which together account for more than half of the market for primary insurance. The excess D&O market is broader, but both primary and excess markets are intermediated through the personal connections of relatively few brokerage firms. Moreover, a small number of outside law firms handle the settlement responsibilities of most of the D&O insurers and, thus, serve to bring to claims managers the same breadth of information about the settlement market that the brokers bring to underwriters about the D&O insurance market.

We obtained access to top people in each of these areas. Our requests for interviews were rarely turned down and not disproportionately by any one group such that we would fear a skew in our results, although defense lawyers tended to be the most difficult to schedule. We also countered the problem of bias by interviewing professionals on every side and in every role and by checking their responses against each other. Except as noted in the chapters that follow, our participants provided consistent reports during the interviews, allowing us to conclude comfortably that we are reporting shared understandings of most of those working in the field.

While our research protocol prevents us from identifying the people we interviewed or which companies or firms they worked for, we can say this: We were very mindful of the respective reputations and market shares of the insurers, plaintiffs’ lawyers, defense lawyers, mediators, and monitoring counsels working in this area, and with remarkably few exceptions, we were able to interview every person we wanted to. Most of the people we interviewed knew of all or most of the other people we spoke to, and many of them knew one another personally. Risk managers, policyholder coverage counsel, and plaintiffs’ lawyers typically were, as would be expected, less well connected to everyone else, and the people involved in the sales process were not well connected to the people involved in the claims process, except within companies and, to a lesser extent, through professional associations.

Through this process we came to have a kind of bird’s-eye perspective on shareholder litigation and D&O insurance. Obviously we cannot claim to understand any particular aspect of the field at the level of detail of the active participant. But, because of our access to multiple perspectives, we can develop a holistic understanding of the field that is very difficult for participants to develop. Consistent with that understanding, we have heard from a variety of people in the field that they now recommend as
a valuable introduction our earlier articles to new underwriters, brokers, and lawyers working in and around the field.

As a result of having found our way inside these interconnected networks, we are confident that we can accurately describe the interaction of insurance and shareholder litigation on the basis of a number of interviews that may seem small to researchers used to working with large quantitative data sets. We would have liked very much to run quantitative analyses of our research questions, and we hope to one day. But the key data for this kind of quantitative analysis—insurance limits and premiums and detailed information on how settlements are funded—simply are not publicly available. It is our hope that our work can be used to frame more systematic quantitative analyses, should the data one day be made available. In the meantime, the explanatory power of qualitative research depends, like traditional doctrinal and policy arguments, on the persuasive coherence and plausibility of the analysis.

Prior research has used liability insurance as a window on liability, tracked the historical relationship between liability and insurance, modeled that relationship, and explored some of the ways that liability insurance changes behavior in litigation. But the research we report here is the first to systematically explore the relationship between liability and liability insurance through the entire insurance relationship, from underwriting to claims settlement, and to provide a theoretically informed account of the real world impact of this relationship on the particular form of liability that we examine. Thus, our research has both immediate policy relevance for securities regulators and the D&O insurance market and also long-term implications for liability and insurance research.

**Roadmap of the Analysis to Come**

Looking forward, our account will proceed as follows. We begin, in chapter 2, by exploring the various claims that can be brought by shareholder plaintiffs, examining the legal elements and general characteristics that distinguish each of the basic causes of action as well as those underlying features that the various claims have in common. Because our focus is on the interaction of shareholder litigation and D&O insurance and how insurance both transfers and transforms the risk of shareholder litigation, we proceed from our account of shareholder litigation to a discussion, in chapter 3, of D&O insurance. There we describe the basics of D&O
insurance—what it is, what it does and does not cover, and how the coverage works—and provide an account of important coverage exclusions and the market for D&O insurance. We further discuss how most D&O insurance packages provide several different types of coverage, including coverage for individual directors and officers as well as coverage for the corporate entity itself for losses resulting from shareholder litigation.

This preliminary material leads us, in chapter 4, to our first puzzle. That is, Why do firms purchase D&O insurance coverage for the corporate entity? This strikes us as a puzzle for two main reasons. First, if all that D&O insurance does is spread the risk of loss, this entity-level coverage seems unnecessary since shareholders themselves can spread the risk of loss by holding a diversified portfolio of investments. We therefore devote a considerable portion of the discussion in chapter 4 to analyzing potential explanations for the purchase of the entity-level coverage aspect of D&O insurance. As already noted, this has been a fertile area for economic analysis, and our main contribution here is to highlight an agency cost explanation that has not been emphasized in the prior literature. Second, by transferring so much of the corporation's liability risk to a third-party insurer, entity-level coverage would seem to create a significant moral hazard problem, thus diminishing the deterrent effect of shareholder litigation. Indeed, we find several reasons to suggest that D&O insurance produces significantly greater moral hazard than more traditional corporate property and casualty insurance.

Chapters 5–8 present our empirical results, examining the insurance relationship through the eyes of our interviewees in order to determine whether there is some mechanism to constrain the problem of moral hazard and reinvigorate the deterrence effect of shareholder litigation. As noted above, there are in theory three ways insurers might manage this trade-off. First, by pricing coverage to risk, D&O insurers could preserve deterrence by forcing riskier corporations to pay more for coverage, thus creating an incentive for corporate insureds to improve their governance in order to reduce the cost of D&O insurance. We examine this possibility in chapter 5 and find that corporations do indeed seek to price coverage to risk. Nevertheless, we also describe several reasons offered by our participants to doubt that the differential pricing of D&O premiums deters corporate wrongdoing or provides adequate incentives to optimize corporate governance.

A second means by which D&O insurers might maintain the deterrence function of shareholder litigation is by monitoring corporate insureds dur-
ing the life of the contract, forcing them to steer clear of risky conduct or to adopt governance practices designed to prevent the kinds of events that lead to shareholder litigation. Yet in chapter 6, we report our finding that D&O insurers in fact do almost nothing to monitor and control the conduct of their corporate insureds. Loss-prevention programs, common in other areas of insurance, are typically not offered by D&O insurers, and when loss-prevention advice is given, it is given as a suggestion rather than as a mandate and is designed, according to our participants, more to promote or market the insurer than to constrain the conduct of the insured. In chapter 6, we seek to account for the absence of monitoring by insurers and emphasize again its implication—namely, moral hazard.

Third and finally, another means by which D&O insurers might reintroduce the deterrence function of shareholder litigation is through control over defense and settlement. At the most basic level, insurers could work to make sure that cases get resolved on the merits and that settlement amounts bear a close relationship to the harm, so that the insurance loss costs that are used into the D&O insurance pricing formulas provide the right signal. In addition, insurers could force defendants in the worst cases—that is, those with greater evidence of genuine wrongdoing—to pay more toward the defense and settlement of their claims, thus incentivizing corporate insureds to avoid the kinds of wrongdoing that will lead to a reduction in coverage. We examine such strategies in chapter 7, where we seek to understand how insurance coverage influences the defense and settlement of shareholder litigation. There we find that, although insurers do have substantial control over settlements, they have almost no control over the conduct of the defense. And although they may occasionally use their settlement control to extract concessions from corporate defendants—how much and how often is impossible to say—there are nevertheless many features of the settlement process, discussed in chapter 8, that prevent D&O insurers from insisting that final settlement amounts track the underlying merits of claims.

From there, we move on to discuss coverage disputes. The coverage dispute is the last opportunity for a D&O insurer to force a bad corporate actor to account for its bad acts. As such, it is the last moment when the deterrence function of shareholder litigation can be reintroduced by an insurer. In chapter 9, we discuss the most common bases upon which insurers assert coverage defenses. In reviewing developments in this area of law, we find a loose correlation between coverage defenses and corporate wrongdoing—the insurer’s coverage defenses seem strongest when
the plaintiff’s underlying claim is meritorious. Nevertheless, as we also
discuss in chapter 9, insurers are likely to really press coverage defenses
in relatively few cases, for fear of an adverse impact in the insurance mar-
et. Instead the insurer may “cash in” the coverage defenses by agreeing
to a settlement that is partially funded by the defendant. As a result, the
insurer’s defenses may function, to an admittedly indeterminate degree,
somewhat like a moral hazard coinsurance provision, so that a corpora-
tion’s contribution to the settlement varies according to the wrongfulness
of its employees’ conduct. The low value of D&O insurance policy limits
in relation to the potential damages in a serious fraud case functions very
crude in the same way. Accordingly, by keeping insurance policy limits
low in relation to companies’ market capitalization and by cashing in their
coverage defenses, D&O insurance companies may preserve some of the
deterrent impact of shareholder litigation. Determining how often this
actually occurs is yet another quantitative question that we cannot answer
because of the absence of insurance data.

We conclude, in chapter 10, by arguing that our findings show that
D&O insurance as it is currently structured significantly undermines
the deterrence value of shareholder litigation. Nevertheless, we offer a
set of three narrowly tailored solutions that we believe both could and
should be enacted in order to improve the regulatory effect of shareholder
litigation.

Throughout this analysis, our guiding question is the extent to which
liability insurance subverts or preserves the deterrence objectives of cor-
porate and securities law. This is a critically important question since its
answer should ultimately guide policy makers in debates over the value
of shareholder litigation. Deterrence is the raison d’être of shareholder
litigation. If shareholder litigation does not deter, it is not necessarily the
case that bad corporate acts are utterly undeterred, since a variety of other
constraints, such as SEC enforcement actions, criminal prosecutions, and
market constraints may still operate to deter the worst corporate miscon-
duct. But if shareholder litigation does not deter, then it loses its core justi-
fication and ought, therefore, to be abolished. Yet if we can identify a way
to restore the deterrence role of shareholder litigation, notwithstanding
the presence of liability insurance, there is no need to consider the more
radical solutions of either abolishing shareholder litigation or abolishing
insurance. That is what we will seek to do in the pages that follow.
Notes

Chapter One

3. Ibid., 7.
4. In the field of tort law, there is a competing, nonconsequentialist justification referred to as “corrective justice” or “civil redress.” In the context of shareholder litigation, however, where all liabilities are ultimately funded by shareholders, such a justification seems self-defeating since shareholders would thus be forced to correct injustices perpetrated against themselves. As a result, such justifications have not found acceptance in corporate law and finance, and, accordingly, we will not address them here.

5. The consensus position is concisely summarized in Rose 2008. Prominent academic lawyers writing from the consensus perspective include Alexander 1996; Coffee 2006; Easterbrook and Fischel 1985; Langevoort 1996; Pritchard 1999.

8. On the problem of setting sanctions to promote optimal deterrence, see Shavell 2004, 483.
9. The problem of the plaintiffs’ attorneys’ incentives or “litigation agency costs” has been studied by Bebchuk 1988; Coffee 1985; Katz 1990; Romano 1991; and Rosenberg and Shavell 1985. Litigation agency costs can be understood as interfering primarily with the effectiveness of specific deterrence—that is, whether a claim, once brought, will succeed in reforming the governance practices of the corporate defendant. It is on this point that, for example, Romano expresses doubt when she charges that “shareholder litigation is a weak, if not ineffective, instrument of corporate governance.” Romano 1991, 84. Nevertheless, shareholder litigation is often viewed as a more or less effective instrument of general deterrence—that is, the tendency of prospective defendants to adjust their practices on the basis of...
their perceived liability risk. From the perspective of general deterrence, the question is whether shareholder litigation overdeters or underdeters. For an excellent discussion of overdeterrence and underdeterrence in the context of 10b-5 litigation that thoroughly reviews the current literature, see Rose 2008.


11. Towers Perrin 2008. This annual survey of D&O purchasing trends in the United States, although based upon a nonrandom sample, provides the only currently available aggregate data on coverage. It is therefore an invaluable source in understanding broader patterns in D&O coverage.

12. Defendant payment cases constitute 8 percent of the cases for which a final payment is reported. We computed this number by using the description of the class actions on the Stanford Class Action Clearinghouse Web site to identify payments by defendants, and, where it was not possible to determine whether the payment reported was within the deductible or self-insured retention, we used a cutoff of $5 million, which is a conservative (i.e., low) proxy for the deductible amount in a corporate D&O insurance policy. These calculations were based on the cases reported on the Clearinghouse Web site in the fall of 2008, with an update for the latest settlement information conducted in June 2009. These estimates are biased in a variety of ways. First, our sense is that the Stanford Class Action Clearinghouse has more complete information on the larger cases and more visible cases. For reasons explained in chapters 8 and 9, we believe that more visible cases are more likely to be more meritorious cases, and more meritorious cases are more likely to include defendant payments. This problem would tend to bias our estimate of the percentage of defendant payment cases upward. Second, the Clearinghouse collected information on defendant payments by examining the defendants’ financial reports during the litigation. These reports may not include defendant payments that are nonmaterial to the financial health of the corporation but that would nevertheless be worth counting for this purpose. This problem would tend to bias our estimate of the percentage of defendant payments downward. Third, the Clearinghouse does not report whether the payment that was made fell within the self-insured retention or was within a layer (or layers) of insurance with coinsurance or an insolvent insurer. This problem would tend to bias our estimate of the percentage of defendant payments upward. Without the public disclosure that we call for in this book, more accurate estimates would be very difficult to make.


15. For a very recent exception see Cheyne and Nini 2010.


17. Ericson, Doyle, and Barry 2003 (offering an institutionally informed account of the governance role of a variety of forms of first-party insurance). See
also Ericson and Doyle 2004, 5 (describing the underappreciated prominence of uncertainty, as opposed to risk, in the insurance business) and Heimer 1985 (investigating how insurers use contract provisions to manage moral hazard.

18. Our research protocols are approved by the institutional review boards of the University of Connecticut and Fordham University. Interviewees participated under a promise of anonymity. The interviews were recorded and transcribed, with participant-identifying information removed from the transcripts.

19. Monitoring Counsel no. 3, 73.
20. Monitoring Counsel no. 8, 25.
21. These figures were computed from Savett 2007 using the “SCAS 50—Total Settlements” table. Of note, we treat Milberg, Weiss and Lerach Coughlin as two separate firms even in 2003, and we treat firms that have retained the same key name partner(s) over the years as the same firm. See also Choi and Thompson 2006, table 3 (reporting that four firms handled cases that represent 50 percent of the total settlement value since 1995).
23. Only about twenty-six brokerage firms are active in the public D&O insurance market at any time. Towers Perrin 2007, exhibit 54.
24. See Baker forthcoming (summarizing research using insurance statistics and insurance field research to understand liability law in action).
25. See Abraham 2008 (exploring the relationship in a variety of fields throughout the “liability century”); Baker 2005b (exploring the relationship in the medical malpractice field).
27. See, e.g., Zeiler et al. 2007 (examining the impact of insurance policy limits on the settlement of medical malpractice litigation; Baker 2002 (exploring the role of insurance in settling personal injury litigation); Pryor 1997 (explaining how liability insurance exclusions lead parties to “underlitigate,” forgoing intentional injury claims in favor of negligence claims); Baker 1998 (describing how the lack of insurance for punitive damages in some jurisdictions leads parties to “transform punishment into compensation”).

Chapter Two

1. Eisenberg and Miller 2004, 54 (finding that 77 percent of shareholder actions from 1993 to 2002 were securities class actions); see also Towers Perrin 2007, exhibit 83 (reporting that more than 80 percent of claims made against public companies dealt with securities issues).
2. “The big exposure to D&O, as I am sure you know, that is number one,
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