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Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details concerning Directors' and Officers' Liability Insurance Policies

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UNCOVERING A GATEKEEPER:
WHY THE SEC SHOULD MANDATE DISCLOSURE OF DETAILS
CONCERNING DIRECTORS' AND OFFICERS' LIABILITY
INSURANCE POLICIES

SEAN J. GRIFFITH[†]

This Article explores the connection between corporate governance and D&O insurance. It argues that D&O insurers act as gatekeepers and guarantors of corporate governance, screening and pricing corporate governance risks to maintain the profitability of their risk pools. As a result, in a well-working insurance market, D&O insurance premiums would convey the insurer's assessment of a firm's governance quality. Simply stated, firms with better corporate governance would pay relatively low D&O premiums, while firms with worse corporate governance would pay more. This simple relationship could signal important information to investors and other capital market participants. Unfortunately, the signal is not being sent. Corporations lack the incentive to disclose this information on their own initiative, and U.S. securities regulators do not require registrants to do so. This Article therefore advocates a change to U.S. securities regulation, making mandatory the disclosure of D&O policy details—specifically, premiums, limits, and retentions under each type of coverage, as well as the identity of the insurer.

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I. GATEKEEPING

Much of the blame for the recent spate of corporate governance scandals has fallen on gatekeepers. Soon after the collapse of Enron and WorldCom, a leading corporate law scholar remarked that “Enron is more about gatekeeper failure than board failure.”¹ Moreover,

¹ John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1419 (2002) [hereinafter Coffee, *Understanding Enron*]. Professor Coffee’s fix for the gatekeeper crisis was a regime of strict liability for the outside auditor, essentially converting the auditor to an insurer. See John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 349 (2004) (“[T]he most direct and practical means [to improve corporate governance] would be to convert the gatekeeper into the functional equivalent of an insurer, who would back its auditor’s certification with an insurance policy that was capped at a realistic level.”); cf. Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 492 (2001) (advocating a “modified strict liability regime,” under which “gatekeepers could limit their liability by agreeing to and disclosing a percentage limitation on the scope of their liability for the issuer’s damages”). Comparing his proposal to Professor Coffee’s, Professor Partnoy wrote:

The key to our proposals is the creation of a reinsurance market for securities fraud risks, where gatekeepers would behave more like insurers. There are a variety of ways to do this. Professor Coffee favors the use of caps based on a multiple of the gatekeeper’s revenues; I prefer limiting gatekeeper liability through contracting based on a percentage of the issuer’s liability.

Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365, 375 (2004). Others have recently advanced a more direct insurance-market solu-

although gatekeepers can include a variety of third-party intermediaries—including auditing firms, debt rating agencies, equity analysts, investment bankers, and lawyers²—most of the post-Enron attention has been focused on the failings of the outside auditor.³ Yet for all of the focus on the shortcomings of the outside auditor, another potential gatekeeper has escaped notice—the directors' and officers' (D&O) liability insurer.⁴

Although their primary role is to spread the risk of loss from shareholder litigation, and not necessarily to provide the verification and certification services expected of third-party gatekeepers, D&O insurers have strong incentives to act as corporate governance gatekeepers. Because the D&O insurer assumes an insured's risk of shareholder litigation, the insurer must have a means of assessing that risk in order to determine an appropriate premium. Insofar as the risk of shareholder litigation is related to the quality of a firm's corporate governance, D&O insurers will use corporate governance assessments to screen prospective insureds and to quantify the risk of loss. In a well-working insurance market, the D&O insurer will thus serve as an

tion: financial statement insurance. See, e.g., Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413, 415 (2004) (proposing that financial statement insurance, which would provide retroactive coverage for financial statements made during a specific year and "cover damages arising from audit failure," would serve as an efficient monitor of corporate governance); Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited*, 8 STAN. J.L. BUS. & FIN. 39, 48 (2002) (suggesting that financial statement insurance purchased by companies to "provide[] coverage to investors against losses suffered as a result of misrepresentation in financial reports" is an effective gatekeeping mechanism).

² Professor Coffee defines gatekeepers as "reputational intermediaries who provide verification and certification services to investors." Coffee, *Understanding Enron*, *supra* note 1, at 1405; see also Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53 (1986) (defining gatekeepers as "private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers").

³ Most, not all. See, e.g., Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7245 (Supp. II 2002) (adopting standards to increase the gatekeeping role of outside counsel); Claire A. Hill, *Rating Agencies Behaving Badly: The Case of Enron*, 35 CONN. L. REV. 1145, 1148-51 (2003) (describing the failure of debt rating agencies to act as gatekeepers); Susan P. Koniak, *Corporate Fraud: See, Lawyers*, 26 HARV. J.L. & PUB. POL'Y 195, 195 (2003) (arguing that a "lion-sized portion of blame" for Enron and other corporate governance crises rests with lawyers).

⁴ On the ability of insurance generally to serve a gatekeeping function, see TOM BAKER, *INSURANCE LAW AND POLICY* 9 (2003), which discusses how various insurance arrangements perform a gatekeeping role, and RICHARD V. ERICSON ET AL., *INSURANCE AS GOVERNANCE* 3 (2003), which presents an ethnographic study to describe "how the insurance industry governs our lives."

accidental gatekeeper, guarding the entrance of its risk pool by evaluating the governance quality of prospective insureds.

The D&O insurer's incentive to serve as a corporate governance gatekeeper produces a simple but powerful hypothesis concerning the relationship of D&O insurance to corporate governance: *firms with worse corporate governance pay higher D&O premiums than firms with better corporate governance.* Details from a firm's D&O policy should thus convey important information about the firm. By examining an insured firm's premiums, limits, and retentions, and by controlling for such variables as market capitalization, volatility, and industry, investors and other capital market participants should be able to glean the insurer's assessment of the quality of the firm's corporate governance.⁵

This Article develops the governance-insurance link and explores its implications and limitations. Part II examines the connection between corporate governance and shareholder litigation. It argues that better corporate governance ought to lower a firm's total costs from shareholder litigation, thus providing ample incentive for D&O insurers to evaluate a firm's corporate governance. Part III reviews the role and function of D&O insurance in corporations, describing how D&O insurance works and why corporations buy it. Part IV then considers the relationship between corporate governance and D&O insurance, arguing that D&O insurers *should* and in fact *do* take corporate governance into account when writing (and pricing) D&O policies. As a result, Part IV ultimately concludes that a firm's D&O coverage ought to convey an important signal to investors and other capital market participants. Unfortunately, as discussed in Part V, this signal is not reaching the market. Corporations typically do not disclose the details of their D&O policies and, in the United States at least, there is no generally applicable rule forcing them to do so.

There should be. Because basic D&O policy details could signal important information to investors and thereby improve the efficiency of the capital markets, this Article argues that U.S. securities regulation should be changed to require the disclosure of such information. The SEC has sufficient authority to make this change, which, as described in Part V, would be technically simple and unlikely to incur principled opposition. Moreover, the benefits of this change are po-

⁵ A policy's "limit" is the total amount of coverage—that is, the maximum amount the insurer could be made to pay. The "retention," also referred to as the "deductible," is the portion of the claim that the insured must pay even if the policy's limits are not exhausted.

tentially large: it will effectively uncover a new gatekeeper in American corporate governance and unleash a flood of useful information into the market. The Article concludes that the SEC should change the law and require D&O insurance disclosure.

II. SHAREHOLDER LITIGATION AND CORPORATE GOVERNANCE

The hypothesis that D&O insurers function as corporate governance gatekeepers depends, first, on the relationship between shareholder litigation and corporation governance. As used in this Article, "shareholder litigation" refers to all claims covered under a D&O policy, whether brought by a shareholder or a regulatory agency, for which the resolution depends upon corporate or securities law.⁶ The Article gives a similarly expansive definition to "corporate governance," defining it broadly to refer to any policies or structural mechanisms affecting management of a firm.⁷ If there were no relationship

⁶ See, e.g., Am. Int'l Group (AIG), Executive and Organization Liability Insurance Policy § 2(z) (Feb. 2000), <http://www.aignationalunion.com/nationalunion/public/natfiledownload/0,2138,2634,00.pdf>? [hereinafter AIG Specimen Policy] (covering "any actual or alleged breach of duty, neglect, error, misstatement, misleading statement, omission or act or any actual or alleged Employment Practices Violation . . . with respect to an Executive of an Organization"); Chubb Corp., Executive Protection Portfolio: Executive Liability and Entity Securities Liability Coverage 7 (Nov. 2002), <http://csi.chubb.com/products/pdf-files/14027303.pdf> [hereinafter Chubb Specimen Policy] (covering "any other matter claimed against an Insured Person solely by reason of his or her serving in an Insured Capacity"); Hartford Fin. Prods., Directors, Officers and Company Liability Policy § IV(O) (June 1996), <http://www.hfpinsurance.com/forms/nj85.pdf> [hereinafter Hartford Specimen Policy] (covering "any matter claimed against the Directors and Officers solely by reason of their serving in such capacity"). Although D&O policies may also cover employment-related claims against directors and officers, employment claims are an important component of D&O coverage only for nonpublic companies. See TILLINGHAST, TOWERS PERRIN, 2004 DIRECTORS AND OFFICERS LIABILITY SURVEY 4 (2004) [hereinafter TILLINGHAST 2004 SURVEY] (reporting that 57% of the claims against public companies were brought by shareholders and that 96% of the claims brought against nonprofits were brought by employees); see also Interview with Confidential Source, D&O Advisor, Outside Counsel, in New York, N.Y. (Oct. 12, 2004) (transcript on file with the University of Pennsylvania Law Review) [hereinafter D&O Advisor Interview] (confirming that for public companies, shareholder litigation is by far the larger liability risk under a D&O policy). Therefore, although employee claims may introduce some noise into the signal sent by the D&O premium, the distortion should be minimal for public companies, given the dominant role of shareholder claims.

⁷ Questions of which specific governance terms and policies matter most are beyond the scope of this Article. There is considerable academic debate over which governance terms are the best predictors of shareholder returns. See generally Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 109-10 (2003) (describing how an index of corporate governance provisions correlates with "returns, firm value, and operating performance"); Lucian Bebchuk et al., *What Matters in Corpo-*

between shareholder litigation and corporate governance, then the D&O insurer could not improve the quality of its risk pool by evaluating a firm's corporate governance. As a result, insurance premiums would have nothing more than a random, accidental relationship to corporate governance. This Part argues, however, that the relationship between corporate governance and shareholder litigation is strong enough to support the insurer-as-gatekeeper hypothesis.

Shareholder litigation typically involves three types of claims: shareholder derivative actions, shareholder direct actions, and securities fraud claims. Derivative suits—actions brought by shareholders on the corporation's behalf to recover for a manager's breach of duty—were once thought to exert an important constraint on managerial agency costs.⁸ Now, however, a wide variety of procedural mechanisms enables boards to terminate such claims early and at relatively low cost.⁹ In addition to the derivative suit, state corporate law

rate Governance? 33-34 (John M. Olin Ctr. for Law, Econ., & Bus., Harvard Law Sch., Discussion Paper No. 491, 2004), available at <http://ssrn.com/abstract=593423> (arguing that provisions indicating managerial entrenchment matter most for shareholder returns); K.J. Martijn Cremers & Vinay B. Nair, *Governance Mechanisms and Equity Prices* 3-5 (Yale Int'l Ctr. for Fin., Working Paper No. 03-15, 2004), available at <http://ssrn.com/abstract=412140> (exploring how corporate governance mechanisms affect firm value); Lawrence D. Brown & Marcus L. Caylor, *Corporate Governance and Firm Performance* 3 (Dec. 7, 2004), <http://ssrn.com/abstract=586423> (evaluating the relationship between certain corporate governance data and "operating performance, valuation, and cash payouts"). The question of which governance terms are the best predictors of shareholder litigation is, of course, distinct. See, e.g., 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) (predicting earnings restatements and litigation activity for high-growth firms with managers who are overcommitted to continued growth and arrogantly view internal controls or financial reporting as a nuisance, subservient to their entrepreneurial goals); Eric Helland & Michael Sykuta, *Who's Monitoring the Monitor? Do Outside Directors Protect Shareholders' Interests?*, 40 FIN. REV. 155, 157 (2005) (finding that firms with a higher proportion of inside directors have a higher probability of being sued by their shareholders). The question of which corporate governance variables insurers believe are most important is the subject of an empirical project that I am currently undertaking with my colleague Tom Baker.

⁸ See, e.g., *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949) (stating that the derivative action, "born of stockholder helplessness, was long the chief regulator of corporate management" and noting the argument that "without it there would be little practical check on such abuses"). This Article will refer to the divergence of interests between management and shareholders as "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, 309 (1976) (identifying the divergence in interests between principal and agent as a central feature of the separation of ownership and control).

⁹ These include the requirement that the plaintiffs make demand on the board and, in some states, post a bond for corporate defense costs. More broadly, procedural

also allows shareholders to sue individually or as a class when they can allege an injury that is not derivative of an injury to the corporation.¹⁰ These direct claims, typically brought as class actions challenging board conduct in the context of takeovers or acquisition transactions, have come to dominate state corporate law filings.¹¹ They are not as easily terminated as derivative claims and, according to some commentators, target precisely those transactions in which agency costs are potentially highest.¹² Finally, securities litigation may be brought in many of the same situations that give rise to state corporate law claims.¹³ Although such claims must be framed around misrepresentations or inadequacies in corporate disclosure,¹⁴ the basic concern—that company managers have misused their positions to the disadvantage of their shareholders—is the same whether the complaint is

hurdles include the business judgment rule and the ability of a special litigation committee to wrest control of the litigation from the plaintiff. See generally N.Y. BUS. CORP. LAW § 627 (McKinney 2003) (requiring the posting of a bond); *Grimes v. Donald*, 673 A.2d 1207, 1215-17 (Del. 1996) (discussing the demand requirement); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981) (explaining the role of the special litigation committee); *Auerbach v. Bennett*, 393 N.E.2d 994, 1001 (N.Y. 1979) (shielding the decisions of a special litigation committee from judicial scrutiny). These procedural obstacles reflect the widely held view that derivative litigation is a corporate nuisance, of value only to plaintiffs' attorneys, leading some to argue that the derivative action should be abolished. See STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 403-04 (2002) (proposing the elimination of derivative litigation).

¹⁰ See *Grimes*, 673 A.2d at 1213-15 (discussing the distinction between derivative and direct claims).

¹¹ See Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 137 & n.12 (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, whereas only 14% of fiduciary duty claims over the same period were derivative suits).

¹² See *id.* at 139 ("[S]hareholder acquisition litigation polices those management transactions with the highest potential for self-dealing."). But see Elliott J. Weiss & Lawrence J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions*, 57 VAND. L. REV. 1797, 1803-04 (2004) (finding high litigation agency costs in acquisition-oriented class actions).

¹³ See Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 861 (2003) (arguing that outside of the contexts of self-dealing and acquisitions, "corporate governance . . . has passed to federal law and in particular to shareholder litigation under Rule 10b-5").

¹⁴ See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 241-47 (1988) (allowing a 10b-5 claim to survive dismissal on the basis of an allegation that shareholders sold at a price reflecting the company's false or misleading statements, thereby replacing traditional notions of fraud with the "fraud-on-the-market" theory).

framed under corporate or securities law.¹⁵ The biggest difference, it seems, is the potential for damages, with securities litigation presenting by far the greatest liability threat to corporations and their managers.¹⁶

A long list of actions may give rise to one or more of these forms of shareholder litigation. A leading treatise provides a 170-item checklist of potential bases for liability with category headings including "Governance, Management and Business," "Informed Business Judgment," "Unauthorized or Ultra Vires Actions," "Self-Dealing and Conflicts of Interest," "Change of Control Situations," and "Disclosures."¹⁷ The common theme underlying all of these liability threats, however, is a corporate structure that enables managers to act selfishly and contrary to the best interests of their shareholders.¹⁸ Whether shareholders bring a derivative claim alleging a wealth transfer from shareholders to management, a direct action claiming that an entrenched board has not acted to maximize shareholder wealth in the context of a takeover, or a securities claim alleging that managers misstated earnings in order to protect their incentive compensation packages, the underlying issue is the failure of the corporation to design a structure to constrain its managers from acting to benefit them-

¹⁵ See Thompson & Sale, *supra* note 13, at 903 (citing as the concern underlying all forms of shareholder suits "that management has misused its position with respect to corporate assets").

¹⁶ See, e.g., ELAINE BUCKBERG ET AL., NERA ECON. CONSULTING, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: BEAR MARKET CASES BRING BIG SETTLEMENTS 4 (2005), available at http://www.nera.com/image/Report_WEB_Recent_Trends_2.2005.pdf (reporting that the mean securities settlement increased by 33% in 2004 to \$27.1 million and stating that, although the median settlement fell slightly from \$5.5 million to \$5.3 million, the "increase in mean settlements cannot be explained by a handful of extraordinary settlements"); LAURA E. SIMMONS & ELLEN M. RYAN, CORNERSTONE RESEARCH, POST-REFORM ACT SECURITIES LAWSUITS: SETTLEMENTS REPORTED THROUGH DECEMBER 2003, at 4 (2004), available at http://securities.stanford.edu/Settlements/REVIEW_1995-2003/2003_Settlements.pdf (reporting that "average 'estimated damages' [in securities claims] have consistently increased" since 1997).

¹⁷ 2 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 17.02 (7th ed. 2002).

¹⁸ Although some shareholders may benefit from, for example, overstated earnings—specifically, those who sell prior to the earnings correction—shareholders as a whole and prospective shareholders, especially those who buy prior to the earnings correction, are harmed. On the potential for conflict between present and future shareholders' interests, see Steven L. Schwarcz, *Temporal Perspectives: Resolving the Conflict Between Current and Future Investors*, 89 MINN. L. REV. 1044, 1045 (2005).

selves at the expense of shareholders.¹⁹ Much shareholder litigation, in other words, arises as a result of managerial agency costs.²⁰

Good governance ought to lead to less litigation. Corporate governance constraints are designed to control managerial agency costs. By preventing the defections from shareholder interests that lead to lawsuits, better corporate governance should result in less shareholder litigation. Alternatively, even if it cannot prevent managers from behaving opportunistically, good corporate governance may enable the detection and eradication of such behavior, thereby limiting the total loss to shareholders and, ultimately, the cost of litigation.²¹ In other words, insofar as managerial agency costs underlie shareholder litigation and corporate governance constrains managerial agency costs, better governance ought to translate into less litigation or, at least, less costly claims.

The assertion that better governance leads to less litigation is not the same as the assertion that litigation will lead to better governance. Indeed, there is considerable doubt concerning the latter proposition. In an influential study of derivative litigation, for example, Professor Roberta Romano concluded that "shareholder litigation is a weak, if not ineffective, instrument of corporate governance."²² The fundamental insight driving this analysis can be characterized as "litigation agency costs"—that is, the divergence between the interests of the plaintiffs' attorney controlling the litigation and the shareholder plaintiffs that the attorney supposedly represents.²³ This disconnect leads plaintiffs' lawyers both to file claims that shareholders would prefer not to press,²⁴ and to settle claims that shareholders would pre-

¹⁹ The same harm may thus give rise to a claim under corporate law, whether derivative or direct, and securities law. See Thompson & Sale, *supra* note 13, at 904 (noting the overlap in potential causes of action).

²⁰ See generally Jensen & Meckling, *supra* note 8, at 309-10 (discussing agency costs in firms).

²¹ See generally OLIVER E. WILLIAMSON, *THE MECHANISMS OF GOVERNANCE* 47-48 (1996) (discussing the costs of opportunism).

²² Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 84 (1991).

²³ See *id.* at 57 ("[A]ttorneys' incentives are the key factor in shareholder litigation."); see also John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5, 12 (1985) (discussing the problem of litigation agency costs).

²⁴ See, e.g., Lucian Arye Bebchuk, *Suing Solely to Extract a Settlement Offer*, 17 J. LEGAL STUD. 437, 437-41 (1988) (providing a formal model of the incentive of plaintiffs' attorneys to file frivolous suits); Avery Katz, *The Effect of Frivolous Lawsuits on the Settlement of Litigation*, 10 INT'L REV. L. & ECON. 3, 5 (1990) (same); D. Rosenberg & S. Shavell, *A*

fer to pursue.²⁵ Litigation agency costs thus distort the ability of shareholder litigation to check managerial agency costs.²⁶

Skepticism that shareholder litigation operates as an effective governance constraint should not, however, be taken as reason to doubt that effective corporate governance will lead to less shareholder litigation.²⁷ Litigation agency costs disrupt the causal connection between litigation and governance, but not necessarily the link between governance and litigation. The distortion of litigation agency costs arises only *after* conduct giving rise to a potential claim has occurred, at which point plaintiffs' lawyers may pursue nuisance suits and settle valid claims so that the ultimate result bears little relation to the so-

Model in Which Suits Are Brought for Their Nuisance Value, 5 INT'L REV. L. & ECON. 3, 3-4 (1985) (same).

²⁵ Cf. Romano, *supra* note 22, at 61 (finding that although only half of the settlements in her sample resulted in any recovery to shareholders, 90% awarded attorneys' fees). See generally Robert D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LITERATURE 1067, 1075-82 (1989) (summarizing various settlement theories). On the question of when shareholder litigation should and should not be pursued, see Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1737-44 (1994).

²⁶ See Romano, *supra* note 22, at 55 ("The efficacy of shareholder litigation as a governance mechanism is hampered."). See generally Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1488-89 (1996) (proposing alternatives to securities litigation); Randy J. Kozel & David Rosenberg, *Solving the Nuisance-Value Settlement Problem: Mandatory Summary Judgment*, 90 VA. L. REV. 1849, 1850-51 (2004) (discussing nuisance value strategies); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 19 (1991) (recommending changes in the system); A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 947-49 (1999) (discussing class actions and their competing goals of compensation and deterrence). The problem of litigation agency costs also shaped the reforms adopted in the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered subsections of 15 U.S.C. §§ 77-78), which includes titles dealing with reductions of "abusive litigation" and "coercive settlements." D&O insurance arguably exacerbates these distortions by effectively releasing directors and officers from the threat of personal liability. See James D. Cox, *Private Litigation and the Deterrence of Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 1, 21-37 (1997) (weighing arguments that insurance undercuts the deterrent effects of shareholder litigation).

²⁷ Skepticism on this later point would tend to lead to the cynical view that shareholder litigation is essentially random, unable to serve either a compensatory or deterrence function, and therefore ought to be abolished. See generally James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 775-76 (1984) (noting that deterrence seems to dominate compensatory objectives in derivative suits); Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 865 (1984) (noting the essential deterrence function of shareholder litigation).

cially optimal sanction for the conduct.²⁸ Corporate governance mechanisms, by contrast, operate *before* the harmful conduct has occurred. Because corporate governance operates at a level prior to the introduction of litigation agency costs, and therefore may prevent the harm from ever taking place, corporate governance has a more direct impact on shareholder litigation than shareholder litigation does on corporate governance.²⁹ Stated most concisely, better corporate governance should lead to less shareholder litigation regardless of whether shareholder litigation leads to better corporate governance.

It is, of course, possible to press the objection, arguing that litigation agency costs are so severe that they have effectively unmoored shareholder litigation from underlying corporate governance practices. In this vein, critics often argue that securities class action filings cluster around sudden declines in stock price rather than any solid evidence of corporate misfeasance.³⁰ Members of the plaintiffs' bar have sought to rebut this argument, citing studies that find relatively few cases accompanying sharp declines in stock price.³¹ To argue

²⁸ Cf. Kraakman et al., *supra* note 25, at 1741 (arguing that shareholders would like suits to be brought only when the suit would increase share value as measured by deterrence benefits plus expected recoveries minus litigation expenses and ex ante salary and insurance adjustments).

²⁹ The problem may be conceptualized on a three-point timeline, placing in order (1) the firm's initial governance structure, (2) shareholder litigation, and (3) the firm's postlitigation governance structure. Because litigation agency costs arise with the litigation, they disrupt the causal chain between points (2) and (3), but not between points (1) and (2). A firm's initial governance structure should affect shareholder litigation at point (2) regardless of whether litigation at point (2) affects the governance structure at point (3).

³⁰ See, e.g., *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 103d Cong. 3 (1993) [hereinafter *Senate Hearings*] (statement of Sen. Donald W. Riegle, Jr., Chairman, S. Comm. on Banking, Housing, and Urban Affairs) ("Companies, particularly growth firms, say they are sued whenever their stock drops."); *id.* at 5 (statement of Sen. Pete V. Domenici, Member, S. Subcomm. on Securities) ("[R]ule 10(b)(5) lawsuits can be filed within weeks, sometimes days, or even in hours after a stock drops in price."); *id.* at 16 (statement of Richard J. Egan, Chairman, EMC Corp.) ("[Suits] are typically filed within days or sometimes hours of a company's announcement of adverse news and disappointing earnings."); see also Michael Selz, *Lawsuits Often Follow When Small Firms Go Public*, WALL ST. J., Jan. 13, 1992, at B2 (reporting the high frequency of shareholder lawsuits when a company's stock price drops sharply soon after a public offering).

³¹ See, e.g., *Securities Litigation Reform: Hearings Before the Subcomm. on Telecomm. and Fin. of the H. Comm. on Energy and Commerce*, 103d Cong. 309-14 (1994) (testimony of Leonard B. Simon, Partner, Milberg Weiss Bershad Hynes & Lerach) (demonstrating quantitatively that only a small portion of 10% or greater one-day drops in stock price result in class action suits against the company).

about the *filing* of securities or other shareholder litigation claims, however, is to miss the point. Plaintiffs' attorneys may file claims without much investigation because some claims will not yield solid evidence of fraud until some time after the initial decline in stock price.³² As a result, some claims will be meritorious regardless of the amount of investigation at the time of filing, while others will turn out to be meritless and, therefore, will be quickly dropped or easily dismissed.³³ Thus, regardless of the dynamics at filing, the real issue is whether meritorious claims are more difficult to dismiss or more costly to settle. In other words, do firms with better corporate governance face lower overall costs from shareholder litigation?

Securities law scholars have addressed this question by investigating whether firms face similar or different costs from shareholder litigation. Their principal data source has been settlement amounts. Variance in settlement amounts would suggest that idiosyncratic variables, such as the merits of a particular claim or the quality of a particular firm's corporate governance, explained settlement outcomes, but if settlement amounts tended to cluster along the lines of a simple variable, such as alleged damages or market capitalization, the data would seem to suggest that outcomes are explained by features other than the merits of particular claims or the attributes of individual firms. Professor Janet Cooper Alexander's famous study of securities settlements employed precisely this methodology, finding that most settlements in her sample followed a very simple "going rate" of approximately one quarter of the potential damages."³⁴ The implication, which became highly influential in the call for securities law reform,³⁵ was that the merits of individual claims do not determine settlements and therefore do not matter in securities class actions.

³² See generally David L. Gilbertson & Steven D. Avila, *The Plaintiffs' Decision to Sue Auditors in Securities Litigation: Private Enforcement or Opportunism?*, 24 J. CORP. L. 681, 684 (1999) (studying the length of time between market reaction and filing of suit).

³³ This, of course, assumes that nonmeritorious claims are more easily dismissed or otherwise cheaply resolved. See Joel Seligman, Commentary, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority"*, 108 HARV. L. REV. 438, 455 (1994) ("A substantial percentage of Rule 10b-5 claims are dismissed by courts on a motion by defendants. This suggests that many nonmeritorious suits do not survive until settlement.").

³⁴ Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 500 (1991) (concluding that the merits do not matter).

³⁵ See William S. Lerach, "The Private Securities Litigation Reform Act of 1995—27 Months Later": *Securities Class Action Litigation Under the Private Securities Litigation Reform Act's Brave New World*, 76 WASH. U. L.Q. 597, 598 (1998) (stating that Congress "relied

Alexander's study has been criticized for various methodological flaws—that the merits do not matter is, after all, a rather broad conclusion to draw from a sample of only eight cases within the same industry in the same year.³⁶ But the study's gravest error is its failure to control for broader market declines that may have accompanied the drop in the defendants' stock price.³⁷ This is a critical adjustment because each defendant would have had the opportunity to argue negative causation—that is, that part of the drop in stock price was due to a broader market decline, as measured by some market index.³⁸

Negative causation introduces an important difference into Alexander's otherwise homogeneous sample: each company had a different market window for mitigating damages based on broader market declines. Therefore, adjusting the decline in each company's stock price for general market declines significantly changes the potential damages for each claim. Recalculating the settlement amounts as percentages of potential damages so adjusted, Professors Elliott Weiss and John Beckerman found that Alexander's 25% "going rate" could no longer be supported.³⁹ Instead, settlements varied considerably, between about 23% and 80% of recoverable damages, suggesting that idiosyncratic characteristics of the particular claims, such as their indi-

heavily upon Professor Janet Cooper Alexander's article" in enacting the Private Securities Litigation Reform Act of 1995).

³⁶ See Leonard B. Simon & William S. Dato, *Legislating on a False Foundation: The Erroneous Academic Underpinnings of the Private Securities Litigation Reform Act of 1995*, 33 SAN DIEGO L. REV. 959, 966-76 (1996) (arguing that Alexander's methodology was flawed, in part due to her sample's small size and homogeneity). Simon and Dato went further, seeking to replicate Professor Alexander's results with a slightly larger sample, but failing to do so. They found instead that settlements varied widely (between 0% and 70% of potential damages), even when not adjusting for market-wide movements. *Id.* at 996.

³⁷ See James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 503 (1997) (pointing out this omission and concluding that Professor Alexander did not therefore prove her thesis).

³⁸ See 15 U.S.C. § 77k(e) (2000) ("[I]f the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from [the alleged fraud], . . . such portion or all such damages shall not be recoverable."); *Beecher v. Able*, 435 F. Supp. 397, 407-09 (S.D.N.Y. 1977) (recognizing the potential validity of a negative causation defense to a fraudulent registration claim); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 586 (E.D.N.Y. 1971) (adjusting a damage award downwards to account for a drastic decline in the stock market).

³⁹ 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).

vidual merits, may indeed have influenced outcomes at settlement.⁴⁰ Several other empirical studies reaching the same conclusion as Alexander's suffer from similar methodological defects.⁴¹

The question of whether the merits matter in securities litigation may require a more nuanced answer than a simple yes or no. Several studies by National Economic Research Associates, Inc. (NERA), a research and consulting firm affiliated with the insurance industry, have returned ambiguous results, finding that although the merits of securities litigation seem to matter *less* than other factors, they nevertheless retain some explanatory force.⁴² More recently, Professor Stephen Choi reviewed empirical research on the merits of securities litigation both before and after passage of the Private Securities Litigation Reform Act of 1995 (PSLRA),⁴³ and summarized the findings as follows:

⁴⁰ *Id.*; accord Simon & Dato, *supra* note 36, at 990 (analyzing Alexander's sample, factoring in general market forces, and finding that adjusted settlement figures varied between approximately 3% and 80% of potential damages). See generally Willard T. Carleton et al., *Securities Class Action Lawsuits: A Descriptive Study*, 38 ARIZ. L. REV. 491, 494-99 (1996) (describing various models of damages, the assumptions each model makes, and the widely differing results each model gives).

⁴¹ See, e.g., *Senate Hearings*, *supra* note 30, at 46-48 (statement of Dr. Vincent E. O'Brien, Law and Economics Consulting Group, Inc.) [hereinafter O'Brien Senate Statement] (finding that securities class action settlements from 1988 to 1993 clustered at 6% of total trading losses, but failing to adjust for "actual damages" under the securities laws).

⁴² Compare, e.g., Denise N. Martin et al., *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions*, 5 STAN. J.L. BUS. & FIN. 121, 122-23 (1999) (representing NERA and rejecting the hypothesis that securities litigation produces optimal deterrence of corporate wrongdoing, but finding that "the timing of settlements may indeed be reflective of a case's merits" and that "only a portion of low-valued settlements are likely to be nuisance suit settlements"), with Frederick C. Dunbar & Vinita M. Juneja, NERA, *Recent Trends II: What Explains Settlements in Shareholder Class Actions?* (1993), reprinted in *Senate Hearings*, *supra* note 30, at 739, 747-48 ("[N]o factor on which we have data, other than investor losses, plaintiffs' damage estimate, and number of insurable co-defendants, has consistent, statistically significant impacts on settlement size."). The older NERA study goes on to state:

Our statistical results . . . leave almost 60 percent of the dispersion in settlements unexplained. Some of this unexplained variation may be due to factors reflecting the merits about which we have no data. Also, because investor losses may be correlated with either availability of assets or actual damages, some of the explanation of settlement size may depend upon potential damage exposure which in turn may be reflecting the merits of a case.

Id. at 748.

⁴³ Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered subsections of 15 U.S.C. §§ 77-78).

[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. Lawsuits relating to more obvious indicia of fraud, such as accounting restatements, are more prevalent in post-PSLRA filings and are more important in determining outcomes in the post-PSLRA time period. Cases also seem to take longer to settle in the post-PSLRA period, indicating perhaps more work on the part of plaintiffs' attorneys in litigating these suits.⁴⁴

The PSLRA, in other words, made the merits matter more than they previously had.

This Article's thesis does not require the merits to be all that matters in shareholder litigation. As long as the total cost of shareholder litigation depends, at least in part, on corporate wrongdoing that can ultimately be traced to a failure of corporate governance, firms with better corporate governance should face lower total costs in shareholder litigation. Better governed firms will suffer fewer meritorious claims and pay less in total litigation costs than similarly situated firms with relatively worse corporate governance because, when nonmeritorious claims do arise, they are resolved more cheaply than meritorious claims. Because insurers are the parties ultimately on the hook for these costs,⁴⁵ they have ample incentive to inquire into a firm's corporate governance practices before selling it a D&O policy.

⁴⁴ Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1498 (2004). On the shift toward more objective evidence of corporate fraud in securities litigation, see Marilyn F. Johnson et al., *Do the Merits Matter More After Securities Litigation Reform? Evidence from Restatements, Earnings Forecasts and Insider Trading 2* (July 2004), <http://ssrn.com/abstract=589221> ("[W]e find a significantly greater correlation between litigation and both earnings restatements and insider trading after the PSLRA.").

⁴⁵ See O'Brien Senate Statement, *supra* note 41, at 48 (indicating that 94% of securities class action settlements are within typical insurance coverage limits and that insurance proceeds are usually the sole source of settlement funds).

III. THE ROLE AND FUNCTION OF D&O INSURANCE

D&O insurance arose in the 1950s and 1960s as a species of the basic liability policies that insurers had long marketed.⁴⁶ The first D&O policies were not well adapted to the special context of corporate litigation, leaving gaps in coverage and, because they seemed to clash with public policy objectives, raising issues of enforceability.⁴⁷ The troubling public policy question was whether a corporation could insure its managers against losses for which they could not be legally indemnified.⁴⁸ Although commentators had argued that insurance payments should not be allowed in any circumstance where indemnification was illegal,⁴⁹ state legislators ultimately mooted the argument

⁴⁶ See Joseph F. Johnston, Jr., *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993, 2012 (1978) ("Although [D&O] policies have been marketed since the 1950s, the coverage had little attention until the mid-1960s."); see also Joseph W. Bishop, Jr., *New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability*, 22 BUS. LAW. 92, 103 (1966) (noting that the author had written four years earlier that directors and officers "do not commonly insure themselves against the expenses of litigation arising out of their corporate status," but that since that time insurers had found a highly receptive market for D&O insurance, representing "a violent new twist" on the problem of the propriety of indemnification payments (citing GEORGE THOMAS WASHINGTON & JOSEPH WARREN BISHOP, JR., *INDEMNIFYING THE CORPORATE EXECUTIVE* 75 (1963))).

⁴⁷ Professor Bishop quipped:

Perusal of the Lloyd's form and its American imitations leaves me with a distinct impression that the draughtsman, though possessed of broad and solid experience in the field of insurance law, got his corporation law from some rather sketchy recollections of Business Units I (or whatever they happened to call the basic corporation course in his law school) and a quick glance at *Corpus Juris*.

Bishop, *supra* note 46, at 103.

⁴⁸ See *id.* at 106-07 (questioning whether corporations could, for example, indemnify directors from liability predicated on self-dealing). Corporate indemnification of directors and officers is broadly permitted under the law of most states. See *infra* note 58 (noting the few situations in which indemnification is not legally permitted).

⁴⁹ See, e.g., Bishop, *supra* note 46, at 107 ("[W]here the applicable statute flatly prohibits indemnification inconsistent with its terms, it seems to me plainly illegal for the corporation to pay for insurance against expenses, such as payments to the corporation to compensate it for a breach of duty to it . . ."); *id.* at 109-10 (arguing that because "courts would never allow a corporation to indemnify an insider against amounts paid the corporation in settlement or satisfaction of judgment" of a claim for breach of fiduciary duty, the same criteria should be applied "to the corporation's payment for insurance which may operate to relieve the insider of such liability"); see also Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1087 (1968) (arguing that "an insurance policy paid for by the corporation whose effect was to free corporate managers from the fear of civil liability for breach of their duty to show good faith in their dealings with the

by passing statutes that expressly allowed corporations to purchase and maintain D&O insurance, even against those losses that the corporation could not itself indemnify.⁵⁰

D&O insurance thus operates as a contractual mechanism to spread the risk of shareholder litigation. It moves the risk from individual directors and officers to the corporation they manage and then to a third-party insurer, with the ultimate result that individual managers are almost never saddled with personal liability for causing corporate losses.⁵¹ If the shareholders sue, the corporation or its insurer pays. This Part offers a close examination of this insurance arrangement.

A. *How D&O Insurance Works*

The general label "D&O insurance" is often applied to three distinct insurance arrangements. First, there is coverage to protect individual managers from the risk of shareholder litigation. Second, there

corporation" would violate public policy); Note, *Indemnification of Directors: The Problems Posed by Federal Securities and Antitrust Legislation*, 76 HARV. L. REV. 1403, 1428 (1963) ("Insurance in its present form should be voided as contrary to public policy wherever it would free the director from a liability burden from which he could not be freed by indemnification."); Note, *Public Policy and Directors' Liability Insurance*, 67 COLUM. L. REV. 716, 719 (1967) (arguing that insurance against breach of the duty of loyalty is contrary to public policy, even if paid by the director herself).

⁵⁰ For example, Delaware law 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 or officers against liabilities incurred in such capacities, whether or not the corporation would have the power to indemnify against such liabilities.").

⁵¹ See Bernard Black et al., *Outside Director Liability* 5 (John M. Olin Program in Law & Econ., Stanford Law Sch., Working Paper No. 250, 2003), available at <http://ssrn.com/abstract=382422> (noting the extremely low risk of director liability). Recent settlements involving WorldCom and Enron compel the "almost" qualification. See Gretchen Morgenson, *Ex-Directors at WorldCom Settle Anew*, N.Y. TIMES, Mar. 19, 2005, at C1 (describing an agreement in which former WorldCom directors will personally contribute \$20 million to a settlement). On the difficulties of reaching personal assets rather than insurance assets in the ordinary tort context, see Tom Baker, *Blood Money, New Money, and the Moral Economy of Tort Law in Action*, 35 LAW & SOC'Y REV. 275, 277 (2001).

is coverage to reimburse the corporation for its indemnification obligations. And third, there is coverage to protect the corporation from the risk of shareholder litigation to which the corporate entity itself is a party. The first two aspects of D&O coverage trace to the original Lloyd's of London D&O form.⁵² The third form of coverage is a newer development. A D&O insurance package may consist of these forms of coverage in any proportion.

The only form of D&O insurance that actually insures individual directors and officers is referred to within the industry as "Side A coverage."⁵³ Side A coverage essentially provides that the insurer will pay covered losses on behalf of covered managers when the corporation itself does not indemnify them.⁵⁴ Covered losses include compensatory damages, settlement amounts, and legal fees incurred by the individual in connection with her service as a director or officer of the corporation.⁵⁵

⁵² The original Lloyd's form contained two policies, "ALS(D4)" and "ALS(D5)," one for individual coverage and one for corporate coverage. Joseph Hinsey, IV, et al., *What Existing D&O Policies Cover*, 27 BUS. LAW. 147, 150 (1972).

⁵³ The types of coverage are named in reference to the insurance documents listing the respective rights and obligations. Side A coverage relates to "Insuring Agreement A," Side B coverage to "Insuring Agreement B," and so on.

⁵⁴ Typical policy language provides:

Except for Loss which the Insurer pays pursuant to Insuring Agreement (B) of this Policy, the Insurer will pay on behalf of the Directors and Officers Loss which the Directors and Officers shall become legally obligated to pay as a result of a Claim first made during the Policy Period or Discovery Period, if applicable, against the Directors and Officers for a Wrongful Act which takes place during or prior to the Policy Period.

Hartford Specimen Policy, *supra* note 6, § I(A); *see also* AIG Specimen Policy, *supra* note 6, § 1 (providing similar language); Chubb Specimen Policy, *supra* note 6, at 2 (same). The effect of the carve-out for losses paid pursuant to Insuring Agreement B is to prevent the managers from being paid twice for the same loss.

⁵⁵ AIG Specimen Policy, *supra* note 6, § 2(p); Chubb Specimen Policy, *supra* note 6, at 5; Hartford Specimen Policy, *supra* note 6, § IV(J). The policies define "claims" 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. AIG Specimen Policy, *supra* note 6, § 2(b); Chubb Specimen Policy, *supra* note 6, at 3-4; Hartford Specimen Policy, *supra* note 6, § IV(A). Wrongful acts 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. AIG Specimen Policy, *supra* note 6, § 2(z)(1); Chubb Specimen Policy, *supra* note 6, at 7; Hartford Specimen Policy, *supra* note 6, § IV(O).

The second form of D&O coverage, "Side B coverage," does not protect individual managers at all but rather reimburses the corporation for indemnifying its directors and officers.⁵⁶ Payments under Side B coverage are thus triggered when the corporation incurs an obligation to indemnify its managers, which most policies deem to be required in every case where a corporation is legally permitted to do so.⁵⁷ Together, Side A and Side B coverage allocate the risk of loss from shareholder litigation as follows. First, when a company is legally permitted to indemnify its managers for their liabilities, as it generally is, it must do so.⁵⁸ Second, when a company does indemnify its man-

⁵⁶ 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, § I(B); *see also* AIG Specimen Policy, *supra* note 6, § 1 (providing similar language); Chubb Specimen Policy, *supra* note 6, at 2 (same).

⁵⁷ *See* Hartford Specimen Policy, *supra* note 6, § 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* AIG Specimen Policy, *supra* note 6, § 6 (same); Chubb Specimen Policy, *supra* note 6, at 11 (same). When a corporation that is legally able to indemnify its directors and officers refuses to do so, the insurer remains obligated under the policy's Side A coverage, but the obligation is subject to the (higher) Side B retention as well as a coinsurance percentage. AIG Specimen Policy, *supra* note 6, § 6; Chubb Specimen Policy, *supra* note 6, at 12; Hartford Specimen Policy, *supra* note 6, § VI(F). This presumptive indemnification aspect of the D&O policy is aimed at preventing the possibility of opportunism, where a corporation refuses to indemnify solely to cause the payment obligation to fall on the insurer.

⁵⁸ Although most state corporate law codes broadly permit indemnification, many states, including Delaware, do not allow indemnification for settlements (or judgments) in derivative litigation on the theory that such awards benefit the company and are paid, minus the chunk awarded to the plaintiffs' attorneys, into the corporate treasury. *See* DEL. CODE ANN. tit. 8, § 145(a) (2004) (permitting indemnification for expenses, judgments, and settlements for actions except those "by or in the right of the corporation"). Because derivative litigation is asserted by shareholders in the corporation's name, it is an action "by or in the right of the corporation." To allow indemnification in such situations would be circular: the director would pay the settlement to the corporation only to be given back the same amount by the corporation as indemnification. *See* Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 BUS. LAW. 573, 580 (1996) ("The theory is that the corporation would be indemnifying the director or officer for a settlement ultimately paid to the corporation itself as plaintiff. Certain state legislatures, including Delaware's, have determined that such circularity of payment is unacceptable."). Delaware does, however, permit corporations to indemnify directors for defense costs incurred by directors and officers in reaching settlement or judgment. DEL. CODE ANN. tit. 8, § 145(b) (2004). Finally, although the SEC has long maintained that indemnification for securities law claims is contrary to public policy, it

agers, the insurer will reimburse the company pursuant to the terms of its Side B coverage.⁵⁹ Third, when a company is not legally permitted to indemnify its directors and officers, as in the case of derivative suit settlements, the insurer will pay pursuant to the company's Side A coverage.⁶⁰

The result is that an insurer's Side A coverage obligations are triggered principally when liabilities arise from the settlement of derivative litigation or when the company is insolvent. Otherwise, and in the vast majority of cases, the liability falls on the corporation in the form of an indemnification obligation to its managers.⁶¹ Side B coverage then shifts this liability, albeit at a higher retention, to the third-party insurer. The basis for both forms of coverage, it is important to note, is a claim against the company's managers. Neither Side A nor Side B coverage is available to cover liabilities that the corporation itself may have to a party in any given action.

Side C coverage emerged to fill this void. Evolving first as a solution to the disputes between insurance companies and corporate de-

is firmly established that the settlement of federal securities law claims may be indemnified. *See Raychem Corp. v. Fed. Ins. Co.*, 853 F. Supp. 1170, 1178 (N.D. Cal. 1994) (holding that the indemnification of federal securities claims was lawful).

⁵⁹ Side B coverage has higher retentions than Side A coverage, which may have no retention at all. *See, e.g.*, AIG Specimen Policy, *supra* note 6, § 6; Chubb Specimen Policy, *supra* note 6, at 12; Hartford Specimen Policy, *supra* note 6, § VI(F); Hartford Fin. Prods., Directors, Officers and Company Liability Policy Declarations (June 2005), <http://www.hfpinsurance.com/forms/na00h002.pdf> [hereinafter *Hartford Declarations Page*] (providing for higher retentions under Side B than under Side A); *see also* TILLINGHAST 2004 SURVEY, *supra* note 6, at 46 (reporting that 98% of U.S. respondents who purchased D&O insurance had no deductible associated with their Side A coverage).

⁶⁰ A slight wrinkle arises when a corporation's legal ability to indemnify diverges from its financial capacity to do so. Most policies resolve this issue by creating a "financial insolvency" exception to the presumptive indemnification provision which requires the insurer to reimburse individual managers under Side A of the policy when the corporation is financially unable to indemnify them. *See, e.g.*, Hartford Specimen Policy, *supra* note 6, § VI(F) (providing the financial insolvency exception); *id.* § 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* AIG Specimen Policy, *supra* note 6, § 19 (providing for coverage in the event of bankruptcy or insolvency); Chubb Specimen Policy, *supra* note 6, at 12 (providing the financial impairment exception); *id.* at 2 (defining financial impairment). These provisions allow managers of insolvent firms to collect insurance proceeds without becoming subject to the higher retention amounts and coinsurance payments required when a corporation otherwise refuses to indemnify.

⁶¹ *See* Dan A. Bailey, Side-A Only Coverage 4 (Feb. 11, 2004), http://www.baileycavalieri.com/CM/Articles/bc-SECTION_II_OF_365747.pdf ("[T]he vast majority of Claims covered under a D&O Policy are indemnified by the Company . . .").

fendants over what portion of a securities settlement ought to be allocated to the managers (and therefore reimbursed by the insurer under the corporation's Side B coverage) and what portion allocated to the corporation (and therefore uncovered and paid directly by the corporation),⁶² Side C coverage moots the allocation issue by insuring the corporation itself against direct claims.⁶³ 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"⁶⁴

To ensure that the company retains some "skin in the game" at settlement, insurers may insist on a higher retention amount for Side C claims as well as a significant coinsurance percentage.⁶⁵ Still, Side C

⁶² See, e.g., *Safeway Stores, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh*, 64 F.3d 1282, 1288-89 (9th Cir. 1995) (applying the "larger settlement rule," which entitles the corporation to reimbursement of all settlement costs where the corporation's liability is purely derivative of the liability of insured officers and directors); *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424, 1431-36 (9th Cir. 1995) (ruling that where the corporation had no liability except that derived from its officers and directors, the D&O insurer had no right to allocate discovery costs to the corporation); *First Fidelity Bancorp. v. Nat'l Union Fire Ins. Co. of Pittsburgh*, No. 90-1866, 1994 U.S. Dist. LEXIS 3977, at *38 (E.D. Pa. Mar. 30, 1994) ("[B]oth the directors and officers as well as the corporate entity faced liability in the underlying litigation. The mere fact that liability arises exclusively from the conduct of the insured does not provide a basis for the insurer to be responsible for the liability of those who are uninsured." (footnote omitted)); *PepsiCo, Inc. v. Cont'l Cas. Co.*, 640 F. Supp. 656, 661-62 (S.D.N.Y. 1986) (addressing the issue of allocation between covered and noncovered parties and holding that the insurer bore the burden of proving that the ultimate allocation was reasonable in light of the "relative exposures" of the parties); see also Joseph P. Monteleone et al., *Allocation of Defense Costs and Settlements Under D&O Policies*, INSIGHTS, Nov. 1991, at 19, 24 (concluding that negotiation is a better alternative to costly and lengthy adjudication of allocation issues).

⁶³ See Monteleone & Conca, *supra* note 58, at 618-20 (discussing predetermined allocation agreements and entity coverage as responses to allocation disputes).

⁶⁴ Hartford Specimen Policy, *supra* note 6, § I(C); see also AIG Specimen Policy, *supra* note 6, § 1 (using similar language); Chubb Specimen Policy, *supra* note 6, at 2 (same). A securities claim is defined in the policy to include claims by securities holders alleging a violation of the Securities Act of 1933, the Securities Exchange Act of 1934, or rules or regulations promulgated pursuant to either Act, as well as claims alleging violations of similar state laws and regulations, and includes claims "aris[ing] from the purchase or sale of, or offer to purchase or sell, any Securities issued by the Company" regardless of whether the transaction is with the company or over the open market. Hartford Specimen Policy, *supra* note 6, § IV(M); see also AIG Specimen Policy, *supra* note 6, § 2(x) (providing a similar definition); Chubb Specimen Policy, *supra* note 6, at 6 (same). 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. See, e.g., Hartford Specimen Policy § IV(A), (J), (O)(1).

⁶⁵ See Hartford Declarations Page, *supra* note 59, at 1 (providing for separate retention amounts for Side A, B, and C coverage); *id.* at 2 (providing for coinsurance

coverage is the final step in the process of shifting the cost of shareholder litigation to a third-party insurer.

Although each of these arrangements—Side A, B, and C coverage—may be referred to generally as D&O insurance, the collective label may be misleading since only Side A coverage insures the directors and officers. Side B and Side C coverages are for the corporation. Nevertheless, referring to the arrangement as a whole as D&O insurance underscores the broader point that corporations buy insurance *packages*. Pure Side A (or B or C) coverage is rare. Coverage types are mixed to achieve the distinct insurance goals of (1) protecting managers from personal liability for shareholder litigation; (2) protecting the company from indirect liability, through its indemnification obligations, for shareholder litigation; and (3) protecting the company from direct liability from securities litigation. What all of these goals have in common, however, is the shifting of risk from shareholder litigation, in whole or in part, from the corporation to a third-party insurer.

B. *Why Corporations Buy D&O Insurance*

The vast majority of American public companies—a proportion consistently reported at well over 90%—buy D&O insurance.⁶⁶ This presents a puzzle. Insurance, after all, is not free. Insurance premiums reflect not only the policy's risk—an actuarially determined probability of loss—but also a loading fee reflecting the insurer's costs and profits.⁶⁷ This means that it always costs more to buy insurance for a risk than to bear it oneself.⁶⁸ Moreover, unlike individuals, for

percentages for nonsecurities claims); *see also* Am. Int'l Group (AIG), Side-A Excess and DIC Executive Liability Insurance Policy Declarations § 4 (Apr. 2003), <http://www.aignationalunion.com/nationalunion/public/natfiledownload/0,2138,1894,00.pdf?> [hereinafter AIG Declarations Page] (providing similar policy terms).

⁶⁶ *See* TILLINGHAST 2004 SURVEY, *supra* note 6, at 21 fig.12 (showing that since 1997, 90% or more of U.S. respondents have purchased D&O insurance, with 99% of U.S. respondents purchasing coverage in 2004).

⁶⁷ K. BORCH, *ECONOMICS OF INSURANCE* 13-15, 163 (Knut K. Aase & Agnar Sandmo eds., 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, and later referring to the difference between expected claims payments and the insurance premium as the "loading" of the contract).

⁶⁸ 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 against small losses—through extended consumer warranties, for example—that one could easily bear oneself. *See* ROBERT I. MEHR & EMERSON CAMMACK, *PRINCIPLES OF INSUR-*

whom third-party insurance may be the only available means of spreading risk, corporations are themselves sophisticated risk-shifting mechanisms, ultimately allocating the risk of business failure to shareholders whose losses, thanks to limited liability, cannot exceed the extent of their investment. Furthermore, because shareholders can spread this risk costlessly (or nearly so) by holding a diversified portfolio of stocks, it is a puzzle why corporations buy insurance at all. Why would corporations pay extra for something that their shareholders can get for free in the capital markets?

For basic property and casualty insurance, economists have largely answered this question.⁶⁹ First, features of the tax code, including the availability of deductions for insurance premiums but not for internal reserves,⁷⁰ create incentives for corporations to purchase insurance rather than to self-insure.⁷¹ In addition, because transaction costs in bankruptcy are often high,⁷² creditors and shareholders alike may prefer that the corporation purchase insurance against large potential losses in order to keep the firm out of bankruptcy.⁷³ Creditors may

ANCE 35 (6th ed. 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.").

⁶⁹ Professors Mayers and Smith addressed this puzzle in a series of articles. See David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance: Evidence from the Reinsurance Market*, 63 J. BUS. 19 (1990) (using data from the reinsurance industry, where insurance purchases are systematically reported, to see the effects of ownership structure, geographic concentration, and line-of-business concentration on the demand for reinsurance); David Mayers & Clifford W. Smith, Jr., *Corporate Insurance and the Underinvestment Problem*, 54 J. RISK & INS. 45 (1987) (describing an incentive conflict between bondholders and shareholders and using insurance to solve the problem); David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance*, 55 J. BUS. 281 (1982) [hereinafter Mayers & Smith, *Demand*] (analyzing corporate incentives to purchase insurance policies in accordance with the modern theory of finance). For further discussion, see Richard MacMinn & James Garven, *On Corporate Insurance*, in HANDBOOK OF INSURANCE 541 (Georges Dionne ed., 2000).

⁷⁰ See 26 U.S.C. § 162(a) (2000) (allowing, generally, deductions for "business expenses"); *Carnation Co. v. Comm'r*, 640 F.2d 1010, 1013 (9th Cir. 1981) (disallowing a business expense deduction for amounts set aside for self-insurance); Rev. Rul. 69-491, 1969-2 C.B. 22 (ruling that insurance premiums for D&O insurance are deductible business expenses).

⁷¹ See MacMinn & Garven, *supra* note 69, at 557-60 (describing and modeling tax incentives for corporate insurance purchases); Mayers & Smith, *Demand*, *supra* note 69, at 289-91, 294-95 (same).

⁷² See Jerold B. Warner, *Bankruptcy Costs: Some Evidence*, 32 J. FIN. 337, 338-39 (1977) (describing direct and indirect transaction costs of bankruptcy).

⁷³ See MacMinn & Garven, *supra* note 69, at 548-50 (noting the impact of bankruptcy as an incentive to insure); Mayers & Smith, *Demand*, *supra* note 69, at 284-85 (describing the effect of transaction costs in bankruptcy on incentives to purchase insurance).

also insist that corporations insure major assets in order to protect the security of their loans.⁷⁴ Some forms of property and casualty coverage may thus add value to the corporation.

These explanations, however, do not apply with equal force to the purchase of D&O insurance. Although there still may be some tax advantage to buying insurance over reserving, such advantage shrinks with the size of coverage. Because D&O policies and premiums are smaller than standard corporate property and casualty coverages, the relevant tax deductions as well as the costs associated with creating self-insurance reserves are also smaller.⁷⁵ Similarly, because likely D&O losses are a fraction of potential losses under a standard corporate property and casualty policy, they pose less of a bankruptcy threat. Finally, there is no evidence that creditors insist on D&O insurance as a condition for making corporate loans. All of this suggests that the corporate benefits from the purchase of D&O insurance are considerably smaller than the corporate benefits from the purchase of basic property and casualty insurance. Worse, the effect of removing the threat of personal liability from those persons most able to keep the corporation from incurring liability for shareholder litigation raises the specter of moral hazard, an additional cost of D&O insurance that may outweigh the shrinking benefits to the corporation.⁷⁶

Still, at least one aspect of the corporate purchase of D&O insurance is easy to explain. Recall that D&O insurance has two parts—Side A, benefiting individual managers, and Side B and Side C, bene-

⁷⁴ See MacMinn & Garven, *supra* note 69, at 550-57 (modeling corporate insurance as a means to mitigate agency problems between corporate managers and bondholders); Mayers & Smith, *Demand*, *supra* note 69, at 287 ("Bond indentures frequently contain covenants requiring the firm to maintain certain types of insurance coverage.").

⁷⁵ The general property and casualty market is much larger than the D&O market. One source estimates the total size of the D&O market (primary and excess) at approximately \$705 million in 2004, while another source estimates the total size of the general corporate property and casualty market (commercial multiple peril lines) at over \$27 billion in 2003. Compare TILLINGHAST 2004 SURVEY, *supra* note 6, at 64 tbl.50 (estimating the primary D&O market at \$312,457,586), and *id.* at 71 tbl.54 (estimating the excess D&O market at \$391,882,895), with A.M. BEST CO., BEST'S AGGREGATES & AVERAGES: PROPERTY/CASUALTY, UNITED STATES & CANADA 351 (2004) (aggregating commercial multiple peril net premiums underwritten at \$27,359,792,000). Clearly, general property and casualty lines are much larger than D&O lines. However, it is difficult to generate comparisons since state insurance commissioners do not require D&O results to be disclosed as a separate line item in insurers' filings. As a result, A.M. Best cannot provide aggregate statistics for D&O lines as they do for other separately reported insurance lines, and D&O results must be estimated from other sources.

⁷⁶ See generally BAKER, *supra* note 4, at 4-5 (discussing the moral hazard of insurance, which reduces incentives to "protect against loss or minimize the cost of a loss").

fitting the corporation itself. Because Side A coverage protects individuals, it can be justified on the basis of individual risk aversion.⁷⁷ Corporate managers insist on D&O insurance to protect their personal wealth from the risk of shareholder litigation, making such coverage necessary to attract qualified persons to board service and executive-level employment.⁷⁸ Side A coverage is thus explained as an aspect of the individual's compensation package, a cost that the labor market has allocated to the employer.⁷⁹ However, this is not a complete explanation for D&O insurance. It does not explain why corporations also purchase coverage, under Side B and Side C of the policy, for the corporation itself.

Indeed, entity-level coverage for the risk of shareholder litigation is particularly puzzling since the corporation controls the governance processes that create litigation risk. Because corporations can mitigate this litigation risk by improving their governance practices and shareholders can eliminate the risk of business failure by holding a diversified portfolio, the party in the best position to bear the risk of shareholder litigation would seem to be the corporation itself.⁸⁰ Moreover, once the loading fees associated with D&O insurance are taken into account, the costs of entity-level coverage appear to outweigh the benefits. Entity-level D&O insurance, in other words, appears to be a negative net present value investment. Why, then, do corporations buy it?

⁷⁷ See generally PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* 207-09 (17th ed. 2001) (describing risk aversion and its relationship to the diminishing marginal utility of income).

⁷⁸ Participants in the insurance market cite this as the basic explanation for D&O insurance. See, e.g., Randy Parr, *Directors and Officers Insurance*, in *D&O LIABILITY & INSURANCE 2004: DIRECTORS & OFFICERS UNDER FIRE* 13, 13 (PLI Commercial Law & Practice, Course Handbook Series No. A-865, 2004) ("[I]t is difficult for corporations to attract and keep outside directors.").

⁷⁹ Coverage for individual directors and officers was recognized as an aspect of compensation early in the evolution of D&O insurance. See, e.g., Johnston, *supra* note 46, at 2013 (stating that the fact that the corporation paid D&O premiums "was nothing more than another form of compensation for the executives and way of attracting capable managers"). Interestingly, the first D&O policies allocated a portion of the premium, usually 10%, to the individual insured. See Stanley L. Wallace, *More on Sitting Ducks: (Officers and Directors, That Is)*, *INSURANCE*, Apr. 16, 1966, at 32, 36 (describing the then-typical "ratio 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.

⁸⁰ Although D&O insurance may guarantee a recovery ex post for shareholders who sue a bankrupt or insolvent firm, ex ante shareholders could more efficiently manage the risk of corporate bankruptcy by holding a diversified portfolio of shares.

If the purchase of entity-level D&O insurance is not a sensible investment for the firm, it may nevertheless serve the interests of the firm's managers. Managers, unlike diversified shareholders, have a significant personal stake in the firm they manage, and therefore a greater personal incentive to avoid corporate-level losses.⁸¹ Even if losses are unlikely to lead to insolvency (and manager unemployment), they may still impact corporate assets and earnings, drawing unwelcome scrutiny from the capital markets, perhaps including a challenge to the management of the firm.⁸²

More directly, managers may use corporate funds to purchase entity-level D&O coverage because management compensation packages are tied to accounting measures of performance and because shareholder litigation is likely to have an adverse impact on these measures.⁸³ Entity-level D&O insurance allows managers to avoid shocks to the firm's accounting statements.⁸⁴ By buying D&O insurance, managers essentially trade large but infrequent expected losses for smaller

⁸¹ As a general matter, this incentive arrangement benefits shareholders by mitigating agency costs. In this one instance, however, because using D&O insurance to avoid corporate-level losses appears to be a negative net present value investment, shareholder and manager interests are not aligned.

⁸² The challenge may be in the form of a proxy fight or an unwanted takeover bid. See generally Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1161-62 (1981) (arguing that resistance by managers to premium tender offers decreases shareholder welfare); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 820 (1981) (arguing that Delaware corporation law does not successfully resolve the conflict between managers' and shareholders' interests in the tender offer context); Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 6 (1983) (positing that "the takeover market is an important component of the managerial labor market" through which "alternative managerial teams compete for the rights to manage corporate resources"); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965) (describing the role of management inefficiency and low share prices in triggering takeover bids). Significant reductions in earnings or assets may also result in a credit downgrade. See generally Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 79 (2004) (describing how credit ratings work and what they signal to the market).

⁸³ Cf. LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 121-74 (2004) (detailing defects in the design of executive compensation packages that lead to similarly distorted incentives).

⁸⁴ In addition, a positive externality of this system (from the managers' point of view) may be that shareholder litigation becomes a less noteworthy event since it is handled almost exclusively by the third-party insurer and rarely threatens the corporation itself. This would not be the case if corporations had to fund their own defense and had their own assets at risk, which would presumably cause shareholders to pay closer attention each time a shareholder claim arose.

annual costs in order to reduce the volatility of corporate earnings.⁸⁵ Entity-level coverage, in other words, is a form of earnings management. Managers buy it to protect their compensation in spite of the fact that it may often be a negative net present value investment for the corporation. In this way, entity-level D&O coverage is a paradigmatic example of agency costs—the dislocation between shareholder and manager incentives.⁸⁶

Why, then, do corporations buy D&O insurance? The answer to this question, it seems, has two parts. First, corporations buy Side A coverage in order to attract risk-averse individuals to their boardrooms and executive suites. The second part of the answer is more complex and, perhaps, more sinister: Corporations buy entity-level coverage under Side B and Side C of the D&O policy because they are run by selfish managers who are willing to invest corporate assets in negative net present value projects in order to protect their own compensation packages.

IV. D&O INSURANCE AND CORPORATE GOVERNANCE

Once corporations buy D&O insurance, regardless ultimately of why they do, the risk of shareholder litigation shifts, in whole or in part, to a third-party insurer. The insurer thus subjects its capital reserves to risks determined, at least in part, by the insured's corporate governance.⁸⁷ This Part explores the implications of this transfer of risk.

⁸⁵ See BUCKBERG ET AL., *supra* note 16, at 1 (reporting that the mean securities settlement in 2004 was \$27.1 million, while the median settlement was \$5.3 million).

⁸⁶ Accord John M.R. Chalmers et al., *Managerial Opportunism? Evidence from Directors' and Officers' Insurance Purchases*, 57 J. FIN. 609, 610-11 (2002) (investigating whether managers buy high-priced D&O coverage because they receive all of the benefits of the coverage but bear slight costs and finding that "managers choos[e] abnormally high D&O insurance coverage based on their belief that their shares are priced too high"); John E. Core, *On the Corporate Demand for Directors' and Officers' Insurance*, 64 J. RISK & INS. 63, 81 (1997) (investigating the hypothesis that more-entrenched managers are more likely to purchase D&O insurance and finding, in a sample of Canadian firms, that the "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).

⁸⁷ See *supra* Part II (positing that insofar as corporate governance and shareholder litigation are related, D&O insurance risk should reflect the quality of the insured's corporate governance).

A. *Pricing the Policy:*
Correlating Corporate Governance and D&O Liability Risk

Insurance companies are experts at assessing risk. Because the success of an insurer's business depends upon taking in more capital than it pays out, the insurer must develop an ability to assess the probable payout obligations of each exposure and then charge an appropriate premium for the risk. Just as providers of auto insurance must assess the likelihood that a particular driver will cause an accident, a D&O underwriter must determine the likelihood that a particular management team will incur shareholder litigation. D&O underwriters therefore ought to develop categories of high risk corporate governance and low risk corporate governance and, in a well-working insurance market, seek to price and sell their policies at least partly on that basis.⁸⁸

Insurers may assess a prospective insured's governance risk at the time the D&O policy is first underwritten and then on an ongoing basis, at each annual renewal. Each year the underwriter has the option of refusing to renew a policy or of increasing a premium in response to new information about a firm's governance risk. Similarly, because D&O policies are bought and sold in competitive markets, prospective insureds have an opportunity to shop for the most comprehensive and least expensive coverage.⁸⁹ Each party to the insurance arrangement is thus constrained by competition: a company with very poor corporate governance may be unable to find a willing underwriter, and an underwriter that prices its coverage very high may be unable to find customers for its policies.

⁸⁸ Market failure in the insurance market, of course, could disrupt the connection between corporate governance and policy pricing. Insurance industry cycles—between hard and soft markets—are sometimes taken as evidence of market failure. See *infra* note 151 and accompanying text (describing insurance market cycles). Cyclicity alone, however, does not disrupt the connection between governance and pricing since all insurers enter soft and hard markets together. As a result, although their ratios of premium to loss may change (rising in a hard market and falling in a soft market), insurers retain incentives across markets not to write coverage below cost. See Lynna Goch, *Falling Markets, Rising Risks*, BEST'S REVIEW, May 2001, at 55, 56 ("Market conditions, type of risk, industry and terms of the policy . . . affect [D&O] pricing."); Lisa S. Howard, *European D&O Insurance Carriers Swearing Off "Drive-By" Underwriting*, NAT'L UNDERWRITER, Dec. 2, 2002, at 20, 20 ("[U]nderwriters are . . . digging deep to really analyze a company, its board structure, who the people are and what their history is, what business they're in, and how they conduct their business.").

⁸⁹ Chubb and AIG are the leading primary underwriters in the U.S. market, together accounting for over 36% of all policies and 47% of premium volume in 2003. TILLINGHAST 2004 SURVEY, *supra* note 6, at 63 tbl.50.

The policy application is the first step in the underwriting process and the insurer's most basic tool for collecting information on a prospective insured.⁹⁰ Application forms are required of both new and renewal applicants, but the questions asked of each differ. New applicants are asked whether they or any subsidiary corporation has previously held a D&O policy and, if so, they are asked for further details concerning the identity of the prior insurer, the previous policy's limit and deductible, and the policy premium.⁹¹ This information may allow the underwriter to make an initial assessment of the prospective insured, using the reputation of the prior insurer to judge the overall acceptability of the risk profile and the previous policy's limits, deductible, and premium as a proxy for the prior insurer's ultimate assessment of the risk. The application form also asks new applicants about prior claims experience and whether any covered person has knowledge of acts or omissions that may give rise to a claim.⁹² Both new and renewal applicants are asked about recent or planned corporate restructurings, including acquisitions, reorganizations, and sales or distributions of businesses as well as any plans to register an offering of securities.⁹³ New and renewal applicants are also asked to attach a list identifying all directors and officers, the company's most recent annual report, proxy notices, securities law filings, and the company's most recent interim financial statements.⁹⁴ The apparent purpose of these documents is to enable the underwriter to perform due diligence on the insured, but perhaps as importantly, these documents become incorporated into the application, which becomes the basis of the policy and, if the documents contain a material misstatement or omission, a possible grounds for rescission.⁹⁵ This fea-

⁹⁰ See E-mail from Confidential Source, Executive, Major D&O Underwriter, to author (Feb. 16, 2005) (on file with the University of Pennsylvania Law Review) [hereinafter D&O Underwriter E-mail] ("[C]ompletion of the application typically begins the process and precedes any meetings between the prospective insured and the underwriters.").

⁹¹ See, e.g., Hartford Fin. Prods., Proposal for Directors, Officers, and Company Liability Insurance § 4(a) (Nov. 2003), <http://www.hfpinsurance.com/apps/do09r288.pdf> (requiring new applicants to furnish this information about their previous D&O insurer).

⁹² *Id.* § 5.

⁹³ *Id.* § 4.

⁹⁴ *Id.* § 7.

⁹⁵ The Hartford Specimen Application provides in its boilerplate that "[a]ll written statements and materials furnished to the insurer in conjunction with this proposal form are hereby incorporated by reference into this proposal and made a part hereof" and that "this proposal shall be the basis of the contract should a policy be issued."

ture of the application binds a corporation to the credibility of all statements made in the application and in any documents supplied to the insurer in connection with the application. A corporation defeats the purpose of buying insurance if it supplies false or misleading statements in connection with the application since such statements could be used by the insurer to deny coverage should a dispute later arise.

In many cases, the information supplied in the policy application is supplemented by meetings during which the prospective insured makes presentations, described by participants as similar to an IPO road show,⁹⁶ to prospective underwriters.⁹⁷ These presentations show-case, among other things, the prospective insured's corporate governance. One document I obtained from an insurance broker seeks to prepare clients for these presentations.⁹⁸ The document highlights corporate governance and advises prospective insureds to discuss their auditing firm and disclose whether the company also purchases consulting services from the same firm, essentially flagging a key corporate governance issue that arose in the wake of the Enron collapse.⁹⁹ The same document urges clients to emphasize any steps taken to improve corporate governance, such as "[p]articipating [in] or completing any Corporate Governance workshops," and lists key governance talking points, including the directors' equity interest in the company,

Id. at 4. This language in the application is immediately followed by state-specific fraud warnings. *Id.*

⁹⁶ See D&O Advisor Interview, *supra* note 6 ("Usually somewhere in the process, a company might essentially have to do an IPO-type road show and the underwriters would try to get a very good knowledge of the company . . ."). These meetings are organized by the company's insurance broker and involve key company officials, typically the CFO and occasionally the CEO, and one or more insurance underwriters. *Id.*

⁹⁷ See D&O Underwriter E-mail, *supra* note 90 ("In the case of a very large (e.g., Fortune 1000) risk with multiple layers of coverage being sought, there may be an in-person meeting with the primary [insurer] and participation of excess insurers by teleconference.").

⁹⁸ See Company Facts (unpublished industry document, on file with the University of Pennsylvania Law Review). An introductory passage counsels:

The purpose of this list is to highlight all the important facts that we want to be sure the underwriters know. If we can include any of the below items in our discussions, we will have set the stage to deliver a risk profile that is desirable to the underwriting community.

Id.

⁹⁹ *Id.* On the problem of accounting firms providing nonaudit services to their audit clients and its role in the Enron collapse, see Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1237-39 (2002).

how directors are screened and chosen, and whether the corporation has separated the roles of board chair and chief executive officer.¹⁰⁰

Another document prepared by a D&O broker to help clients prepare for these meetings lists "Examples of Questions Being Asked by D&O Underwriters" and counsels clients to prepare for specific questions involving related-party transactions,¹⁰¹ earnings management,¹⁰² and takeover planning.¹⁰³ In this document, the company is asked to consider how it responds to pressures to meet earnings targets and to address any company practices that might be criticized as "earnings management."¹⁰⁴ The questions also highlight general corporate governance issues, including:

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?

¹⁰⁰ Company Facts, *supra* note 98. Such terms have repeatedly arisen in recent discussions of corporate governance. On their likely significance, see generally sources cited *supra* note 7.

¹⁰¹ Examples of Questions Being Asked by D&O Underwriters (unpublished industry document, on file with the University of Pennsylvania Law Review). Listed questions include:

Does the Parent Company or any Subsidiary utilize any off balance sheet entities for financial transactions?

Does any member of the Board of Directors have any outside affiliation or any common business interest with any major shareholder (10% or more)?

Within the past three years, did the Parent Company or any Subsidiary engage in any related party transactions?

Id.

¹⁰² These questions include:

Has the Parent Company changed auditors or restated its financials in the past three years?

Please discuss the extent of the experience of the Audit Committee Members. How often do they meet? Does the Internal Audit Function have a direct report to the Audit Committee/Board of Directors?

Has your external auditor approved revenue recognition practices?

What is the length and scope of the company's relationship with its outside auditors? What percentage of fees has the company paid for auditing vs. consultant fees? Are there any planned changes to this mix going forward?

How does management cope with pressure to meet "street" expectations?

Where might the company be subject to criticism, if at all, for "earnings management"? How strong are internal controls over the financial reporting process?

Id.

¹⁰³ See *id.* ("How does the company review potential mergers and acquisitions?").

¹⁰⁴ *Id.*

Are significant developments shared with the Board of Directors as they become available?

How does the company select a new member of the Board? How does the search process take place?¹⁰⁵

All of these questions relate directly to the quality of a firm's corporate governance. Earnings management and related-party transactions may trigger securities litigation or derivative lawsuits, or both.¹⁰⁶ Similarly, a board's takeover planning may indicate entrenchment and the possibility that shareholder suits will be brought in connection with acquisition activity.¹⁰⁷ Perhaps most significant, however, is the question of intracorporate information flow. Although not tied to a specific shareholder claim, answers to this question may indicate how potential problems are handled within the organization and then perhaps resolved before they give rise to shareholder litigation. In this way, the underwriter appears to be looking for clues to the health of the organization that go beyond issues tied to specific governance terms or types of litigation.

The underwriter's access to corporate officials in these meetings allows it to assess the prospective insured's corporate governance on the basis of information beyond that which is publicly available in the company's securities filings or other public documents. In addition to the completion of the policy application and oral answers to questions, prospective insureds may be asked to provide sensitive information or confidential documents to enable the underwriter to complete its evaluation. Such disclosures are typically made pursuant to non-disclosure agreements (NDAs).¹⁰⁸ Moreover, because the insurer is not an equity analyst or rating agency, the company has no obligation under SEC Regulation FD to disclose the information to the market as a whole and can, instead, keep the information confidential under the terms of the NDA.¹⁰⁹ Unlike equity analysts, in other words, under-

¹⁰⁵ *Id.*

¹⁰⁶ See Thompson & Sale, *supra* note 13, at 887-90 (discussing various forms of shareholder lawsuits arising from the same underlying conduct).

¹⁰⁷ See Thompson & Thomas, *supra* note 11, at 139 (discussing shareholder suits in the acquisition context).

¹⁰⁸ See E-mail from Confidential Source, Partner, Major New York Law Firm, to author (May 9, 2005) (on file with the University of Pennsylvania Law Review) ("[A]pplications may contain certain confidential disclosures that may not be legally required to be disclosed publicly and may have been submitted to the insurer pursuant to a non-disclosure agreement.").

¹⁰⁹ See 17 C.F.R. § 243.100 (2005) (preventing selective disclosure of material non-public information).

writers can commit to keep any secrets their prospective insureds share with them, enabling the underwriters to base their assessments of prospective insureds on information that, because it is not publicly available, is not already reflected in share price.¹¹⁰

In addition to enjoying unique access to nonpublic information, insurers stake their own capital on their risk assessments and therefore have the optimal incentive to perform a careful analysis of governance risk. First, unlike other third-party evaluators of corporate governance, including equity analysts, Institutional Shareholder Services, and ratings agencies such as Moody's and Standard & Poor's,¹¹¹ all of which operate on a fee-for-services model and therefore do not suffer when a rating is incorrect, insurers stake their own capital on their governance assessments and suffer directly from any error in evaluating risk.¹¹² Second, unlike mutual funds, pension funds, and other diversified equity investors, insurance companies cannot eliminate the nonsystematic risk of firm-specific governance. To be sure, insurers build portfolios of insureds, but insurance underwriting takes place in a competitive market and not every insurer receives a portion of every risk. As a result, each insurer's portfolio of insureds is different, with insurers that are skilled at distinguishing good and bad risks predictably building better overall portfolios than those who are

¹¹⁰ The semi-strong version of the efficient capital markets hypothesis requires information to be publicly available in order for it to be reflected in price. See generally STEPHEN A. ROSS ET AL., *CORPORATE FINANCE* 319-35 (5th ed. 1999) (detailing the different versions of the efficient capital markets hypothesis).

¹¹¹ For a description of each of these organizations, see Inst'l S'holder Servs., About ISS, <http://www.issproxy.com/about/index.jsp> (last visited Mar. 25, 2006); Moody's Investors Serv., About Moody's, <http://www.moody.com> (follow "About Moody's" hyperlink) (last visited Mar. 25, 2006); Standard & Poor's, S&P About Us, <http://www.standardandpoors.com> (follow "About Us" hyperlink) (last visited Mar. 25, 2006).

¹¹² It is possible to argue that the reputation of a governance rating agency suffers when its assessment proves incorrect, leading to fewer customers for the service and therefore reduced revenues. See, e.g., Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 1-2 ("Rating agencies are . . . motivated to provide accurate and efficient ratings because their profitability is directly tied to reputation."). However, the diminution in revenues due to a harm to reputation may be less immediate and less drastic than the insurer's loss of capital as a result of a misestimation leading to an incurred loss. Moreover, because their success is not tied directly to the ratings they generate, but to the organizations that hire and pay them, corporate governance rating agencies' evaluations can be captured by other kinds of agendas—for example, either pro- or anti-regulatory—that do not necessarily correspond to accurate evaluations of governance risk.

not.¹¹³ Because diversified equity investors can eliminate these kinds of nonsystematic risk, there is less incentive for institutional investors to develop expertise in actively distinguishing good and bad risks. Third, unlike bondholders, who can control their downside risk through a combination of contract, security, and priority, insurers have no security interest and no system of priority to protect their rights if their risk assessments are ultimately wrong.

Given the structure of their incentives and their unique access to information, one can expect insurers to develop expertise in distinguishing good and bad governance risks and to build these assessments into their models for pricing D&O insurance. And there is evidence that they do. In filings required by state insurance commissioners, underwriters disclose that they modify insurance rates for industry and ownership structure as well as items such as "relationship with constituency groups" and "management experience."¹¹⁴ Insurers thus do seem to attempt to relate D&O pricing to firm-specific governance attributes. The effect of these efforts across a well-working insurance market would seem to tie the amount a firm pays for its D&O insurance to the quality of its corporate governance.

This relationship has two significant implications. First, it could cause corporations to improve their overall governance structure in order to reduce firm costs since worse governance leads to higher premiums. This possibility is explored in Section B. Second, even if corporations do not respond to differences in the cost of D&O insurance pricing by optimizing their governance structure, the price that a firm pays for D&O insurance could convey an important signal to investors and other market participants. This possibility is explored in Section C.

¹¹³ This is the phenomenon of adverse selection, with insurers who are worse at screening governance risk building systematically worse risk pools than their competitors who are better at it. See generally George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489-90 (1970) (providing the classic account of adverse selection from the example of a used car market).

¹¹⁴ 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 2-7 (Cal. Dep't of Ins. file no. EO CA0019310C01, filed Dec. 22, 2003) (reporting rate modifications to the base D&O premium for, among other things, industry, stability of earnings, "board/management architecture and controls," qualifications of individual directors and officers, executive compensation, and litigation history).

B. *Incentive Effects*

Businesses can improve their earnings in two ways: by increasing revenues or by cutting costs. Insurance expenses, including D&O premiums, are a source of cost. It follows, then, that corporations could improve their earnings by cutting them and, in order to create a competitive advantage, have an incentive to do so. One way to cut insurance costs, of course, is not to buy coverage. As discussed above, however, corporations tend to purchase coverage even if it is on the whole a negative net present value investment.¹¹⁵ Another way that corporations might try to manage insurance costs is to eliminate those governance features that lead to higher D&O premiums.

Building upon the hypothesis that insurers charge different rates to companies with different corporate governance structures, D&O premiums might provide an incentive for corporations to improve corporate governance. By continually optimizing its governance structure, a corporation ought to find that it pays consistently less for D&O insurance than its competitors. Better corporate governance, in other words, would mean lower D&O insurance costs and, therefore, higher earnings and improved share values relative to competitors who have not also optimized their governance structure.

One problem with this incentives story is that while D&O insurance premiums are by no means small—the average total premium for U.S. companies with a market capitalization of over \$10 billion was \$5,126,213 in 2003¹¹⁶—they may not be large enough to spur large changes in corporate governance practices. If, as seems to be the case, the D&O insurance premium has a relatively small overall effect on a corporation's net income, the marginal costs of regularly reviewing and revising internal governance policies—involving expensive legal and financial advisors as well as the time and attention of the general counsel and top level management—may easily outweigh the marginal benefits of savings in policy premiums.

Also, insofar as the corporation's reason for purchasing entity-level coverage is based upon agency costs within the firm,¹¹⁷ it is rather quixotic to expect corporations to cut D&O expenses in order to increase earnings. It is always true that managers could make their corporations run better by trimming agency costs. Managers could improve the bottom line by cutting their salaries, giving back their

¹¹⁵ See *supra* Part III.B (discussing D&O insurance as an example of agency costs).

¹¹⁶ TILLINGHAST 2004 SURVEY, *supra* note 6, at 57 tbl.45C.

¹¹⁷ See *supra* Part III.B.

benefits packages, and firing their cronies. But it is also true that they will be generally disinclined to do so. In this way, just as it would not be surprising for D&O premiums to be higher for companies with bad managers, it would not be surprising for bad managers to refuse to be good in order to reduce an expense that is ultimately borne by the shareholders. Any reduction in agency costs would be better for shareholders, but if bad managers are not willing to fix these problems generally, it is unlikely that the additional corporate expense of marginally higher D&O premiums would spur them to do so.

In sum, in spite of the incentive effects of D&O premiums—essentially, better-governed companies pay less—one ought not expect the insurance premium alone to push companies to adopt better corporate governance. The marginal costs of continually optimizing corporate governance might not be worth the marginal benefit of reduced D&O premiums. Moreover, to the extent that D&O insurance purchases correspond to agency costs, managers are unlikely to reduce their private benefits to save costs borne by shareholders.

C. Signaling Effects

Even if the cost of D&O insurance does not provide a sufficiently strong incentive to spur a corporation to optimize its governance structure, a company's D&O policy may nevertheless contain information that would be valuable to capital market participants. First, the type of insurance package purchased by a particular firm may convey information concerning the firm's likely motives in purchasing it and, by extension, provide some gauge of the extent of agency costs within the organization. Second, following the hypothesis that insurers develop expertise in separating acceptable from unacceptable governance risks in order to charge appropriate premiums, the price of a firm's D&O policy represents the insurer's assessment of the quality of the firm's corporate governance. Equipped with the information revealed by these signals, investors and other capital market participants may adjust their reservation values, thereby creating a discount on the share price of firms whose D&O policies reveal high agency costs or low-quality corporate governance. The result of this discount might be the creation of another incentive for firms to improve their corporate governance.

The type of D&O coverage that a corporation purchases could convey an important signal to the market. As discussed in Part III, D&O insurance may be intended to benefit either or both the corporation's managers individually and the corporate entity itself. Insofar

as the insurance is intended to benefit individuals, it may be a necessary feature of the benefits package required to attract top-level talent to the firm. Entity-level coverage, however, may trace to agency costs. Because it is simple to distinguish whether D&O coverage was purchased to benefit individual managers, on the one hand, or the corporate entity, on the other—Side A coverage only benefits individuals, while Side B and Side C coverages only benefit the corporate entity¹¹⁸—a company's D&O package can serve as a simple proxy for agency costs. A corporation purchasing only Side A coverage may suffer less from agency costs than a firm that has also purchased a large amount of Side B and Side C coverage.¹¹⁹ Market participants could learn about the quality of a company's governance structure simply by reviewing how much of each type of coverage a particular company has purchased.

Second, insofar as corporations buy individual coverage in order to persuade directors to sit on their boards, the question arises as to how much coverage these individuals will require in order to accept the job. Other things being equal, a relatively high level of coverage—high limits, low retentions—signals individual discomfort with the firm's governance risk while, by contrast, low limits and high retentions suggest that individual managers do not expect their firm to generate significant liabilities from shareholder litigation. In this way, the level of coverage alone may signal the managers' own assessment of governance risk.

Finally, and perhaps most importantly, the price the corporation pays for its coverage conveys important information concerning its governance quality. If firms fail to continually optimize their corporate governance and firms with worse corporate governance pay more for D&O insurance than firms with better corporate governance, then

¹¹⁸ See *supra* Part III.A.

¹¹⁹ My conversations with insurance industry participants revealed that some firms do in fact purchase "Side A only coverage." As one executive with a major D&O underwriter described it to me:

[A] lot of companies are purchasing what we call Side A insurance only . . . [for] two reasons. Number one, the company is extremely well financed. We don't care about our own exposure as a company. You know we'll handle that . . . But we need to give some comfort to our outside board members in the event we ever become insolvent. We don't think we will but before someone serves on our board they want to know about our D&O insurance.

Interview with Confidential Source, Executive, Major D&O Underwriter, in New York, N.Y. (Nov. 12, 2004) (transcript on file with the University of Pennsylvania Law Review); accord Bailey, *supra* note 61, at 3 ("[A] D&O policy affording only Side-A coverage can provide greater protections to D&Os than a typical D&O insurance policy.").

market participants could use D&O insurance pricing as a proxy to evaluate the quality of a firm's corporate governance. The most obvious place to look for this information is the firm's D&O premium.

A company's insurance premium could be converted into a proxy for governance quality with a few relatively simple adjustments. First, because insurance premiums depend in part on the coverage limits and the firm's retention, premium data must be adjusted to effective coverage amounts. This, however, would be a relatively easy adjustment to make, provided that one is given data that include each company's insurance premiums, limits, and retentions under each line of coverage. Second, in addition to these features of the insurance policy itself, insurance premiums may correlate to other features of the corporation or its business. Firms within a particular industry—an industry that has attracted the attention of New York Attorney General Eliot Spitzer, for example—may be subject to systematically higher D&O rates than firms in other lines of business with less industry-wide risk of shareholder litigation.¹²⁰ However, this distortion could be corrected by comparing D&O insurance pricing across a set of firms within a specific industry in order to identify norms and outliers. Finally, insurance premiums may correlate to market capitalizations,¹²¹ whether because larger firms attract more attention in shareholder litigation (perhaps because they appear more often on the front page of the *Wall Street Journal*) or because firms with high share prices have farther to fall in measuring damages.¹²² Similarly, the volatility of a

¹²⁰ See Howard, *supra* note 88, at 22 (quoting a director at Aon Professional Risks that “if you happen to be in an industry group that insurers perceive as extremely high risk at the moment, and you also happen to have your shares listed [in the United States], then you’re going to be paying a hell of a lot more premium than you did last year” (alteration in original)).

¹²¹ See Goch, *supra* note 88, at 56 (“D&O underwriters price policies based on market capitalization of public companies . . .”); see also 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) (noting that market value of equity is an important variable in determining the price of insurance); George D. Kaltchev, *The Demand for Directors’ and Officers’ Liability Insurance by US Public Companies* 52 (July 2004), <http://ssrn.com/abstract=565183> (highlighting the correlation between premium price and the market value of a firm’s equity). For a detailed discussion on the implications of this relationship, see *infra* Part V.B.

¹²² This is true whether the theory of damages is the traditional “out of pocket” measure—i.e., the difference between what the plaintiff received and what she would have received had there been no fraudulent conduct—or “recessionary” damages. See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972) (awarding out-of-pocket damages in the securities fraud context); *Randall v. Loftsgaarden*, 478 U.S. 647, 659 (1986) (granting recessionary damages in the securities fraud context).

firm's share price may influence its D&O premium since shareholder litigation is believed to follow sudden drops in share price.¹²³ Nevertheless, the influence of market capitalization and share price volatility on insurance pricing can be removed by adding variables to adjust for market capitalization and volatility.

Thus, in spite of some distortions in the correlation between insurance prices and the quality of corporate governance, with a few simple adjustments, a firm's premium for D&O insurance should convey important information concerning the firm's corporate governance. Most basically, the more a firm pays, the worse its governance. Moreover, because the insurer risks its own capital in making this assessment, the D&O premium functions as a revealed preference and is therefore likely to be a reliable indicator of the insurer's best assessment of the insured's governance quality. Understanding this, fund managers, arbitrageurs, and other professional investors can be expected to build these signals into their models of firm value. D&O insurance data could thus provide another data point for analysts to crunch as they seek to value firms.¹²⁴ If D&O insurance policies reveal negative information—for example, unusually high premiums or a high degree of entity-level coverage—the corresponding negative impact in the equity and credit markets may provide yet another incentive for firms to optimize their corporate governance.

V. SENDING THE SIGNAL

American companies do not disclose the details of their D&O policies. Annual reports and other corporate filings typically do not include D&O coverage limits, retentions, or premiums, and firms do not attach copies of their D&O policies as exhibits to their public fil-

¹²³ See sources cited *supra* note 30.

¹²⁴ As discussed in Part IV.A, in cases where firms are already covered by equity analysts, disclosure of D&O insurance information may provide useful supplemental information on governance quality due to (1) underwriters' unique access to non-public information in the underwriters' meeting and through NDAs with the prospective insured, (2) underwriters' unique focus on downside risk, and (3) underwriters' unique incentives—through risking their own capital—to estimate risk accurately. Additionally, it is worth noting that many public companies do not receive any analyst coverage at all. See Harrison Hong et al., *Bad News Travels Slowly: Size, Analyst Coverage, and the Profitability of Momentum Strategies*, 55 J. FIN. 265, 269 (2000) (“[T]he reality [is] that many firms are simply not covered by analysts . . .”). Yet these firms are likely to purchase D&O insurance. See *supra* note 66 and accompanying text (reporting that 99% of U.S. for-profit firms purchased D&O insurance in 2004). For such firms, the information signaled through the disclosure of D&O details may therefore be the only reliable third-party assessment of governance quality.

ings. The information therefore is not publicly available. This presents a puzzle. If, as this Article has argued, the details of a firm's D&O policy convey an important signal regarding the governance quality of the firm, why are these details undisclosed? Why do individual firms not voluntarily disclose this information? And, since they do not, why does the law not require it? Why is the signal not being sent?

This Part explores these puzzles, first probing the dynamics of voluntary disclosure in order to account for its absence in the case of D&O policy information, then reviewing current state and federal law on D&O insurance and disclosure. After contrasting U.S. law with that of a neighboring jurisdiction, Canada, which does require disclosure of D&O policy details, this Part argues that the U.S. Securities and Exchange Commission should require registrants to disclose details concerning their D&O policies immediately upon entering or renewing a policy.

A. *Explaining the Absence of Voluntary Disclosure*

Capital market dynamics compel companies to disclose information. All firms that seek to raise capital from investors will seek to convince investors that they are issuers of high-quality securities. Because it is difficult for investors to distinguish between high- and low-quality securities, firms will produce information to persuade investors that their securities are the former rather than the latter. This information is credible, largely, due to the rules against fraud.¹²⁵ To encourage investment, firms will be especially eager to release good news. Firms' natural incentive to disclose good news, however, will cause investors to be suspicious of and to discount the value of any firm not disclosing similar information.¹²⁶ If the nondisclosing firm had similar good news, the investor will reason, it would have disclosed it; because it did not, it must have only bad news. This outcome extends the childhood maxim: "If you don't have something nice to say, don't say anything at all." Firms that do not say anything

¹²⁵ Federal securities law antifraud rules include, for example, section 11 of the Securities Act of 1933, 15 U.S.C. § 77k(a) (2000), and, perhaps most importantly, Rule 10b-5 of the rules promulgated pursuant to the Securities and Exchange Act of 1934, 17 C.F.R. § 240.10b-5 (2005).

¹²⁶ See FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 280-83 (1991) (discussing the market's incentives on firms to disclose information); see also Akerlof, *supra* note 113, at 495-96 (describing sellers' incentives to disclose and warrant quality in an adverse selection model).

at all, the investor will conclude, must have nothing nice to say. This logic, and the resulting discount to the value of their securities, provides all firms with an incentive to make regular disclosures of both the good and the bad. Thus, firms will voluntarily create an environment of robust corporate disclosure.¹²⁷

Because any piece of information that might affect the value of a firm's securities—including D&O policy details—ought therefore to be disclosed voluntarily, the absence of such disclosures may be taken to imply that the information is not sufficiently valuable to merit disclosure. If the information mattered, in other words, firms would release it. Is this true of the information embedded in the details of the firm's D&O policy? Does the absence of voluntary disclosure of D&O policy details imply that the information does not, in fact, matter?

Irrelevance of the information, of course, is not the only explanation for a lack of disclosure. Easterbrook and Fischel themselves identify three situations in which a regime of voluntary disclosure would predictably fail.¹²⁸ The characteristic problem in each of these three situations involves information that is valuable to investors of other firms as well as the investors of the firm in possession of the information. Because the firm with the information cannot charge the investors of other firms for it, the information is likely to be underproduced.¹²⁹ The situations in which Easterbrook and Fischel found this problem included, first, the production of industry-wide, as opposed to firm-specific, information. Although all firms would prefer that this information be made available, no one firm has an incentive to produce it since doing so would allow other firms to free-ride on its efforts.¹³⁰ Second, and relatedly, information that primarily facilitates comparisons among firms would be underproduced because the information is valuable only once several firms have made similar disclosures. No firm is willing to be the first to disclose because the information by itself is worthless and, if it includes competitively sensitive information or a damaging revelation, potentially harmful.¹³¹ Finally, because some disclosures are easier to understand than others, there may be information that would be valuable to investors if disclosed in

¹²⁷ See EASTERBROOK & FISCHEL, *supra* note 126, at 289 (“[A company] must disclose the bad with the good, else investors will assume that the bad is even worse than it is.”).

¹²⁸ *Id.* at 290-96.

¹²⁹ *Id.* at 290-91.

¹³⁰ *Id.* at 291.

¹³¹ *Id.*

a particular format, but because no firm has an incentive to search for and adopt the optimal format (again because the benefits would rebound largely to the investors of other firms who cannot be charged), the information nevertheless goes undisclosed.¹³² In each of these three situations, then, a regime of voluntary disclosure can be expected to fail.¹³³

D&O policy information has several of these features. First and foremost, the value of D&O policy information is purely comparative. The relevance of a firm's policy premium, payout limits, and retention amounts emerges only upon comparison with similarly situated firms. Moreover, as noted above, comparing similarly situated firms means taking a broad industry-wide sample and controlling for such variables as market capitalization and volatility.¹³⁴ D&O policy data, in other words, are only valuable once the data are available for an entire industry. Each of the firms within the industry, however, will be disinclined to produce the information because it is of value largely to investors of other firms who cannot be charged for it. It is, in other words, a paradigmatic example of a situation in which voluntary disclosure is likely to fail.

In addition to the free-rider effects on which Easterbrook and Fischel focus, investors in an individual firm may not want their firm to be the first to disclose D&O details for fear that disclosing the cost of the policy would harm the firm.¹³⁵ Explicitly stating that a corporation pays millions of dollars per year to insure its executives against the cost of their own negligence may not sit well with investors. The

¹³² *Id.* at 291-92.

¹³³ Easterbrook and Fischel do not argue that these failures of voluntary disclosure are necessarily fatal, since there are information intermediaries with incentives to seek out valuable information regardless of whether it is voluntarily produced by firms. Their argument, instead, is that a regime of mandatory disclosure may be less costly overall than a regime in which information intermediaries are charged with resolving these deficiencies. *See id.* at 300-14 (assessing the relative costs and benefits of mandatory disclosure regimes).

¹³⁴ *See supra* notes 121-22 and accompanying text.

¹³⁵ In contrast to these investors are those who hold the market portfolio and whose incentive therefore is to act in the best interest of all firms rather than favoring any one over others. Such investors would thus favor disclosure of D&O policy information for every firm in their portfolio. Unfortunately, such investors are typically passive and therefore less active in determining the governance structure of firms than investors who focus their holdings in individual firms. *See* Larry E. Ribstein, *The Constitutional Conception of the Corporation*, 4 SUP. CT. ECON. REV. 95, 134 (1995) ("Most individuals either hold diversified portfolios of investments or invest in corporations indirectly through institutions such as mutual funds. Accordingly, they care little about the internal affairs of individual companies . . .").

amounts paid by a particular firm may be low when compared to peer firms, but absent disclosures from peer firms to enable these comparisons, such amounts, alone, may seem high. In this way, investors' views of D&O expenses may create a first-mover *disadvantage*. Even if investors would prefer that all firms make such disclosures, the investors in any one firm are likely to hesitate for fear of harming that firm.

In this way, the absence of voluntary disclosure of D&O policy details does not point to the irrelevance of the information, but rather to a coordination problem among investors. All investors would prefer that D&O policy information generally be disclosed, but the investors of any one firm may be disinclined to cause it to disclose since that firm will not fully capture the value of its disclosure. Additionally, the disclosure of D&O premiums may be damaging to a firm unless its competitors also disclose.

Another objection to disclosure of D&O policy information is the assertion that revelation of coverage limits will expose the disclosing firm to greater risk of shareholder litigation. The argument is simple: once plaintiffs' lawyers know which firms have large D&O policies, they have an incentive to sue those firms, and once they know the policy limits, they know what to seek in settlement. Although this argument may seem initially plausible, the disclosure of D&O policy details would probably have little impact on shareholder litigation for the simple reason that plaintiffs' lawyers, the driving force behind shareholder litigation, are already well informed about these matters. It is no secret that virtually all public companies carry D&O insurance and that average limits for companies with assets in excess of \$100 million are in the tens of millions of dollars.¹³⁶ Plaintiffs' lawyers are well aware of these facts and, as this is how they make their living, are likely to be able to estimate a particular company's coverage within a fairly accurate range.¹³⁷ Moreover, once in litigation, a company's D&O policy must be disclosed prior to discovery, soon after the claim has been filed.¹³⁸ As a result, it is unlikely that disclosure of such details

¹³⁶ TILLINGHAST 2004 SURVEY, *supra* note 6, at 33 tbl.13C (reporting total limits by market capitalization of U.S. public companies).

¹³⁷ *Cf.* Cox, *supra* note 37, at 512 ("[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.").

¹³⁸ See FED. R. CIV. P. 26(a)(1)(D) (listing insurance policies as an initial disclosure item, prior to discovery); see also 6 JAMES WM. MOORE ET AL., MOORE'S FEDERAL PRACTICE §§ 26.22[4][d], .46[14] (3d ed. 2005) (analyzing the history and applicability of Rule 26(a)(1)(D) and the ability to discover unprivileged information in securities litigation under Rule 26(b)(1)). Because D&O policies must be disclosed soon after the

will add anything substantial to the plaintiffs' lawyers' arsenal or significantly alter the dynamics of shareholder litigation.

Nevertheless, even if it will not constitute a boon to plaintiffs' attorneys, free-rider effects and coordination problems currently inhibit voluntary disclosure of D&O policy details. Investors in each firm face the same incentives, and as a result, firms typically choose not to disclose D&O policy information. Given the failure of voluntary disclosure to trigger release of this valuable information, we must consider a mandatory rule.

B. *U.S. Law on the Disclosure of D&O Insurance Information*

U.S. corporations are regulated by both state and federal law.¹³⁹ Either state corporation law or federal securities law could mandate disclosure of D&O policy details. For the most part, neither does.

1. State Law Governing D&O Insurance

As noted above, state corporate law places no limits on the ability of corporations to purchase D&O insurance.¹⁴⁰ Regardless of whether the corporation would have the power under state law to indemnify its directors against a particular loss, it can insure them. Moreover, state corporate law typically does not require disclosure of D&O policy details. In Delaware, the primary source of American corporate law,¹⁴¹

filing of a securities claim, plaintiffs' attorneys even now are made aware of these policy details prior to settlement.

¹³⁹ In principle, the federal securities laws police the sale of securities, while the states regulate corporate governance. However, the federal securities laws in fact create a broad opening for federal preemption of state law, whether through further acts of Congress, agency rulemaking, or judicial interpretations of existing statutes. Thus, in spite of the often-recited division of authority between the states and federal government with respect to corporate governance, the so-called internal affairs doctrine is a result not of a constitutional imperative but of federal forbearance. The federal government could regulate the whole of corporate governance if it chose to do so. See *Santa Fe Indus. v. Green*, 430 U.S. 462, 479 (1977) ("*Absent a clear indication of congressional intent*, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities" (emphasis added)); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 597 (2003) ("[T]he internal affairs 'doctrine' is just an informal arrangement, not a hard limit on federal lawmaking.").

¹⁴⁰ See *supra* note 50 and accompanying text.

¹⁴¹ The number of major firms incorporating in Delaware has established Delaware law as national corporate law. See Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 350 (2001) ("The aggregated choices of a majority of publicly traded U.S. corporations have resulted in a convergence on the Delaware General Corporation Law as a de facto national corporate law."); see also Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation*.

no part of the General Corporation Law requires firms to disclose information concerning their D&O policies.¹⁴² Most states follow Delaware, but New York is an exception.

Like Delaware, New York is broadly permissive of D&O insurance.¹⁴³ Unlike Delaware, however, New York requires D&O insurance contracts to include a retention and coinsurance in amounts deemed acceptable by the state's superintendent of insurance before the contract can cover nonindemnifiable losses.¹⁴⁴ Also unlike Delaware, New York does not allow insurance payments, other than defense costs, to be made in the event that final adjudication establishes material "acts of active and deliberate dishonesty" or that the director or officer "personally gained . . . a financial profit or other advantage to which he was not legally entitled."¹⁴⁵ Although each of these provisions plainly regulates the relationship between insurer and insured to a much greater degree than Delaware law, these requirements may simply mimic the terms to which the parties would otherwise agree: D&O insurance contracts often include retention amounts¹⁴⁶ and co-insurance,¹⁴⁷ with deliberate fraud and final adjudication of wrongdoing as common exclusions.¹⁴⁸

ration Choice: Evidence on the "Race" Debate and Antitakeover Overreaching, 150 U. PA. L. REV. 1795, 1804 (2002) (supplying statistics on the rise of incorporation in Delaware).

¹⁴² The Delaware code mentions D&O insurance only to authorize its purchase and expressly provide that it may cover losses regardless of whether the corporation itself could indemnify directors against them. DEL. CODE ANN. tit. 8, § 145(g) (2004).

¹⁴³ See N.Y. BUS. CORP. LAW § 726(a) (McKinney 2003) (allowing a corporation to insure itself and its directors and officers against liability subject to provisions in § 726(b), even when the insurance contract includes a retention amount and coinsurance).

¹⁴⁴ See *id.* § 726(a)(3) ("[A] corporation shall have the power to purchase and maintain insurance . . . [t]o indemnify directors and officers in instances in which they may not otherwise be indemnified by the corporation . . . provided the contract of insurance covering such directors and officers provides, in a manner acceptable to the superintendent of insurance, for a retention amount and for co-insurance.").

¹⁴⁵ *Id.* § 726(b)(1).

¹⁴⁶ See, e.g., AIG Declarations Page, *supra* note 65, § 4 (limiting liability to losses over the stated retention amounts); Hartford Declarations Page, *supra* note 59, at 1 (providing for retention amounts under Side A, B, and C coverage).

¹⁴⁷ See, e.g., Hartford Declarations Page, *supra* note 59, at 2 (providing for coinsurance percentages for securities claims).

¹⁴⁸ See Hartford Specimen Policy, *supra* note 6, § V(J) (excluding coverage for "any deliberately dishonest, malicious or fraudulent act or omission or any willful violation of law" established by "judgment or final adjudication"); see also Chubb Specimen Policy, *supra* note 6, at 8-9 (excluding coverage for "any deliberately fraudulent act or omission"); AIG Specimen Policy, *supra* note 6, at § 4(c) (excluding coverage for "any deliberate criminal or deliberate fraudulent act by the Insured").

The most significant difference between the New York and Delaware statutes may be New York's requirement of disclosure of D&O policy information. Section 726(d) of the New York Business Corporation Law provides:

The corporation shall . . . mail a statement in respect of any insurance it has purchased or renewed under this section, specifying the insurance carrier, date of the contract, cost of the insurance, corporate positions insured, and a statement explaining all sums, not previously reported in a statement to shareholders, paid under any indemnification insurance contract.¹⁴⁹

New York corporate law, in other words, includes a mandatory disclosure rule that triggers the release of some D&O policy information in the company's proxy statement. Because several prominent firms are incorporated in New York, section 726(d) triggers the release of much interesting information. Table 1 and Figure 1, opposite, compile the D&O premiums of prominent New York corporations, including the New York Times Company (NYT), Bank of New York (BK), American Express (AXP), Xerox (XRX), and McGraw-Hill (MHP).¹⁵⁰

¹⁴⁹ N.Y. BUS. CORP. LAW § 726(d) (McKinney 2003).

¹⁵⁰ This information was derived from the companies' respective proxy statements filed with the SEC, which are available from the SEC's EDGAR database, <http://www.sec.gov/edgar/searchedgar/companysearch.html>. The data presented here are only intended to illustrate the potential signaling effect of the D&O premium; as further described in this section, because existing data do not permit controls for limits, retention, and coinsurance, no firm conclusions can be drawn from the information presented in the table or the figure. Note also that the numbers and dates listed here are approximations: several of the policies were for multiyear periods, did not always run concurrent with the calendar year, and included both primary and supplemental D&O premiums.

Table 1: D&O Premiums of Selected New York Corporations
(in thousands of dollars)

Company	Date						
	1999	2000	2001	2002	2003	2004	2005
NYT	997	997	997	4462	7823	7233	7544
BK	812	812	812	864	8685	7114	6546
AXP	778	778	1211	1211	2032	13579	10962
XRX	517	517	517	4903	4903	6892	5442
MHP	569	538	538	538	1612	1724	1600

Figure 1: D&O Premiums of Selected New York Corporations

Several observations emerge from these data. First, the D&O premiums for all of these companies increased considerably around 2001-2002. This is consistent with the data reported by the Tillinghast survey of annual D&O premiums and evidence of the beginning of a hard insurance market.¹⁵¹ However, as illustrated in Figure 1, premiums did not increase at the same rate for every company. The premium paid by the New York Times Company, for example, quadrupled between 2001 and 2002, then almost doubled the following year. Meanwhile, the premium paid by the Bank of New York increased more than tenfold in a single policy year. By contrast, the premiums paid by McGraw-Hill increased much less dramatically, tripling upon the expiration of its three-year policy in 2003, but leveling off and falling immediately thereafter. This suggests that while broad characteristics of the insurance market influence premiums, there is still significant variation in premiums resulting from firm-specific characteristics.

One of the most significant firm-specific characteristics is market capitalization, and it is tempting to compare D&O premiums to market capitalization in a simple ratio dividing a firm's annual D&O premium by its market capitalization on the effective date of the policy. This "D&O Premium Ratio" would enable quick comparisons between firms as well as checks against other governance metrics to test the correlation between D&O premiums and governance quality.¹⁵² Of course, as this Article has already noted, in order for the D&O Premium Ratio to yield useful comparisons, it must control for insurance limits—more coverage, after all, should yield higher premiums.¹⁵³ This adjustment to the ratio could be made easily by recalculating

¹⁵¹ See TILLINGHAST, TOWERS PERRIN, 2002 DIRECTORS AND OFFICERS LIABILITY SURVEY: EXECUTIVE SUMMARY OF U.S. AND CANADIAN RESULTS (2002), available at http://www.towersperrin.com/tillinghast/publications/reports/Directors_and_Officers_2002/DO_summary2002a.pdf ("The widespread and dramatic hardening of the D&O insurance market that began in 2001 continued during 2002 Nearly all segments in the U.S. saw sharp increases in premiums . . ."). A hard insurance market is one in which premiums are high and capacities are low. Such conditions are typically followed by soft markets in which new capacity is brought to the market and, as a result of this increase in available coverage, premiums fall. See generally Sean M. Fitzpatrick, *Fear is the Key: A Behavioral Guide to Underwriting Cycles*, 10 CONN. INS. L.J. 255, 262 (2004) (explaining underwriting cycles and noting the beginning of a hard market in late 2001).

¹⁵² See *supra* note 7 (describing various metrics for rating governance quality).

¹⁵³ See *supra* notes 120-22 and accompanying text (noting the importance of calculating the cost per dollar of coverage and controlling for industry and market capitalization).

premiums per dollar of coverage.¹⁵⁴ Unfortunately, a glance at Table 1 reveals that this adjustment is impossible with current data. The New York statute does not require disclosure of policy limits, and most of the companies listed do not include it in their proxy statements.¹⁵⁵ Without this information, the D&O Premium Ratio cannot be calculated on a per-dollar-of-coverage basis and therefore cannot generate useful comparisons.

There are several other weaknesses in the New York data. In addition to coverage limits, retentions and coinsurance amounts are not disclosed, making it difficult to evaluate actual coverage amounts. Similarly, most companies make no effort to break out different lines (Side A, B, or C) of coverage. The New York Times Company's disclosure that it has additional limits available under Side A is interesting, but we are ultimately no closer to understanding the exact D&O package purchased by the company.¹⁵⁶ We do not know, for example, whether the limits under Side C are affected by different retention and coinsurance amounts. As described in greater detail above, it is necessary to understand each of these aspects of a company's D&O package before one can fully understand its cost and ultimately compare the costs of similarly situated firms.

¹⁵⁴ Per-dollar premiums could be obtained by dividing the premium by the effective coverage limit. This number would then be placed in the ratio over market capitalization. In other words: per dollar premium = (total annual premium / effective coverage limits) / market capitalization at the beginning of the policy period.

¹⁵⁵ Again, this could be to keep the information from plaintiffs' lawyers, a theoretically unsound justification for nondisclosure. See *supra* notes 136-38 and accompanying text (explaining why plaintiffs' lawyers' knowledge of a company's D&O limits will not negatively affect the company). This justification is further weakened by the fact that some companies—the New York Times Company and McGraw-Hill, among others—do in fact disclose coverage limits. See, e.g., N.Y. Times Co., Notice of 2005 Annual Meeting and Proxy Statement 20 (Mar. 11, 2005), available at http://www.nytimes.com/pdf-reports/2005_Proxy_Statement.pdf ("The aggregate limit for the combined insurance for D&O claims is \$100 million."); McGraw-Hill Cos., Proxy Statement, 2005 Annual Meeting of Shareholders 15 (Mar. 21, 2005), available at <http://www.mcgraw-hill.com/2005mhpproxy/2005mhpproxystatement.pdf> ("[The Company's D&O insurance] coverage, subject to a number of standard exclusions and certain deductibles, indemnifies the Directors and officers of the Company and its subsidiaries for liabilities or losses incurred in the performance of their duties up to an aggregate sum of \$65,000,000."). If such disclosures threatened to expose companies to higher litigation costs, it is unlikely that any company would disclose the information.

¹⁵⁶ See N.Y. Times Co., *supra* note 155, at 20 ("If the \$100 million combined limit is exhausted, there is a separate \$50 million side limit available for directors' and officers' liability.").

Finally, New York is not Delaware. While several important firms are incorporated in New York, most are not.¹⁵⁷ Because the signaling value of D&O premiums lies in comparisons between similarly situated firms, we cannot know the real significance of the D&O premiums paid by any of the companies in Table 1 unless we know the premiums paid by their closest competitors. And, as long as those competitors incorporate in states other than New York, that information will remain unavailable. In sum, the D&O disclosures compelled by the state of New York are interesting, but ultimately unhelpful. Worse, until every company moves to New York, the legislators in Albany cannot solve the problem. There must be a national solution.

2. Federal Law and D&O Insurance

Federal securities regulators have adopted a tortured, somewhat contradictory approach to the issues raised by D&O insurance. Congress has never explicitly addressed the matter, but the SEC, following Congress's stated intent of inducing compliance with the securities laws,¹⁵⁸ has taken a firm position against the indemnification of officers and directors for securities law violations, requiring that all registrants under the Securities Act of 1933 include the following language in their registration statements:

Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers or persons controlling the registrant pursuant to the foregoing provisions, the registrant has been informed that in the opinion of the Securities and Exchange

¹⁵⁷ Most prominent corporations incorporate in Delaware. See Division of Corporations, State of Delaware, <http://www.state.de.us/corp> (last visited Mar. 25, 2006) (noting that 60% of Fortune 500 companies are incorporated in Delaware); see also Subramanian, *supra* note 141, at 1804 ("[B]y 2000 approximately half of NYSE companies were incorporated in Delaware. . . . Delaware in the 1990s had achieved a dominant share of the existing corporate charter market (50%), the reincorporation market (54%), and the IPO charter market (approximately 60%).") (footnote omitted)).

¹⁵⁸ See H.R. REP. NO. 73-85, at 3, 9 (1933) (discussing civil liability for noncompliance with the provisions of the Securities Act of 1933 and "insist[ing] that there . . . be full disclosure of essentially every important element attending the issue of a new security"); S. REP. NO. 73-47, at 3 (1933) ("The Committee believes it to be essential to accomplish the objects of the [Securities Act of 1933] to make the directors executing the registration statement liable for the consequences of untrue statements."). See generally James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959) (providing a personal and anecdotal account of the passage of the Securities Act of 1933).

Commission such indemnification is against public policy as expressed in the Act and is therefore unenforceable.¹⁵⁹

The SEC's position on indemnification is rooted in the view that spreading the cost of legal sanction renders managers less likely to comply with the law.¹⁶⁰ Because insuring directors and officers against these costs would seem to implicate precisely the same policy concerns as indemnifying them, it would be reasonable to suppose that the SEC similarly opposes D&O insurance. This supposition, however, appears to be incorrect.

The SEC takes a milder position on D&O insurance than on indemnification. The SEC has not declared insurance against securities law liabilities to be a violation of public policy. In fact, the SEC has arguably endorsed the corporate purchase of D&O insurance, stating that the maintenance of a D&O policy, even when paid for by the company, will not bar acceleration of a registration statement.¹⁶¹

¹⁵⁹ 17 C.F.R. § 229.510 (2005) (requiring that this statement be included in the registration statements of registrants not requesting acceleration of effectiveness). Registrants requesting acceleration of the effective date are also required to state that, in the event of an indemnification claim by an officer or director, the company will "submit to a court . . . the question whether such indemnification by it is against public policy as expressed in the Act" unless its counsel opines that the issue has been resolved by precedent. *Id.* § 229.512(h). These line-item disclosures are triggered in each of the major forms governing the registration of securities. *E.g.*, SEC Form S-1, item 12A (Dec. 2005), *available at* <http://www.sec.gov/about/forms/forms-1.pdf> (requiring applicants to "[f]urnish the information required by . . . § 229.510"); SEC Form S-3, item 13 (Dec. 2005), *available at* <http://www.sec.gov/about/forms/forms-3.pdf> (same); SEC Form S-4, item 9 (July 2005), *available at* <http://www.sec.gov/about/forms/forms-4.pdf> (same); SEC Form S-8, item 6 (Sept. 2005), *available at* <http://www.sec.gov/about/forms/forms-8.pdf> (requiring disclosure pursuant to § 229.702, regarding the indemnification of officers and directors, but not pursuant to § 229.510); SEC Form S-11, item 34 (Mar. 2005), *available at* <http://www.sec.gov/about/forms/forms-11.pdf> (same).

¹⁶⁰ See 1 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 556 (3d ed. 1998) (noting that the SEC has pressed its position that indemnification of a director or officer against statutory liabilities is unenforceable "because [such indemnification] tends to frustrate the *in terrorem* purposes of individual liability"); see also *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1288-89 (2d Cir. 1969) (concurring with the SEC's position and denying indemnification on the view that liability "was designed not so much to compensate the defrauded purchaser as to . . . deter negligence"). Similarly, public policy has been held to prevent indemnification under other federal statutes. See, e.g., *Sequa Corp. v. Gelmin*, 851 F. Supp. 106, 110-11 (S.D.N.Y. 1994) (holding that an indemnification for RICO liability is against public policy).

¹⁶¹ See 17 C.F.R. § 230.461(c) (2005) ("Insurance against liabilities arising under the Act, whether the cost of insurance is borne by the registrant, the insured or some other person, will not be considered a bar to acceleration . . ."). The SEC does, however, consider registered investment companies a special case, requiring greater scrutiny of insurance arrangements. See *id.* ("[T]he Commission may refuse to accelerate

Moreover, unlike the harsh language imposed on registrants adopting indemnification provisions, the SEC requires only that the existence and "general effect" of D&O insurance policies be disclosed.¹⁶² Considering that insurance and indemnification raise the same policy concerns,¹⁶³ the maintenance of distinct positions seems inconsistent and, in any event, has never been explained by the SEC.¹⁶⁴

The regulation that requires registrants to disclose the existence of D&O insurance does not require the disclosure of any policy details. Item 702 of Regulation S-K merely requires that registrants "[s]tate the general effect of any statute, charter provisions, by-laws, contract or other arrangements under which any controlling persons,

the effective date [for a registered investment company] that protects or purports to protect any officer or director of the company against any liability"); *see also* Investment Companies and Advisers Act, 15 U.S.C. § 80a-17(h) (2000) (prohibiting "any provision which protects . . . any director or officer of [a registered investment company] against . . . willful misfeasance, bad faith, gross negligence or reckless disregard of . . . duties").

¹⁶² 17 C.F.R. § 229.702 (2005). This disclosure is triggered, like the disclosures required by items 510 and 512(h), by each of the major forms governing the registration of securities. *See* SEC Forms S-1, S-3, S-4, S-8, and S-11, *available at* <http://www.sec.gov/about/forms/secformalpha.htm>, for information required for registration under the Securities Exchange Act of 1933.

¹⁶³ Interestingly, the SEC originally treated insurance and indemnification together in item 510 of Regulation S-K, requiring disclosure of insurance arrangements in the subsection of the provision mandating inclusion of the policy statement on indemnification. *See* Adoption of Integrated Disclosure System, Securities Act Release No. 6383, Exchange Act Release No. 18,524, Investment Company Act Release No. 12,264, 47 Fed. Reg. 11,380, 11,383 (Mar. 16, 1982) (splitting what was then S-K 510(a) and (b) into what is now S-K 702 and 510, respectively).

¹⁶⁴ *See* LOSS & SELIGMAN, *supra* note 160, at 557 ("The Commission policy on indemnification is hardly a jewel of consistency. It applies solely to indemnification by registrants and not to indemnification by insurers or by other third parties."); Milton P. Kroll, *Some Reflections on Indemnification Provisions and S.E.C. Liability Insurance in the Light of BarChris and Globus*, 24 BUS. LAW. 681, 687-92 (1969) (reviewing the public policy considerations that arise under the SEC's inconsistent policies on indemnification and insurance). The inconsistencies in the SEC's position are several. On its face, the policy applies only to violations of the Securities Act, not the Securities Exchange Act, and therefore captures disclosure violations in connection with securities issuance but not with securities fraud under section 10b-5, a distinction for which the basis is unclear. Furthermore, the bar on indemnification of securities law liabilities has been interpreted by courts not to apply to defense costs or settlement. *See, e.g., Raychem Corp. v. Fed. Ins. Co.*, 853 F. Supp. 1170, 1179-80 (N.D. Cal. 1994) (holding that indemnification of settlement is not against public policy); *Goldstein v. Alodex Corp.*, 409 F. Supp. 1201, 1205 (E.D. Pa. 1976) (ruling that indemnification of defense costs is not against public policy). Since most securities claims are settled, these exceptions seem to swallow the rule.

director or officer of the registrant is insured or indemnified in any manner against liability which he may incur in his capacity as such.”¹⁶⁵

Although the “general effect” of D&O insurance may be read to require some discussion of policy details, registrants generally provide nothing more than an opaque statement that coverage will be available, subject to unstated limits, to cover liabilities arising from the directors’ or officers’ conduct as such.¹⁶⁶ By granting effectiveness to these registration statements, the SEC effectively accepts such non-descriptive language in fulfillment of the required disclosure.

The SEC could require much more detail. The SEC could, for example, treat D&O insurance as a “material contract” and require that policies be filed as an exhibit to the registration statement.¹⁶⁷ It could also treat D&O insurance as an aspect of executive compensation, triggering an extensive description of policy features, including the cost and value of the policy, as it does in the case of life insurance provided to corporate executives.¹⁶⁸ However, the SEC has made neither of these choices, instead treating D&O insurance as a matter distinct from executive compensation and thereby minimizing the required disclosure of policy details.¹⁶⁹

¹⁶⁵ 17 C.F.R. § 229.702 (2005).

¹⁶⁶ For example, in its registration statement, Yankee Candle made the following statement:

Policies of insurance are maintained by Yankee Candle under which its directors and officers are insured, within the limits and subject to the limitations of the policies, against certain expenses in connection with the defense of, and certain liabilities which might be imposed as a result of, actions, suits or proceedings to which they are parties by reason of being or having been such directors or officers.

Yankee Candle Co., Registration Statement (Form S-3), item 15 (Feb. 25, 2002), available at <http://www.sec.gov/Archives/edgar/data/1084242/000091205702007504/0000912057-02-007504.txt>.

¹⁶⁷ See 17 C.F.R. § 229.601(b)(10) (2005) (requiring that certain “material contracts” not made in the ordinary course of business be filed as exhibits to the registrant’s public filings).

¹⁶⁸ See *id.* § 229.402(b)(2)(v)(E) (requiring disclosure of the dollar value of life insurance provided by the corporation to its executives and the premiums paid by the corporation).

¹⁶⁹ The SEC has expressly stated that it will not treat D&O insurance as a form of executive compensation: “Premiums paid for liability insurance for officers and directors and benefits paid under such insurance plans are not forms of remuneration to the extent that the insurance plan is intended to relieve officers and directors of liability relating to their job performance.” Disclosure of Management Remuneration, Securities Act Release No. 5904, Securities Exchange Act Release No. 14,445, Investment Company Act Release No. 10,112, 43 Fed. Reg. 6060, 6063 (Feb. 13, 1978). In taking this position, the SEC essentially follows the IRS, which similarly does not treat D&O insurance as executive compensation. See Rev. Rul. 69-491, 1969-2 C.B. 22 (“[N]o in-

It is puzzling, given both the SEC's strident position on indemnification and the valuable information that D&O policy details may convey, that the SEC does not require disclosure of registrants' D&O policy premiums, limits, and retentions. This may seem especially strange considering the fact, explored in the next section, that Canadian securities regulators require disclosure of precisely these items.

C. A Canadian Comparison

Unlike their counterparts in the United States, Canadian securities regulators do require disclosure of D&O insurance details. Public companies in Canada must disclose basic information concerning their D&O insurance policies, including coverage limits and premiums, in their proxy filings and registration statements.¹⁷⁰ This provides the opportunity to conduct a natural experiment, identifying whether the information disclosed in these Canadian filings can be used to establish a link between corporate governance and D&O insurance. While economists have examined this data,¹⁷¹ legal differences between the two countries make it difficult to import conclu-

come results to the officers from [D&O] premium payments."); see also KNEPPER & BAILEY, *supra* note 17, § 22.22 (discussing the IRS's view of D&O insurance).

¹⁷⁰ See, e.g., Ontario Securities Commission, Form 30. (While Form 30 applied to the research discussed in this section, it was superseded in late 2003 by NI 51-102. Canadian Securities Administrators, National Instrument 51-102 Continuous Disclosure Obligations (Dec. 18, 2003), available at http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20031219_51-102_con-dis.pdf.) Information offered by companies regarding their policies is publicly available on the Ontario Security Commission's online database of public filings. Ontario Securities Commission, System for Electronic Document Analysis and Retrieval (SEDAR), <http://www.sedar.com>. Canadian corporations are given express permission to purchase D&O insurance under the Canadian Business Corporations Act, 2001 S.C., ch. 15, § 51(b) (amending R.S.C., ch. C-44, § 126(6)) (Can.) ("A corporation may purchase and maintain insurance for the benefit of an [officer or director] against any liability incurred by the individual . . . in the individual's capacity as a director or officer of the corporation . . .").

¹⁷¹ In addition to the work of John Core, discussed below, see generally M. Martin Boyer & Mathieu Delvaux-Derome, *The Demand for Directors' and Officers' Insurance in Canada* (CIRANO, Working Paper No. 2002s-72, 2002), available at <http://www.cirano.qc.ca/pdf/publication/2002s-72.pdf> (studying the demand for D&O insurance in Canada); Martin Boyer, *Directors' and Officers' Insurance and Shareholders' Protection* (CIRANO, Working Paper No. 2003s-64, 2003), available at <http://www.cirano.qc.ca/pdf/publication/2003s-64.pdf> (same); Martin Boyer, *Is the Demand for Corporate Insurance a Habit? Evidence of Organizational Inertia from Directors' and Officers' Insurance* 5-6 (CIRANO, Working Paper No. 2004s-33, 2004), available at <http://www.cirano.qc.ca/pdf/publication/2004s-33.pdf> (same).

sions from Canada (or any foreign jurisdiction) to American corporate governance.¹⁷²

Professor John Core has performed the leading study examining Canadian data to determine whether D&O premiums can be related to corporate governance variables.¹⁷³ Hypothesizing that D&O premiums would be a function both of business-specific risk factors and governance-related risk factors, Core separated proxy variables relating to each.¹⁷⁴ Grouping measures of ownership structure, board size, and management entrenchment together as indicators of “governance quality,” on the one hand, and firm size, financial performance, and U.S. exchange listing as proxies for “business risk,” on the other, Core regressed each variable against D&O premiums, finding approximately half of the governance quality variables to be statistically significant, while each of the business risk variables was statistically significant.¹⁷⁵ Significant governance quality variables—including insider stock ownership and voting control, director independence, and executive employment contracts¹⁷⁶—enabled Core ultimately to conclude that Canadian data supports an association between D&O premiums and governance quality.¹⁷⁷

One of the variables Core found to be most significant, however, underscores the study’s inherent limitations. If a Canadian firm is also listed on a U.S. exchange, exposing it to U.S. securities litigation, the firm has significantly higher D&O premiums.¹⁷⁸ This emphasizes the difference between U.S. and Canadian liability risks. At least with

¹⁷² Although the legal systems of the United States and Canada are broadly similar, Canada is a considerably less favorable environment for representative litigation. See *infra* note 179 and accompanying text.

¹⁷³ See Core, *supra* note 121, at 449 (outlining his study and his findings).

¹⁷⁴ See *id.* at 454 (“[A] firm’s D&O premium is hypothesized to be a function of both the quality of its corporate governance and its business risk . . .”).

¹⁷⁵ *Id.* at 457-62. The business risk proxies included management experience (the longer the manager has been on the board, the lower the firm’s litigation risk), financial performance (the worse the firm’s return on equity, the higher its litigation risk), size (the greater the firm’s total assets, the higher its litigation risk), prior litigation (firms with a history of litigation are higher litigation risks), and U.S. operations or U.S. listing (both of which increase litigation risk). *Id.*

¹⁷⁶ *Id.* at 463-66. Core notes that all governance variables have the predicted sign and that they add explanatory power to the model as a group, even if only four of nine are individually significant. *Id.* at 463.

¹⁷⁷ See *id.* at 451 (“The results indicate that D&O premiums are significantly higher when inside control of share votes is greater, when inside ownership is lower, when the board is comprised of fewer outside directors, when the CEO has appointed more of the outside directors, and when inside officers have employment contracts.”).

¹⁷⁸ *Id.* at 462.

regard to shareholder litigation, and perhaps representative litigation generally, the legal systems between the two countries are different enough to make cross-country comparisons somewhat tenuous. Canada retains the English "loser pays" system, increasing the risk borne by plaintiffs' lawyers.¹⁷⁹ As a result, contingent fees are used less often and, when they are used, are subject to a reasonableness standard.¹⁸⁰ In addition, class actions and derivative suits are filed less often, perhaps because punitive damages are rarely awarded.¹⁸¹ The Canadian environment, on the whole, is thus considerably less favorable for entrepreneurial plaintiffs' lawyers.¹⁸² As a result, although Core's study ultimately supports a link between corporate governance and D&O insurance, U.S. data are needed to confirm the result.

In a recent paper, Professor George Kaltchev attempts to develop his own U.S. data set from proprietary and confidential information supplied by two insurance brokerage firms.¹⁸³ Kaltchev's data set includes information on insurance limits and retentions—that is, data on the *amount* of D&O insurance purchased—for almost 300 companies, which he then used to test hypotheses for why companies purchase D&O insurance.¹⁸⁴ Perhaps unsurprisingly, Kaltchev finds that the best predictor of D&O limits is the insured company's market capitalization.¹⁸⁵ After size, the leading indicators of insurance amounts seem to be returns, with larger returns on assets tending to produce lower insurance limits.¹⁸⁶ This could be taken to suggest that better managers are less likely to insist on high levels of D&O insurance or, relatedly, that companies that perform better are less likely to be sued. Alternately, an inverse relationship between returns and coverage lim-

¹⁷⁹ See *id.* at 451 n.2 (describing relevant differences between the Canadian and American legal systems).

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² See Ronald J. Daniels & Susan M. Hutton, *The Capricious Cushion: The Implications of the Directors' and Officers' Insurance Liability Crisis on Canadian Corporate Governance*, 22 CAN. BUS. L.J. 182, 216-20 (1993) (arguing that the differences in U.S. and Canadian legal liabilities for corporate directors and officers can at least partially explain why Canadian corporations purchase significantly less D&O insurance than their American counterparts).

¹⁸³ See Kaltchev, *supra* note 121, at 34 (outlining his data and methodology).

¹⁸⁴ *Id.*

¹⁸⁵ See *id.* at 52 ("[The market value of firm equity] appears to be directly related to limits, as a measure of the potential size of loss."). This is as one would expect since the larger the market capitalization, the greater the potential damages in shareholder litigation.

¹⁸⁶ *Id.*

its may simply indicate that firms with large cash flows can more easily self-insure against litigation risk. Kaltchev's findings also support a significant relationship between indicators of financial health, as indicated by leverage and volatility, and D&O coverage limits: the higher a company's leverage and volatility, the more insurance it buys. Of the corporate governance variables tested, it is worth noting that companies that have not split the chief executive and chairperson of the board functions tend to buy more D&O insurance and that director and officer ownership of firm stock correlates to lower policy limits.¹⁸⁷

A significant weakness of the Kaltchev study, however, is that it lacks information on insurance pricing. Because almost every firm purchases D&O insurance and because losses correlate to size, insurance pricing is more likely to be sensitive to governance variables than coverage limits or overall demand. Kaltchev was unable to produce this data from his confidential U.S. sources, while Core, in spite of access to pricing information through Canadian firms' proxy statements, was subject to limitations in making comparisons across legal systems that, at least on the issue of shareholder litigation, are significantly different. Thus, the only way to provide researchers and market participants with the information embedded in the D&O insurance premium may be to mandate disclosure of such data in U.S. securities law. This is the solution proposed in the next section.

D. *The SEC Should Mandate Disclosure of D&O Insurance Details*

The law should be changed to require disclosure of more details concerning a company's D&O policies. In addition to disclosing the existence of a policy, companies should be required to disclose the identity of the insurer, the limits and retention under each side type of coverage (Side A, B, and C), and perhaps most importantly, the D&O premium. Each of these disclosures should be required on a regular basis—as each policy is entered or renewed—and, taken together, should provide a valuable indicator of corporate governance quality that is currently unavailable to capital market participants.

¹⁸⁷ See *id.* at 36 (relating these findings and arguing that they confirm “the hypothesis that higher managerial ownership aligns the interests [of] managers and shareholders and [that] insurance and ownership are . . . substitutes”). But see Core, *supra* note 121, at 464–65 tbl.2 (finding, in the Canadian data set, that separation between chief executive and chairperson roles does not affect premiums).

This Article has argued that the *price* a firm pays for its D&O coverage—the insurance premium—will convey an important signal concerning the quality of the firm’s governance. Requiring disclosure of the firm’s D&O premium would thus enhance the ability of investors to value the firm, and requiring it on a regular basis would ensure current information, perhaps alerting investors to sudden shifts in governance risk. If, for example, a firm’s D&O insurance significantly increased in a year in which similarly situated firms experienced no change in premium, investors would be put on notice that some aspect of the firm’s governance may have changed. Moreover, because the governance assessment implicit in the insurance premium is based in part on private information provided to the D&O insurer through meetings and nondisclosure agreements,¹⁸⁸ the signal conveyed by a change in insurance premiums may alert investors to information that is otherwise unavailable to them.

Details on the *amount* of D&O insurance purchased—that is, the company’s policy limits and retentions—would also provide several vital pieces of information. First, without information on the amount of insurance purchased, data on premiums would be too noisy to be meaningful. Information on limits and retentions is necessary to specify precisely what the company is paying for and to enable comparisons across firms.¹⁸⁹ Moreover, requiring information about the amount of coverage under each *type* of coverage—that is, Side A, B, and C—would provide additional signals to the market. As described in Part III.A, Side A coverage is the only form of coverage that benefits officers and directors individually. The amount of Side A coverage purchased by a firm could thus convey an important signal about the confidence of its managers regarding the liability risks they expect to face. Sanguine managers may not require their firms to purchase as much coverage as their less confident peers at different firms. As a result, other things being equal, a firm purchasing lower amounts of Side A insurance may tend to pose less risk of shareholder litigation. Unlike Side A coverage, Side B and Side C coverages benefit the company only and, as described above, may be rooted in managerial agency costs. As a result, a company purchasing large amounts of coverage under Side B and Side C sends a signal not only that its managers believe the firm presents a relatively large risk of share-

¹⁸⁸ See *supra* note 108 and accompanying text (describing the use of NDAs between insurers and prospective insureds in the underwriting process).

¹⁸⁹ See *supra* notes 153-55 and accompanying text (describing the need to take limits into account when calculating the D&O Premium Ratio).

holder litigation, but also that it has the kind of managers who would rather waste corporate assets in a negative net present value investment than put their personal compensation packages at risk by allowing the firm to self-insure against shareholder litigation.

Finally, the identity of the D&O insurer would provide valuable information about the gatekeeper itself.¹⁹⁰ In addition to the obvious importance of the insurer's financial rating, different insurers may have different reputations for screening governance risk.¹⁹¹ As a result, investors may draw different conclusions if, for example, a company's primary D&O insurer is a market leader in D&O insurance or an unknown, cut-rate insurer. The cut-rate insurer may have an incentive to lower premiums irrespective of governance risk in order to capture greater market share. Although this will be a losing strategy in the long run, upstart firms may try it in the short run to establish a set of clients, hoping to make up for the increased near-term risk with greater premiums in the future. More directly, some insurers may develop a reputation for compiling better risk pools than others with the result, as with investment banks in securities offerings, that companies covet the opportunity to do business with a "prestige" player.¹⁹²

Given the potential value of this information to market participants, the SEC should change the relevant regulations to force corporations to provide it. This would be a technically simple matter. The SEC could amend Regulation S-K item 702 to mandate—instead of a

¹⁹⁰ Disclosure of the identity of the insurer should include the larger corporate group, if any, of which the D&O insurer is a member. Federal Insurance Company, for example, is a Chubb company. Chubb Corp., Chubb Subsidiaries, <http://www.chubb.com/corporate/chubb2403.html> (last visited Mar. 25, 2006). National Union Fire Insurance Company of Pittsburgh is a division of AIG. Am. Int'l Group (AIG), Welcome to National Union, <http://www.aignationalunion.com/nationalunion/public/nathome> (last updated Jan. 19, 2006).

¹⁹¹ A.M. Best Company and a handful of other firms rate the financial strength of insurance companies. See, e.g., A.M. Best Co., Best's Ratings Methodology, <http://www.ambest.com/ratings/methodology.asp> (last visited Mar. 25, 2006) (describing ratings methodologies and gradations). Insurance companies disclose the ratings they receive. See, e.g., Am. Int'l Group (AIG), Form 10-K (May 31, 2005), available at <http://www.sec.gov/Archives/edgar/data/5272/000095012305006884/y03319e10vk.htm> (disclosing financial ratings); Chubb Corp., The Chubb Corporation Financial Ratings, <http://www.chubb.com/investors/chubb2879.html> (giving Chubb's ratings from A.M. Best, Fitch Ratings, Moody's, and Standard & Poor's).

¹⁹² On the role of "prestige" underwriters in securities offerings, see generally Seha M. Tinic, *Anatomy of Initial Public Offerings of Common Stock*, 43 J. FIN. 789, 819 (1988) (supporting the certification function of "prestige" underwriters); Glenn A. Wolfe et al., *An Analysis of the Underwriter Selection Process for Initial Public Offerings*, 17 J. FIN. RES. 77, 89 (1994) ("[P]restigious investment bankers attempt to manage the risk associated with underwriting unseasoned new issues.").

weak statement of the “general effect” of insurance arrangements—explicit disclosure of the registrant’s D&O premium, its limits and retentions under each type of coverage, and the identity of the registrant’s D&O insurance carriers. Then, in order to force registrants to make this disclosure regularly, the SEC could add a cross-reference in Form 8-K to the amended Regulation S-K item 702, thereby requiring registrants to disclose detailed information on D&O insurance when they change or renew their coverage.¹⁹³

Although such modifications would be technically simple, the SEC may encounter political resistance to this change, both from registrants and insurers. Their most likely objection—that mandating disclosure of D&O insurance details will encourage the filing of non-meritorious lawsuits by plaintiffs’ lawyers eager to reach insurance assets—is, as we have already seen, easily countered. Because plaintiffs’ lawyers already understand these details, there is little likelihood that such disclosures will change the dynamics of shareholder litigation.¹⁹⁴

There may, however, be a subtext to such objections. Registrants may resist the disclosure of D&O insurance data because, as described above, it threatens to reveal new information about the extent of their agency costs. This, of course, is precisely why the SEC should require these disclosures. Moreover, not every company will suffer from the release of this information. There will be companies, for example, that pay relatively little in D&O premiums or that purchase only Side A coverage, both of which signal good governance and low agency costs.¹⁹⁵ Uncovering such information would generate positive data and, potentially, result in a positive adjustment in share price for these

¹⁹³ Registrants are required to report certain material transactions on Form 8-K pursuant to sections 13 and 15(d) of the Securities Exchange Act of 1934. 15 U.S.C. §§ 78m, 78o (2000 & Supp. II 2002); *see also* SEC Form 8-K, § 1.01, *available at* <http://www.sec.gov/about/forms/form8-k.pdf> (requiring disclosure of entry into a material definitive agreement). In addition to the change in securities regulation triggering disclosure, state insurance regulations may need to be changed to enable insurance commissioners to police the possibility that corporations will seek to enter into tying arrangements with their carriers and engage in other attempts to degrade the quality of disclosure by, for example, paying a higher premium for property and casualty coverage in order to receive a discount for D&O coverage.

¹⁹⁴ *See supra* text accompanying notes 136-38 (explaining that plaintiffs’ lawyers can already accurately estimate figures for particular companies).

¹⁹⁵ Consider the example of McGraw-Hill in Table 1; its premiums increased considerably less than other companies in the same market. McGraw-Hill’s ability to keep its premiums relatively low may suggest that it was a more attractive risk over the relevant period than other firms seeking D&O insurance at the same time.

firms. In addition, disclosure of the amount that all registrants pay for D&O coverage may make the market for D&O insurance more competitive. If, when renewing its policy, a company is able to cite the lower premiums paid by several of its competitors, it can force the insurer to justify its own premium and, perhaps, bargain for lower premiums itself. This improved transparency would thus benefit all companies in the market for D&O insurance.¹⁹⁶

Making the market for D&O coverage more competitive may be precisely what the insurance industry would like to avoid. Insurance industry objections to mandatory disclosure may thus be rooted in the fear that such disclosures will drive rates down and make it even more difficult for insurers to profit from their professional liability lines. But this again would be a strange objection to credit since it is rooted in inefficiencies and market power. From a public policy perspective, these are problems to be solved, not rights to be protected, and mandating disclosure of D&O premiums is a step in the direction of solving them.

The likely objections to mandatory disclosure of D&O insurance details from registrants and insurance companies are not highly principled. The basic benefit of this disclosure is improvement of capital market efficiency through the signaling effects provided by D&O policy details. A possible side-benefit of mandatory disclosure of this information is the improvement of product market efficiency for this line of insurance. The SEC thus has strong arguments at its disposal to answer the narrow, self-interested objections of registrants and the insurance industry. Moreover, the modification to the existing regime of securities regulation would be technically simple to accomplish. Because the benefits thus appear to overwhelm the costs, the SEC should change the law to mandate disclosure of D&O policy details in the securities filings of registered companies.

CONCLUSION

This Article has explored the connection between corporate governance and D&O insurance. On the basis of D&O insurers' incentives to act as gatekeepers and guarantors, screening and pricing cor-

¹⁹⁶ It would not benefit insurance brokers, however, who as intermediaries in these transactions purport to add value through their special knowledge and expertise of the marketplace. If this information were made publicly available, the need for intermediaries would be reduced. Although the brokers may object, this may actually be another benefit of disclosure.

porate governance risks to maintain the profitability of their risk pools, this Article has advanced the hypothesis that, other things being equal, firms with relatively worse corporate governance pay higher D&O premiums. A company's D&O insurance premium could thus signal important information concerning the firm's governance quality to investors and other capital market participants. Unfortunately, the signal is not being sent. Corporations lack the incentive to produce this disclosure themselves, and the SEC currently does not require registrants to provide this information. As a result, this Article has advocated a change to U.S. securities regulation, making disclosure of D&O policy details—specifically, premiums, limits, and retentions under each type of insurance, as well as the identity of the insurer—mandatory. Because such disclosure would improve the amount and quality of information in the capital markets, would cost very little to implement, and does not give rise to a principled objection, this Article urges the SEC to adopt this proposed reform as soon as possible.