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

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

TOM BAKER* and SEAN J. GRIFFITH†

This article reports the results of empirical research on the monitoring role of directors' and officers' liability insurance (D&O insurance) companies in American corporate governance. Economic theory provides three reasons to expect D&O insurers to serve as corporate governance monitors: first, monitoring provides insurers with a way to manage moral hazard; second, monitoring provides benefits to shareholders who might not otherwise need the risk distribution that D&O insurance provides; and third, the “bonding” provided by risk distribution gives insurers a comparative advantage in monitoring. Nevertheless, we find that D&O insurers neither monitor corporate governance during the life of the insurance contract nor manage litigation defense costs once claims arise. Our findings raise significant questions about the value of D&O insurance for shareholders as well as the deterrent effect of corporate and securities liability. After exploring various explanations for these findings, we conclude that the absence of monitoring is due, at least in part, to the agency problem in the corporate context. Our analysis thus suggests that the existing form of corporate D&O insurance both results from and contributes to the relatively weak constraints on corporate managers. Corporate managers buy D&O coverage for self-serving reasons, and the coverage itself, because it does not control moral hazard, reduces the extent to which shareholder litigation aligns managers' and shareholders' incentives.

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* Connecticut Mutual Professor and Director, Insurance Law Center, University of Connecticut School of Law. © 2007, Tom Baker.
† Associate Professor of Law, Fordham Law School. © 2007, Sean J. Griffith. For their comments and suggestions on earlier drafts, the authors thank Kenneth Abraham, Bernard Black, Ross Cheit, John Coffee, Melvin Eisenberg, Richard Ericson, Sean Fitzpatrick, Ronald Gilson, Victor Goldberg, Jeffrey Gordon, Zohar Goshen, Steven Halpert, David Hyman, Louis Kaplow, Lewis Kornhauser, Kevin LaCroix, Francis Mootz, Marty Perry, Larry Ribstein, Roberta Romano, Robert Rosen, Tanina Rostain, Margo Schlanger, Daniel Schwarcz, Catherine Sharkey, Steven Shavell, Paul Vaaler, William Wang, Carol Weisbrod, Kathy Zeilier, and workshop participants at Columbia Law School, Harvard Law School, New York Law School, University of Illinois College of Law, and the New England Insurance and Society Study Group. Thanks to Yan Hong and Josh Dobiac for research assistance and to the D&O insurance professionals who volunteered their time to participate in our research project. The viewpoints and any errors expressed herein are the authors' alone.

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INTRODUCTION

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

1. See generally DAVID SKEEL, ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM (2005) (placing the Enron and WorldCom scandals in historical context).
3. See generally HOWARD M. SCHILLT, FINANCIAL SHENANIGANS: HOW TO DETECT ACCOUNTING GIMMICKS & FRAUD IN FINANCIAL REPORTS (2d ed. 2002) (identifying each of these financial reporting techniques and providing examples of their use).
and accountants, and their inside and outside counsel all failed to stop them.\textsuperscript{4}

This Article reports the results of qualitative empirical research on an institution that will be closely involved in any liability-based approach to addressing this problem: directors' and officers' liability insurance (D&O insurance). U.S. publicly traded corporations—virtually all of them—protect themselves against the costs associated with corporate and securities law liability by purchasing D&O insurance.\textsuperscript{5} Significantly, D&O insurance protects the assets of the corporation itself as well as those of the directors and officers of the corporation. Moreover, D&O insurance covers the full costs of the corporate and individual liability, less a deductible, in all but a few of the claims to which it applies.\textsuperscript{6} As a result, the deterrence goals of corporate and securities law liability rules are achieved indirectly, through an insurance intermediary, if indeed they are achieved at all.\textsuperscript{7}

D&O insurers have three ways of furthering the deterrence objectives of corporate and securities law liability and, in order to minimize their own payout obligations, ample incentive to do so. First, they can price their insurance based on their best assessment of the liability risk of each individual corporation, thereby providing an incentive for corporations to minimize that risk. Second, they can monitor and seek to improve the corporate governance practices of the corporations they insure. Third, they can manage the defense and settlement of corporate and securities lawsuits so that only meritorious claims are paid.

In a companion article, we report the results of our investigation into the risk

\textsuperscript{4} See generally John C. Coffee, Jr., \textit{Gatekeepers: The Professions and Corporate Governance} (2006) (attributing the recent corporate scandals to failures of various "Gatekeepers," such as lawyers and accountants).

\textsuperscript{5} See Tillinghast Towers Perrin, 2005 Directors and Officers Liability Survey 20 fig.21 (2006) (reporting that 100% of public company respondents in both the United States and Canada purchased D&O insurance) [hereinafter TILLINGHAST, 2005 SURVEY]. Prior surveys reported slightly smaller percentages of companies purchasing D&O insurance. Although the annual Tillinghast D&O survey is based on a nonrandom, self-selecting sample of companies, it is the only systematic source of information on D&O insurance purchasing patterns in the United States. The information that it provides is consistent over the years, and the D&O insurance professionals we interviewed reported that they rely on the survey. We therefore draw upon it as a source of aggregate data in spite of its methodological weaknesses.

\textsuperscript{6} See, e.g., James D. Cox, \textit{Making Securities Fraud Class Actions Virtuous}, 39 Ariz. L. Rev. 497, 512 (1997) ("[A]pproximately 96\% of securities class action settlements are within the typical insurance coverage, with the insurance proceeds often being the sole source of settlement funds."). Using U.S. data, Cornerstone reports that "[o]ver 65\% of all [securities class action] settlements in 2004 were for less than $10 million," a figure within the policy limits of most publicly traded corporations, and that only seven settlements were larger than $100 million. See Laura E. Simmons & Ellen M. Ryan, \textit{Post-Reform Act Securities Settlements: Updated Through December 2004}, at 3 (Cornerstone Research ed. 2005).

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

This Article is devoted primarily to the second way that D&O insurers might further those goals: by monitoring corporations in order to prevent the misrepresentations and other activities that lead to legally compensable losses. Insurers engage in such loss prevention practices in other insurance contexts—fire insurance companies, for example, provide premium discounts for smoke detectors and sprinkler systems, and liability insurers require college fraternities to forego keg parties. We investigate whether insurance companies engage in similar loss prevention activities in the D&O context as well. In addition, we investigate whether D&O insurers manage litigation costs to the same extent as do other liability insurers.

Our approach is empirical. We interviewed over forty people in the D&O insurance industry—including underwriters, actuaries, claims managers, brokers, lawyers, and corporate risk managers—and asked them to describe the relationship between D&O insurers and their public company insureds. Do insurers offer loss prevention services to their corporate insureds? And, relatedly, do insurers monitor the corporate governance of their insureds? We found

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9. Id.


12. We describe our qualitative research methods in our companion article. See Baker & Griffith, supra note 8. In brief, we used a snowball recruitment technique and conducted semi-structured interviews with twenty-one underwriters from fourteen companies, three D&O actuaries from three companies, six brokers from six brokerage houses, four risk managers employed by publicly traded corporations to purchase their insurance coverage, three lawyers who advise publicly traded corporations on the purchase of D&O insurance, and four professionals involved in the D&O claims process (two claims managers, one monitoring counsel, and one claims specialist from a brokerage house). In addition, we attended six conferences for D&O professionals (participating as moderators in two of them) and engaged in many informal conversations, supplementing our interviews with industry documents as well as regular reading of trade and industry publications. Because of the concentrated, highly networked nature of the D&O insurance market we are confident that we are reporting shared views despite the small number of interviews. See Tillinghast, 2005 Survey, supra note 5, at 84–93 (describing industry concentration). We observed the highly networked nature of the industry by attending conferences and by conducting interviews.
that the answer to both of these questions was: they do not. The participants in our study unanimously reported that D&O insurers do not offer real loss prevention services or otherwise monitor corporate governance.\(^{13}\)

This finding raises substantial questions about the deterrent effect of corporate and private securities law liability, providing further support for the claim that securities class actions, in particular, are not fulfilling their deterrence promise.\(^{14}\) Indeed, if D&O insurance insulates corporations and their directors and officers from the financial impact of liability, and if D&O insurers do not provide other incentives to prevent the kinds of activities that lead to liability, then D&O insurance seems likely to increase the amount of shareholder losses due to securities law violations. This is the moral hazard of D&O insurance.\(^{15}\)

In other contexts some increase in loss might be a tolerable or even a desirable result of liability insurance because of the benefits that insurance provides to risk-averse individuals who might otherwise not engage in productive activities.\(^{16}\) But public corporations do not need insurance for this purpose.

\(^{13}\) Our interviews focused exclusively on publicly traded corporations. Our findings do not generalize to D&O insurance sold to private or nonprofit corporations. Indeed, participants who are knowledgeable about the private and nonprofit D&O insurance markets report that D&O insurers provide considerably greater governance services—both ex ante and ex post—in those other markets. See E-mail from Underwriter #4 to Tom Baker, (Feb. 2, 2007, 12:53:00 EST) (on file with author).

\(^{14}\) See John C. Coffee, Jr., Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation, 106 COLUM. L. REV. 1534, 1549–56 (2006) (arguing that, because the bulk of class action liability falls on corporations—and therefore on innocent shareholders—securities class actions do not promote the deterrence goals of securities law). We do not in this Article consider public law enforcement. D&O insurance policies generally exclude “fines,” such as those assessed by the SEC. In addition, public enforcement agencies have the ability to specify in settlement agreements that amounts paid may not be recovered from insurance companies, even if the payment is not designated in the agreement as a fine or penalty. See, e.g., Agreement Between the Attorney General of the State of New York and American International Group, Inc. and its Subsidiaries (collectively “AIG”) dated January 18, 2006 ¶ 66, http://www.oag.state.ny.us/press/2006/feb/signedSettlement.pdf (last visited Feb. 4, 2007) (“AIG shall not seek or accept, directly or indirectly, indemnification pursuant to any insurance policy, with regard to any or all of the amounts payable pursuant to this Agreement.”). D&O insurance policies do provide for the payment of criminal and regulatory defense costs, however. See, e.g., AM. INT’L GROUP (AIG), EXECUTIVE AND ORGANIZATION LIABILITY INSURANCE POLICY § 2(b), (f) (2000) [hereinafter AIG SPECIMEN POLICY] (including a “criminal . . . proceeding” within the definition of “claim” and providing that “defense costs means reasonable and necessary fees, costs, and expenses . . . resulting solely from the . . . defense of . . . a claim”).

\(^{15}\) “Moral hazard” is the term economists and insurers alike use to describe “the effect of insurance on incentives,” namely, that insurance against loss reduces the incentive to take care to prevent loss. See Kenneth J. Arrow, Uncertainty and the Welfare Economics of Medical Care, 53 AM. ECON. REV. 941, 961 (1963); see also CAROL A. HEIMER, REACTIVE RISK AND RATIONAL ACTION: MANAGING MORAL HAZARD IN INSURANCE CONTRACTS (1985) (studying the use of insurance contract provisions to control moral hazard); Tom Baker, On the Genealogy of Moral Hazard, 75 TEX. L. REV. 237 (1996) (describing the evolution and uses of the term and discussing the empirical literature testing moral hazard); Steven Shavell, On Moral Hazard and Insurance, 93 Q.J. ECON. 541 (1979) (modeling the impact of moral hazard on insurance offerings).

\(^{16}\) Cf. Steven Shavell, On Liability and Insurance, 13 BELL J. ECON. 120, 121–22 (1982) (modeling the relationship between liability and insurance and concluding that, “[a]lthough the purchase of liability insurance changes the incentives created by liability rules, the terms of the insurance policies sold in a competitive setting would be such as to provide an appropriate substitute (but not necessarily equivalent) set of incentives to reduce accident risks”).
because shareholders can spread the risk of corporate losses by holding diversified portfolios. Indeed, by the standard economic account, corporations buy insurance for seemingly ancillary services like loss prevention and tax savings, not for the risk distribution that motivates individuals to buy insurance.

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

Our analysis thus suggests that the existing form of corporate D&O insurance both results from and contributes to the relatively weak constraints on corporate managers. Corporate managers buy this form of coverage for self-serving reasons, and the coverage itself, because it has almost no means of controlling the problem of moral hazard, reduces the extent to which shareholder litigation aligns managers’ and shareholders’ incentives.

The Article proceeds as follows. Part I provides brief background on shareholder litigation and D&O insurance. Part II reports our empirical findings: contrary to expectations, D&O insurers do not provide corporate governance monitoring or other loss prevention services ex ante or defense cost manage-

17. Entity-level D&O insurance spreads the risk of corporate and securities litigation, but shareholders do not necessarily benefit from this form of insurance because they can spread these risks costlessly themselves by holding a diversified portfolio of equity securities. See infra text accompanying notes 132–35; see also Burton G. Malkiel, A RANDOM WALK DOWN WALL STREET 224 (2d ed. 2001) (including accounting fraud in a list of firm-specific risks that investors can reduce through diversification: “The whole point of portfolio theory is that, to the extent that stocks don’t move in tandem all the time, variations in the returns from any one security tend to be washed away or smoothed out by complementary variation in the returns from other securities”); Coffee, supra note 14, at 1558 (illustrating how a diversified investment strategy spreads shareholder litigation costs). See generally Edwin J. Elton et al., MODERN PORTFOLIO THEORY AND INVESTMENT ANALYSIS (6th ed. 2002) (providing a general overview of portfolio theory).

18. See, e.g., Clifford Holderness, Liability Insurers as Corporate Monitors, 10 INT’L REV. L. & ECON. 115, 116 (1990) (claiming that D&O insurers provide monitoring services); David Mayers & Clifford W. Smith, Jr., On the Corporate Demand for Insurance, 55 J. BUS. 281, 294 (1982) ("[I]nsurance purchases by large corporations with diffuse ownership largely eliminates risk aversion as the source of the demand for insurance and allows us to highlight other incentives, such as the real-service efficiencies provided by the insurance companies."). For a detailed discussion of the reasons corporations buy insurance, see infra text accompanying notes 142–61.
Part III explores this gap between theory and practice. We first explain why economic theory predicts that D&O insurers would provide monitoring services in order to control moral hazard and why corporations would demand these services even if insurers were not concerned about moral hazard. We review a variety of explanations for why corporations might buy D&O insurance, and we argue that managerial agency costs provide the most compelling explanation for the nearly pure risk distribution form of D&O insurance that we observed. Other factors, particularly tax benefits and the costs of external capital, may in some cases provide good reasons for corporate insurance, but not for insurance that makes little or no attempt to manage loss costs, either ex ante or ex post. We then explore the corporate insurance and comparative advantage puzzles raised by this finding. We conclude by arguing that, absent more forceful entry by D&O insurers into the “corporate governance industry,” entity-level D&O insurance is unlikely to be in shareholders’ interest.

I. D&O INSURANCE AND SHAREHOLDER LITIGATION

D&O insurance protects corporate officers and directors and the corporation itself from liabilities arising as a result of the conduct of directors and officers in their official capacity. For public corporations, the dominant source of D&O risk, both in terms of claims brought and liability exposure, is shareholder litigation. Shareholder litigation is a significant risk. Studies suggest that the average public company has a 2% chance of being sued in a shareholder class action in any given year, and average settlement values for such claims


20. See, e.g., AIG SPECIMEN POLICY, supra note 14, § 2(z) (stating that the policy provides coverage for “any actual or alleged breach of duty, neglect, error, misstatement, misleading statement, omission or act . . . by such Executive in his or her capacity as such or any matter claimed against such Executive solely by reason of his or her status as such”); CHUBB CORP., EXECUTIVE PROTECTION PORTFOLIO: EXECUTIVE LIABILITY AND ENTITY SECURITIES LIABILITY COVERAGE 7 (2002), http://csi.chubb.com/products/pdf-files/14027303.pdf [hereinafter CHUBB SPECIMEN POLICY] (“Wrongful act . . . means any other matter claimed against an Insured Person solely by reason of his or her serving in an Insured Capacity.”); THE HARTFORD FIN. SERV. GROUP, DIRECTORS, OFFICERS AND COMPANY LIABILITY POLICY § IV.O (1996), http://www.hfpinsurance.com/forms/nj85.pdf [hereinafter HARTFORD SPECIMEN POLICY] (defining coverage to include “any matter claimed against the Directors and Officers solely by reason of their serving in such capacity”).

21. See TILLINGHAST TOWERS PERRIN, 2004 DIRECTORS AND OFFICERS LIABILITY SURVEY 4 (2005) (reporting that “57% of the claims against [participating] public [companies] were brought by shareholders”).

22. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS, 2005: A YEAR IN REVIEW 4 (2006) [hereinafter CORNERSTONE] (reporting that in 2005 class action lawsuits were filed against 2.4% of the “companies [that were] listed on the NYSE, Nasdaq, and Amex at the start of the year”); RONALD I. MILLER ET AL., RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: BEYOND THE MEGA-SETTLEMENTS, IS STABILIZATION AHEAD? 3 (NERA Econ. Consulting, 2006), available at http://www.nera.com/image/BRO_RecentTrends2006_SEC979_PPB-FINAL.pdf (estimating susceptibility of all publicly traded corporations to federal class action lawsuits in 2005 at 1.9%). The exposure of some
exceeded $24 million in 2005.23

Most D&O policies include two basic types of coverage. First, individual-level coverage protects each individual officer or director against covered losses (“Side A” coverage).24 Second, entity-level coverage protects the corporation itself from losses resulting from its indemnification obligations to individual directors and officers (“Side B” coverage),25 or from losses incurred when the corporation itself is a defendant in a shareholder claim (“Side C” coverage).26 Within the D&O insurance industry, only the latter, Side C coverage, is typically referred to as “entity coverage.” Yet Side B coverage protecting the corporation against its indemnification obligations also provides coverage to the corporate entity. In order to avoid confusion with insurance industry terminology, we will use the term “entity-level coverage” when we mean to refer to both B and C side coverage, and we will not use the term “entity coverage” at all.

Side A individual-level coverage obligates an insurer to pay covered losses on behalf of individual directors and officers only when the corporation itself companies, of course, is higher than others. Larger companies are sued more often than small ones and certain industries are sued more often than others. See CORNERSTONE, supra, at 14.

23. See MILLER, supra note 22, at 5. Median settlements, however, are considerably lower—$7 million in 2005—demonstrating that average settlement is driven by a small number of very large settlements. Id.

24. Basic coverage terms obligate an insurer to pay covered losses on behalf of individual directors and officers when the corporation itself cannot indemnify them. See HARTFORD SPECIMEN POLICY, supra note 20 § I.A; see also AIG SPECIMEN POLICY, supra note 14, § I.A; CHUBB SPECIMEN POLICY, supra note 20, at 1.

25. Typical policy language provides:

The Insurer will pay on behalf of the Company Loss 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 20, § I.B; see also AIG SPECIMEN POLICY, supra note 14, § 1.B(ii) (providing similar language); CHUBB SPECIMEN POLICY, supra note 20, at 2 (same). Policies typically deem indemnification to be required in every situation where it is legally permitted, thus preventing the corporation from opportunistically pushing the obligation to the insurer by simply refusing to indemnify its directors and officers. See HARTFORD SPECIMEN POLICY, supra note 20, § 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 14, § 6; CHUBB SPECIMEN POLICY, supra note 20, at 12.

26. Typical policy language provides: “[T]he Insurer will pay on behalf of the Company Loss which the Company shall become legally obligated to pay as a result of a Securities Claim ... against the Company for a Wrongful Act ... .” HARTFORD SPECIMEN POLICY, supra note 20, § I.C; see also AIG SPECIMEN POLICY, supra note 14, § 1.B(ii); CHUBB SPECIMEN POLICY, supra note 20, at 2. A securities claim is defined in the policy to include claims by securities holders alleging a violation of the Securities Act of 1933 or the Securities Exchange Act of 1934, or rules and regulations promulgated pursuant to either act as well as similar state laws. The policy also includes claims “aris[ing] from the purchase or sale of, or offer to purchase or sell, any Security issued by the Company” regardless of whether the transaction is with the company or over the open market. HARTFORD SPECIMEN POLICY, supra note 20, § IV.M; see also AIG SPECIMEN POLICY, supra note 14, § 1(y); CHUBB SPECIMEN POLICY, supra note 20, at 6. 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.
cannot legally indemnify them. This is a rare event, and Side A coverage typically comes into play only when the corporation is bankrupt or insolvent, or when the amounts are paid to settle derivative litigation. In general, the insurer's payments, minus corporate retentions or co-insurance, are under Side B to reimburse the corporation for its indemnification payments or under Side C to cover the corporation's own losses. Our participants confirmed that the vast majority of D&O insurance losses are incurred under Side B and C—that is, entity-level coverage. Thus, to a substantial extent, D&O insurance is corporate insurance.

The shareholder suits covered by D&O insurance may include both corporate fiduciary duty claims, whether derivative or direct, and securities law claims. Of these, federal securities law claims represent by far the greatest liability risk. The most important such cause of action is Rule 10b-5, under Section

27. See Hartford Specimen Policy, supra note 20, § I.A; see also AIG Specimen Policy, supra note 14, § I.A; Chubb Specimen Policy, supra note 20, at 2.
29. Most policies contain a "financial insolvency" exception moving the insurer's obligation to Side A of the policy when the corporation is financially unable to indemnify them. See Hartford Specimen Policy, supra note 20, § VI.F (providing 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 14, § 6 (providing that "[n]o retention amount is applicable to Crisis Loss"); Chubb Specimen Policy, supra note 20, at 12 (providing a financial impairment exception); id. at 4 (defining financial impairment).
30. See Del. Code Ann. tit. 8, § 145(a) (2001) (permitting indemnification for judgments and settlements except for those actions "by or in right of the corporation"). Derivative suits are corporate lawsuits initiated by shareholders on the corporation's behalf. Direct suits are corporate lawsuits initiated by shareholders on their own behalf. See Robert B. Thompson & Randall S. Thomas, The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions, 57 Vand. L. Rev. 133, 137 & 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 and that only 14% of fiduciary duty claims over the same period were derivative suits).
31. See Interview with Underwriter #13 (Nov. 2005), at 16 (transcript on file with author) ("Side A is predominantly a derivative action or an insolvency exposure[,] you have a very solvent company, and you are looking at derivative territory and derivative claims [that] for the most part have been contained in lower limits certainly relative to overall security claims."); see also Interview with Underwriter #15 (Nov. 2005), at 40 (transcript on file with author) ("I think Side A ... has been viewed by the risk management community as a more inexpensive way or a more affordable way to buy D&O insurance, to give the directors the limits they need without spending as much for it.").
32. The possible grounds for shareholder complaint are many. See, e.g., William E. Knepper & Dan A. Bailey, Liability of Corporate Officers and Directors, § 17.02 (7th ed. 2002) (listing 170 possible grounds for liability in shareholder litigation). The basic concern underlying all of these, however, is the problem of divergence between managerial concerns and shareholder welfare—that is, "agency costs." See generally Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, J. Fin.-Econ., Oct. 1976, at 305 (identifying the divergence in interests between shareholder principals and manager agents as a central feature of the corporate form).
33. See Interview with Counsel #1, at 11 (Aug. 4, 2005) (transcript on file with author) ("The big exposure to D&O, as I am sure you know, is that number one head and shoulders above everything else
10(b) of the Securities Exchange Act, which involves misstatements made in connection with a securities transaction. Rule 10b-5 claims may be brought against a broad spectrum of defendants for any misrepresentation made in connection with the purchase or sale of a security. In broad terms, Rule 10b-5 plaintiffs must prove an investment loss caused by a material false statement that the defendant knew or should have known was false—that is, the plaintiff must prove "scienter." Covered losses under a D&O policy include compensatory damages, settlement amounts, and legal fees incurred in the defense of claims arising as a result of the official acts of directors and officers. Shareholder litigation almost always challenges the official acts of the directors and officers. As a result, the D&O insurer typically pays all the costs associated with the defense and settlement of shareholder litigation, above a deductible—as long as the corporation has purchased enough insurance, which is typically the case.

Although there are a number of important exclusions in the D&O insurance policy, D&O insurance professionals report that none of these exclusions have a significant practical impact on D&O insurers' overall responsibility to pay for shareholder litigation. The principal exclusions are for claims involving fraud or personal enrichment, claims either noticed or pending prior to the commence-
ment of the policy period, and claims between insured persons. Significantly, the fraud exclusion has traditionally been subject to a "final adjudication" condition that obligates the insurer to fund the criminal and civil defense of directors or officers unless and until the fraud is finally adjudicated in the proceeding for which coverage is sought. Because shareholder litigation almost always is settled—and, therefore, not adjudicated in the proceeding for which coverage is sought—the "Fraud" exclusion has not had the impact that a simple reading of the D&O insurance policy might suggest. Recently, some D&O insurers have begun attempting to use a broader exclusion, without the final adjudication language, but many corporations have been able to insist on the traditional language. We believe that insurance market conditions will inhibit insurers' ability to insist on the broader term.

The "Prior Claims" exclusion carves out any claims noticed or pending prior to the commencement of the current policy. Ordinarily the prior claims would be covered under a prior policy, so the exclusion simply shifts the obligation to the earlier insurer. Finally, the "Insured v. Insured" exclusion does not apply to derivative actions maintained independent of the board—as, for example, when demand has been excused. The other common exclusions simply remove peripheral claims—such as environmental claims, ERISA claims, claims

41. This is the "prior claims" exclusion. See AIG SPECIMEN POLICY, supra note 14, §§ 4(d)-(e); CHUBB SPECIMEN POLICY, supra note 20, at 7 cls. 6(a)-(b); HARTFORD SPECIMEN POLICY, supra note 20, § V.C.

42. This is the "insured versus insured" exclusion. See AIG SPECIMEN POLICY, supra note 14, § 4(i); CHUBB SPECIMEN POLICY, supra note 20, at 7 cl. 6(c); HARTFORD SPECIMEN POLICY, supra note 20, § V.D.

43. See JOHN H. MATHIAS, JR. ET AL., DIRECTORS AND OFFICERS LIABILITY: PREVENTION, INSURANCE AND INDEMNIFICATION § 8.04 (4th ed. 2003) (collecting cases holding that "if the exclusion requires a final adjudication, that adjudication must take place in the underlying action for which coverage is sought"); see also Little v. MGIC Indem. Corp., 836 F.2d 789, 794 (3d Cir. 1987) (noting that the final adjudication language requires an insurance company to "pay loss as the insured incurs legal obligation for such loss, subject to the requirement that the insured reimburse any monies received if it is subsequently determined in a judicial proceeding that he engaged in active and deliberate dishonesty")

44. MATHIAS ET AL., supra note 43 (noting that the application of the final adjudication provision "drastically diminishes the force and effect of the [actual fraud] exclusion."). Some more recent policies contain broader fraud exclusions, but these exclusions have not yet been tested. Id.

45. See E-mail from Underwriter #4 to Tom Baker, supra note 13 (stating that "it is pretty standard now for the carriers to agree to final adjudication").

46. Corporate fiduciary duty claims must often be brought as shareholder derivative actions. Derivative suit procedures require that shareholder plaintiffs first demand that the corporation's board of directors pursue the claim on their behalf and, if the board elects not to do so, also bind the shareholders to the board's decision. Only where the board itself is conflicted will demand be excused, thus allowing shareholders to pursue the suit without consent of the board. See generally Grimes v. Donald, 673 A.2d 1207 (Del. 1996) (discussing derivative suit procedures); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (same). Derivative suits proceeding without the consent of the board are carved out of the insured v. insured exclusion.

47. See AIG SPECIMEN POLICY, supra note 14, § 4(k); CHUBB SPECIMEN POLICY, supra note 20, at 7 cl. 6(d); HARTFORD SPECIMEN POLICY, supra note 20, § V.E.

48. See AIG SPECIMEN POLICY, supra note 14, § 4(m); CHUBB SPECIMEN POLICY, supra note 20, at 7 cl. 6(f); HARTFORD SPECIMEN POLICY, supra note 22, § V.G.
alleging bodily injury or emotional distress, and claims arising from service to other organizations—from the scope of coverage, leaving shareholder litigation as the principal covered risk. This is not to say that these exclusions cannot become important in the event of insurance coverage litigation, but rather that these kinds of risks lie on the margins of D&O insurance coverage.

Almost all shareholder litigation settles within the limits of the available D&O insurance. Tillinghast reports that in 2005, small cap companies—defined here as those with market capitalizations between $400 million and $1 billion—purchased an average of $28.25 million in D&O coverage limits. Mid cap companies—market capitalization $1–10 billion—purchased an average of $64 million in limits. And large cap companies—market capitalization in excess of $10 billion—purchased an average of $157.69 million in D&O coverage. According to the participants in our study, the largest available coverage limit is $300 million. In recent years some highly publicized cases have settled for very large amounts substantially in excess of the D&O insurance policy, but 65% of all class action settlements in 2004 were for less than $10 million. This is an amount well within the insurance limits of even small cap companies.

49. See AIG SPECIMEN POLICY, supra note 14, §§ 4(h), 4(i); CHUBB SPECIMEN POLICY, supra note 20, at 7 cl. 6(e); HARTFORD SPECIMEN POLICY, supra note 20, § V.A.

50. See AIG SPECIMEN POLICY, supra note 14, §§ 4(f)–(g); CHUBB SPECIMEN POLICY, supra note 20, at 7 cl. 6(g)–(h); HARTFORD SPECIMEN POLICY, supra note 20, § V.F.

51. Each of these types of peripheral claims is covered by another form of liability insurance.

52. See ELAINE BUCKBERG ET AL., NERA ECON. CONSULTING, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: ARE WORLDCOM AND ENRON THE NEW STANDARD? 5 (2005), as reprinted in SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 405, 409 (PLI ed., 2005) ("[S]ettlements on behalf of directors are typically wholly paid by D &O insurers . . .").

53. TILLINGHAST, 2005 SURVEY, supra note 5, at 29 tbl.17C.

54. Tillinghast reports mid cap limits in three categories: 1) companies with market capitalizations between $1 billion and $2 billion, which purchased mean limits of $44.88 million and median limits of $30 million; 2) companies with market capitalizations between $2 billion and $5 billion, which purchased mean limits of $83.2 million and median limits of $75 million; and 3) companies with market capitalizations between $5 billion and $10 billion, which purchased mean limits of $79.4 million and median limits of $65 million. See id. The number reported in the text is an average of these three categories, weighted for the number of observations in the Tillinghast sample.

55. See id. The median reported for companies with market capitalizations in excess of $10 billion was $125 million.

56. See Interview with Risk Manager #3, at 6 (Dec. 15, 2005) (transcript on file with author) ("[T]he most that we could purchase for the corporate side was in the 200 to absolute maximum 300 million available."); see also Interview with Underwriter #13, at 37–38 (Nov. 2005) (transcript on file with author).

57. See Coffee, supra note 14, at 1543 tbl.3 (listing settlements in recent notable cases, including settlements in excess of $300 million); see also Bernard S. Black et al., Outside Director Liability, 58 STAN. L. REV. 1055, 1118–25 (2006) (describing the Enron and WorldCom settlements in excess of policy limits).

58. See SIMMONS & RYAN, supra note 6, at 3.
II. EMPIRICAL FINDINGS: THE MISSING MONITOR

Our research question was very simple: "What do D&O insurance companies do to reduce either the frequency or severity of shareholder litigation filed against the corporations they insure?"59 We set out to investigate this question because (a) economic theory asserts that liability insurance companies should work to prevent and manage insured losses,60 (b) prior sociological research demonstrates that insurance companies do prevent and manage insured losses in some other contexts,61 and (c) some work has claimed that D&O insurance companies do so as well.62 In part because this latter work was not adequately supported,63 we engaged in intensive qualitative research to investigate what

59. Our research methods are described in our companion article, Baker & Griffith, supra note 8. For a brief description of the methods, see supra note 12.

60. See, e.g., George M. Cohen, Legal Malpractice Insurance and Loss Prevention: A Comparative Analysis of Economic Institutions, 4 CONN. INS. L.J. 305, 324–27 (1997–98) (providing an institutionalist account of this assertion); Shavell, supra note 17, at 121–22 (providing the standard account of this assertion).


62. Clifford Holderness asserts:

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

Clifford G. Holderness, Liability Insurers as Corporate Monitors, 10 INT’L. REV. L. & ECON. 115, 116 (1990). In 1997, Noel O’Sullivan reported that he had supported Holderness’s monitoring thesis in the United Kingdom (which, unlike the United States, had required corporations to disclose the purchase of D&O insurance). Finding a correlation between the number of outside directors and the likelihood that the corporation purchased D&O insurance, O’Sullivan reasoned that inside directors are better able to monitor the corporation and, thus, do not need the D&O insurer to serve that role. Noel O’Sullivan, Insuring the Agents: The Role of Directors’ and Officers’ Insurance in Corporate Governance, 64 J. RISK & INS. 545 (1997).

63. Holderness did not provide any empirical evidence in support of his assertion that insurance companies monitor customers’ managers. See Holderness, supra note 62. Although Noel O’Sullivan’s study did offer empirical evidence, his correlation between the number of outside directors and the purchase of D&O insurance does not confirm Holderness’s hypothesis. See O’Sullivan, supra note 62. That correlation is more likely to reflect the outside directors’ demand for risk distribution services to protect themselves than their demand for monitoring to protect shareholders (especially because, as we report, the insurance that the corporation does buy does not provide monitoring). The only other
D&O insurers do to prevent or manage shareholder litigation losses.

When we began this research, we expected to find corporations that treated D&O insurance companies as trusted suppliers of loss prevention services, D&O insurance premiums that provided significant loss prevention incentives, and D&O insurers that conditioned coverage on loss prevention behavior. It did not take many interviews to learn that we were wrong. In practice, D&O insurers do almost nothing to monitor the public corporations they insure, and D&O insurers do not condition the sale of insurance on compliance with loss prevention requirements in any systematic way. Although D&O insurers do occasionally provide loss prevention advice, underwriters report—and brokers and risk managers confirm—that this advice is not highly valued by public corporations, nor is it in any way binding on corporations, for example, by being made a condition of policy renewal. Finally, in sharp contrast to the liability insurance norm, D&O insurers do not actively manage defense costs. In the sections that follow we report these findings.

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

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

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

64

Qualitative research cannot prove that something never takes place. Nevertheless, it does provide access to the common understandings and practices of the field under investigation. As the exception that we discuss indicates, a public corporation may well, on very rare occasions, have changed its disclosure practices, board composition, or insider trading policies because of something that a D&O insurance company did, but our participants uniformly and unequivocally reported research on D&O insurance monitoring found that English D&O insurers were not providing monitoring services in the early 1990s. See Vanessa Finch, Personal Accountability and Corporate Control: The Role of Directors’ and Officers’ Liability Insurance, 57 Mod. L. Rev. 880, 908 (1994) (“United Kingdom insurers have not to date, however, developed systems that routinely give attention to individual directors.”).

64. Interview with Underwriter #5, at 30 (Dec. 2005) (transcript on file with author).
The underwriters reported that they understood why we might think that they would be actively involved in corporate governance. Some even reported that they had tried. For example, the assistant D&O product manager for a leading insurer reported:

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

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

A few of the insurance companies do have D&O loss prevention booklets and newsletters, but underwriters and brokers uniformly described that literature as marketing material with no discernible impact on their clients’ business practices. The statement from this underwriter for a major insurer is typical: “We have a newsletter, but it doesn’t really . . . say, ‘Look, if you do this, you’ll get a better price.’ What we do [say] is, ‘Look, here are some issues.’ . . . It goes in

65. By contrast, loss prevention conditions and advice are frequently provided in the private and non-profit D&O insurance market. In that market, D&O insurance is sold as part of a package policy that also insures against employment liability risks. Employment liability is a more significant risk in that market and is the main subject of the insurers’ loss prevention efforts. See, e.g., Nancy H. Van der Veer, Note, Employment Practices Liability Insurance: Are EPLI Policies a License to Discriminate? Or Are They a Necessary Reality Check For Employers?, 12 CONN. INS. L.J. 173, 194–204 (2005–2006) (reporting that EPLI insurance was a byproduct of D&O insurance and describing the loss prevention aspects of EPLI underwriting and the risk management services offered to insureds).

66. Interview with Underwriter #8, at 50–51 (Dec. 15, 2005) (transcript on file with author).

67. See Tom Baker, Medical Malpractice and the Insurance Underwriting Cycle, 54 DePAUL L. REV. 393, 396 (2005) (reviewing literature on the liability insurance underwriting cycle); see also Baker & Griffith, supra note 8 (addressing the cycle in D&O underwriting specifically).
one ear and out the other."\textsuperscript{68}

Other D\&O insurers produce brochures and sponsor conferences, as reported by the product manager of a leading D\&O insurer: "We produce publications on [good governance], and we subscribe and participate in the best practices and conferences with directors, directors' conferences and things like that. We sponsor things that are the best practices and we publish stuff..."\textsuperscript{69} But he also reported that his company does not condition coverage on any governance practices, provide governance or related loss prevention audits, or even provide identifiable discounts for adopting what he regards as good corporate governance practices for publicly traded companies. Insurer support for best practices certainly is welcome to those engaged in such efforts, but this support is a long way from the bundled package of monitoring and risk distribution services that theory suggests.

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

[W]e felt strongly that there were certain things that, if the companies did [them], would reduce their likelihood of being named in a securities class action lawsuit, and those would be things like controlling insider trading, controlling your disclosure and corporate reporting, having policies and procedures in place in advance in case they have to report bad news. If they do so, they do it in a controlled way that does not exacerbate the situation and wind up in and of itself causing the source of the class action lawsuit. When we first started it, what we were telling people was, "And if you do these things, we will give you a discount..."\textsuperscript{70}

He shared with us their loss prevention guide, which was prepared in the mid-1990s. The guide addressed a variety of topics: analyst communications, insider trading, bad news disclosure, and the mechanics of the protections provided by the then recently enacted Private Securities Litigation Reform Act. For each topic, the guide provided what appeared to be sensible background explanation and concrete procedures, forms, and practices for companies to use to reduce the likelihood of securities litigation. The guide was much longer, more detailed, and appeared to us to be far more practical and useful than any of the other loss prevention materials we obtained from other D\&O insurance companies or brokers.

\textsuperscript{68} Interview with Underwriter #5, supra note 64, at 29.

\textsuperscript{69} Interview with Underwriter #7, at 11 (Nov. 2005) (transcript on file with author). The product manager is the individual with overall responsibility for the profitability of a particular line of business in a company with multiple business areas.

\textsuperscript{70} Interview with Underwriter #4, at 15 (Aug. 4, 2005) (transcript on file with author).
The guide had received substantial attention among D&O insurers and brokers and was one reason the company had developed the loss prevention reputation. The problem, however, was that this loss prevention effort did not work. As the senior official described, "It was a lesson in both directions." From the customer side, what he learned was: "we don't value your message enough." And from the insurance company side he learned that "we couldn't show the discount," meaning that they could not demonstrate that following the guide reduced loss costs: "[W]e had to learn the value of humility too. I still think they are good practices. I still think they work, too. I think what it will do—if you have a lawsuit, it will make it more defensible." Companies were occasionally receptive to the insurer's offer to help them adopt disclosure practices and other corporate governance guidelines. But when this advice came without a discount, competitors undercut these premiums and even marketed against the advice—"as in look [that company] will make you jump through a bunch of hoops; we can get the insurance for you cheaper... without all the fuss and bother." As a result, the company was forced to drop its loss prevention program. "It was costly to maintain, and it was not economically supportive. There was no premium, if you will..." Subsequently, the company left the D&O insurance business entirely. While we have no reason to believe that the failure of the loss prevention experiment explains this decision, nevertheless this experience cannot provide much encouragement for future efforts to adopt a D&O business model emphasizing loss prevention services. Indeed, one lesson to be drawn from this experience is that loss prevention services provided by a D&O insurance company should be specifically designed for the particular customer. General "best practices" advice of the sort contained in the guide is expensive to prepare, but then can be used by any company or broker that gets a copy of the guide.

Having run that loss prevention story to the ground, we then investigated

71. Id. at 16.
72. Id.
73. Id.
74. E-mail from Underwriter #4 to author (July 30, 2006, 12:26:00 CST) (on file with author). In a follow-up communication, the product manager explained that "[t]he prices were undercut just because of the competitive nature of the marketplace" and that "the competition did not relate in any economic way to the loss prevention services, but rather to the abundance of carriers willing to write the risk and hungry for premium." E-mail from Underwriter #4 to author (Feb. 2, 2007, 12:37:00 EST) (on file with author). But even if the provision of loss prevention services did make the primary layer of insurance more expensive, this would not mean that the cost of the loss prevention services exceeded the benefits. As reported in our companion article, D&O insurance programs consist of layers of insurance policies, typically sold by different insurance companies. See Baker & Griffith, supra note 8. The value of the loss prevention services accrues to all of the insurers in the program (as well as the insured corporation); it is to be expected that the insurer in the program that is providing the loss prevention services will expect to be paid more than the other insurers.
75. Interview with Underwriter #4, supra note 70, at 16.
76. See infra text accompanying note 197 (addressing the public good nature of best practices type advice).
whether brokers provide meaningful loss prevention services, mindful of the statement from the D&O product manager we reported earlier: providing loss prevention advice was part of the "value proposition" of the broker. The brokers reported that they do, in fact, sometimes provide such advice, but only in the context of putting clients' best foot forward to insurance companies. For example, one broker from a major brokerage house reported:

There have definitely been points, whether it is governance or, you know, it could be anything, where we would say to our clients, "This is going to be a negative from an underwriter’s perspective," and why. But I guess I would say, we really don’t have the authority or position to turn around and say to them, "You need to change this." I think it is really up to them and, frankly, their board and audit committee as to what they end up doing, but we definitely point out what we would view to be a negative.77

A D&O product manager with close ties to the brokerage community confirmed that when brokers have tried to provide loss prevention advice, "[i]t has generally been poorly received. So I would tell you, it is pretty invasive.... For a broker, an insurance broker to get in there and say, 'Let me have eight hours from your board.'... It is just not taken particularly well...."78

Like D&O insurers, brokers provide little in the way of loss prevention services, and the loss prevention services they do provide did not appear to be highly valued. Brokers provide other valuable services—including negotiating with insurers to structure the insurance tower and, in the event of a claim, using their market power to pressure insurers to settle—but these services relate primarily to risk distribution, not monitoring.

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

77. Interview with Broker #1, at 7–8 (Sept. 2005) (transcript on file with author). The D&O product manager of yet another leading D&O insurer explained his understanding of this situation as follows:

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

Interview with Actuary #2, at 27 (joint interview with chief actuary and D&O product manager) (Feb. 2006) (transcript on file with author).

78. Interview with Underwriter #7, at 11–12 (Nov. 2005) (transcript on file with author).
understanding.\textsuperscript{79}

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

Although D&O insurers do not require corporations to adopt specific loss prevention measures, the insurers do price on the basis of risk. As we reported in our companion article, firms within industries with more shareholder litigation pay more than firms in industries with less litigation, large cap companies pay more than small cap companies, and companies with more volatile stock prices pay more than firms with less volatile stock prices.\textsuperscript{80} These factors, of course, have nothing to do with corporate governance. Corporate governance is also a factor, albeit a secondary one, and other things being equal, our participants reported that they attempt to charge poorly governed corporations more for D&O insurance than better governed corporations.\textsuperscript{81}

Conceivably, this risk-based pricing could lead to loss prevention monitoring in the following manner: Insurer X might grant Corporation Y a discount for adopting a particular governance practice, such as majority board independence, and then "monitor" Y's commitment to that practice by making it a condition for coverage in the event of a claim. Yet none of our participants reported this kind of loss prevention monitoring.

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

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

Indeed, as George Cohen observed in his insightful analysis of legal malpractice insurance, "[a]fter diversification, the risk reduction method most used by legal malpractice insurers, as well as by other liability insurers, is ex post loss reduction."\textsuperscript{82} From the beginning of liability insurance in England in the 1880s,

\textsuperscript{79} See supra note 12 (explaining our methodology).
\textsuperscript{80} See Baker & Griffith, supra note 8.
\textsuperscript{81} Id. While we cannot evaluate whether this claim is correct, we can observe that insurers have a strong incentive to price in this manner and they regularly receive feedback on how well they are doing. Id.
\textsuperscript{82} Cohen, supra note 60, at 325; see also Mayers & Smith, supra note 18, at 285 (noting that "[i]nsurance firms develop a comparative advantage in processing claims because of economies of scale and . . . specialization").
liability insurers routinely have provided this ex post loss reduction through their control over the settlement and defense of covered claims.\textsuperscript{83} Liability insurers negotiate preferred rates, maintain lists of approved counsel, monitor counsel to reduce unnecessary discovery or motion practice, and generally manage the litigation to minimize the sum of defense and settlement (or judgment) expenses. This is the norm in automobile insurance, malpractice insurance, and the general liability insurance that constitutes the main liability insurance protection for most individuals and businesses in the United States.\textsuperscript{84} This norm makes economic sense, because of the ex post moral hazard that would otherwise result.\textsuperscript{85}

D&O insurance sold to public corporations is very different. Rather than providing and controlling the defense, D&O insurers reimburse their policyholders' defense costs.\textsuperscript{86} D&O insurance contracts give policyholders the right to choose defense counsel and manage their own defense at the insurer's expense, subject only to the dollar limits of the policy and the requirement that defense costs be reasonable.\textsuperscript{87} This defense arrangement substantially constrains D&O insurers' ability to provide ex post loss reduction. D&O insurers do have formal authority over settlement, as long as the claim can be settled within the limits of the D&O insurance program (which, as noted above, is typically the case).\textsuperscript{88} But they must exercise that authority without the benefit of the close relationship with defense counsel that comes from controlling the defense.

Our investigation of the claims side of the D&O insurance business is not complete.\textsuperscript{89} The evidence that we have collected so far, however, indicates that the results are what the economics of insurance would predict, based on the defense cost reimbursement structure of the D&O insurance contract.\textsuperscript{90} The predictable effects are, first, D&O insurers are unable to control the costs of

\begin{itemize}
  \item \textsuperscript{83}See Kenneth S. Abraham, The Liability Century (forthcoming 2007) (describing history of defense coverage in liability policies).
  \item \textsuperscript{84}For individuals, this coverage is provided as part of the homeowners or renters insurance package policies. For small businesses, this coverage is provided as part of the business owners or farmers package policies. For larger businesses, this coverage is purchased separately as commercial general liability insurance.
  \item \textsuperscript{85}See Tom Baker, Liability Insurance Conflicts and Defense Lawyers: From Triangles to Tetrahedrons, 4 Conn. Ins. L.J. 101, 107-08 (1998) (explaining why "[a] rational prospective insured would prefer a liability insurance contract giving the company [control over the defense] ... [o]therwise the insured would demand at the point of claim a level of defense that he would not be willing to pay for at the time of purchasing the policy").
  \item \textsuperscript{86}See supra note 38 and accompanying text.
  \item \textsuperscript{87}See id. As discussed infra text accompanying notes 101-04, two leading D&O insurers do maintain lists of preferred counsel, but this practice does not appear to hold down defense costs.
  \item \textsuperscript{88}See supra text accompanying notes 52-58.
  \item \textsuperscript{89}See Tom Baker & Sean J. Griffith, Directors' and Officers' Insurance in the Defense and Settlement of Shareholder Litigation (work in progress) (studying the role of D&O insurance in the defense and settlement of shareholder litigation).
  \item \textsuperscript{90}See, e.g., Mark V. Pauly, The Economics of Moral Hazard: Comment, 58 Am. Econ. Rev. 531, 535-36 (1968) (explaining in the health insurance context how service providers are affected by ex post moral hazard).
\end{itemize}
defending claims, and second, as long as the settlements are within the D&O policy limits, corporations pressure D&O insurers to settle claims sooner and at greater expense than an insurer in full control of defense and settlement would allow.91

As an initial matter, it is important to emphasize that the defense cost component of D&O insurance coverage is substantial. There are no definitive, publicly available defense cost data comparable to the publicly reported data for auto insurance, medical malpractice insurance, and other kinds of duty-to-defend insurance.92 Nevertheless, the Tillinghast survey that forms the basis of much of what is known about D&O insurance purchasing patterns includes questions about defense costs, and the survey results separately identify defense costs for shareholder/investor claims, which is a reasonable proxy for defense costs for public corporation D&O insurance. Excluding claims that were closed with no payment to the claimant, Tillinghast reports that the median and mean defense costs were $538,150 and $1,965,079 per claim.93 Compared to the median and mean settlement amounts reported in the same survey ($5 million and $27 million94), this suggests that defense costs typically are about eleven percent of the costs of paid claims, declining in percentage terms as the settlement amount increases.95

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

We don't have a high level of control. . . . [T]he policy suggests that we will pay for reasonable and necessary defense costs. The case law on that is pretty funky and is not positive to insurers. . . . So the situations where you can absolutely reject it—the behavior has to be incredibly egregious behavior.96

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

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

91. For a structural analysis of the dynamics of settlements within limits, see Baker, supra note 85.
93. TILLINGHAST, 2005 SURVEY, supra note 5, at 112 tbl.106.
94. Id. at 111 tbl.103.
95. This is a conservative estimate. At a D&O industry conference, one senior underwriter reported that defense costs commonly were twenty-five to thirty-five percent of the settlement amount and sometimes as high as fifty percent. Transcript of New York Seminar #1 (name withheld for confidentiality), at 7 (“We are seeing some abuses but, even where you don’t have abuses, we are seeing defense costs not just 25 to 35% of the settlement, . . . but sometimes 50% or 100% of the settlement”).
96. Interview with Claims Manager #1, at 10 (Dec. 2005) (transcript on file with author).
photocopy inflation, okay. That is the fact that they can charge that amount and that the companies will pay it. Increasingly, we get boxes of bills, so to speak, you know, “Here, sort it through and pay it.” So, you know, the inflation on the defense cost side is huge, probably much faster than the overall settlement as a whole, but nobody has really studied it... I just think that it is a function of, “You get what you can,” and I think the defense firms can charge $700 per hour because nobody cares. I mean, it is staggering to me. 97

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

I will give you two customers, both Fortune 500 companies, both in 10b-5 securities class actions. One customer spent $75 million in the course of eighteen months, and another one spent $3.5 [million], and the difference was the deductible. In one case it was our money, and in the other case it wasn’t, it was their money. And the difference was how they watch-dogged it, how they went through the bills, how they leaned on these guys and pushed back. In the case of the $70 million bill, they had a $250,000 deductible, and the insured stopped caring a long time ago and, literally, it boiled down to us opening boxes, you know, exercise bicycles, things in hotel rooms, I mean, you couldn’t believe the stuff that was in that box, but it was all billable, it was all defense expenses. On the other case, they had a $20 million deductible, and they were pounding on that law firm in terms of the bill. Think about that difference, though. I mean, that’s a huge exponential difference in the cost of the case. 98

Of course we cannot evaluate on the basis of qualitative research whether all of the securities litigation defense cost increases are the result of this ex post service-provider moral hazard.99 We can report, however, that D&O insurance underwriters believe that a substantial part of the defense cost escalation is attributable to their inability to control defense costs.

Two of the leading D&O insurance companies have tried to address defense costs by developing lists of “panel counsel” from which all or some of their insureds are supposed to pick a firm to handle litigation covered by their D&O insurance policies. In other lines of insurance, the use of panel counsel is believed to lower defense costs and facilitate insurer loss management. 100 But neither company appears to have been successful in using panel counsel to

97. Transcript of Conn. D&O Insurance Seminar #1 (name withheld for confidentiality), at 8–9.
98. Id.
99. Indeed, at least some of the increased costs are likely to be a rational response to the increased damage claims.
100. See Douglas R. Richmond, The Business and Ethics of Liability Insurers’ Efforts to Manage Legal Care, 28 U. MEM. L. REV. 57, 80 (1997) (“By establishing relationships with select firms, insurers can negotiate reduced hourly fees and special fee arrangements in exchange for continuing business.”)
reduce defense costs of D&O claims.

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

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

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

III. ANALYSIS: A PROBLEM AND TWO PUZZLES

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

The problem is moral hazard: the D&O insurance that we observed seems likely to reduce the deterrent effect of shareholder litigation, and therefore to increase both the amount of losses and the price of D&O insurance. This is one
of the most significant findings of our research for securities and corporate law; it provides additional evidence that shareholder litigation is not providing the deterrence that is ordinarily considered to be its primary purpose.

This finding also raises two puzzles. The first puzzle is closely related to the moral hazard problem. Why do corporations buy this form of D&O insurance when it may increase losses from corporate and securities litigation (or, at the very least, not reduce them), and when shareholders do not appear to need the risk distribution that it provides? The second puzzle is the inability of D&O insurers to capitalize on what would seem to be an obvious comparative advantage in the market for loss prevention services. Law firms, management consultants, accounting firms, and a growing “corporate governance industry” all sell corporate governance loss prevention advice.\textsuperscript{105} Yet, alone among all the potential suppliers of these loss prevention services, D&O insurers pay up when they are wrong. When an insurer’s estimate of an insured’s governance quality is incorrect, the direct consequence is a loss against the insurer’s reserves. In other words, they bond their advice not only with their reputation,\textsuperscript{106} but also with a commitment to pay their customers’ losses. Thus, D&O insurers have the best incentive to get that advice right and should have a comparative advantage over other suppliers of loss prevention advice for this reason.\textsuperscript{107} Yet, their advice is so undervalued that they no longer invest real resources in providing it. Why?

A. THE MORAL HAZARD PROBLEM

The term “moral hazard” refers to the tendency of insurance to reduce an insured’s incentive to take care to avoid loss and, thereby, to increase loss.\textsuperscript{108} The economic analysis of insurance teaches that insurance increases loss whenever the following conditions are met: (1) money compensates for loss; (2) the decision makers are rational loss minimizers; (3) taking care requires effort; (4)

\textsuperscript{105} See Rose, supra note 19.

\textsuperscript{106} As discussed in the gatekeeper literature, accounting firms, law firms and other “reputational intermediaries” bond their services through their reputation. See, e.g., Stephen Choi, Market Lessons for Gatekeepers, 92 Nw. U. L. Rev. 916, 942 (1998) (“To avoid the collapse of the certification market due to certifier infidelity, certifiers may bond themselves to remaining faithful in their screening role.”); John C. Coffee, Jr., Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms, 84 B.U. L. Rev. 301, 302 (2004) (defining gatekeepers as “independent professionals who pledge their reputational capital”); John C. Coffee, Jr., Understanding Enron: “It’s About the Gatekeepers, Stupid,” 57 Bus. Law. 1403, 1405 (2002) (“[A reputational gatekeeper’s] relative credibility stems from the fact that it is in effect pledging a reputational capital that it has built up over many years of performing similar services for numerous clients.”); Assaf Hamdani, Gatekeeper Liability, 77 S. Cal. L. Rev. 53, 93 n.94 (2004) (“It is commonly assumed, for example, that underwriters’ concern for their reputation would make them investigate the quality of prospective issuers even in the absence of liability.”); Frank Partnoy, Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime, 79 Wash. U. L.Q. 491, 495 (2001) (“The arguments in favor of gatekeeper liability assume that when it is too costly for the issuer to bond itself... one or more third party intermediaries will be able to step in and offer their reputation as a replacement for the issuer’s bond.”).

\textsuperscript{107} See Griffith, supra note 7, at 1179–80.

\textsuperscript{108} See sources cited supra note 15.
taking care is effective; (5) the beneficiaries of the insurance have control over the care-taking activity; and (6) insurance payments are not conditioned on a given level of care.109 Especially in the liability insurance context, it is important to keep in mind that the “loss” includes not only the harm that leads to the claim, but also all the financial costs of the claim. Therefore, claims management is part of the care-taking activity.110 

In some other contexts there are good reasons to doubt that insurance poses a real moral hazard problem because one or more of these conditions are not satisfied.111 By contrast, D&O insurance meets all of these conditions. First, unlike health insurance, all of the losses are monetary, and money surely compensates for money. Second, while it is debatable whether corporate executives always behave as rational loss minimizers, corporate decisions conventionally are regarded as rational and the incentive effects of liability are based on that assumption.112 Third, implementing corporate governance controls, complying with securities laws, managing loss costs, and other aspects of care-taking require effort. Fourth, these efforts help prevent loss. Good governance and compliance cannot guarantee that the stock price will not drop and that the shareholders will not sue, but both corporate and securities law are based on the assumption that such efforts will reduce fraud and other bad acts. Fifth, the directors and officers who most directly benefit from the insurance are in charge of the corporation and, thus, control the care-taking activity. Finally, as we have reported, D&O insurers do not condition their coverage on the level of care.113

Are we reporting that D&O insurers do nothing to protect against moral hazard? No. D&O insurers do three things. First, they leave some of the risk on the corporation. B and C Side coverages have deductibles.114 Moreover, corporations do face residual liability in the rare, but very serious event that the settlement amount exceeds the limits of the coverage. As a result of these deductibles and limits, the insurance protection is incomplete, maintaining at least some incentive to prevent loss.115

110. See id. at 276 n.186 (restating the conditions for moral hazard in the ex post context).
111. See id. at 286 (finding that “increasing [workers’ compensation] benefits provides limited incentive for workers to be careless” because “[m]oney does not fully compensate workers for bodily injury, and . . . workers do not control . . . their working environment”).
112. See Marc Galanter, Planet of the APs: Reflections on the Scale of Law to its Users, 53 BUFF. L. REV. 1369, 1373 (2006) (reviewing literature supporting the claim that, “[t]o a far greater extent than natural persons, [corporations] may be capable of acting in the purposeful, rational, calculating fashion that the legal system prefers to ascribe to actors”).
113. See supra text accompanying notes 62–75.
114. See TILLINGHAST, 2005 SURVEY, supra note 5, at 59 tbl.47. The most recent Tillinghast D&O survey contains information on the deductibles for B and C side coverage organized by asset size of the survey respondents. Corporations with $50 to $100 million assets reported median and mean deductibles of approximately $300,000 and $500,000, respectively. By contrast, corporations with over $10 billion assets reported median and mean deductibles of $5 million and $8.9 million. See id. at 112 tbl.107.
115. See Shavell, supra note 15, at 541 (noting that incomplete coverage is a partial solution to the problem of moral hazard).
Second, the D&O policy contains a moral hazard exclusion: the fraud exclusion against liability based on a “dishonest, fraudulent, criminal act or omission or willful violation of any statute, rule or law.” But, as we described earlier, the D&O policy typically has provided that this exclusion only applies if there has been a final adjudication of actual wrongdoing by the insured in the proceeding for which coverage is sought. While there may be a recent trend toward a more restrictive exclusion, corporate advisors report that the more restrictive version of the exclusion can be negotiated away, particularly as market conditions come to favor buyers, as opposed to sellers, of insurance. Moreover, for any officer or director subject to the exclusion, there almost always are others who do not come within the scope of the exclusion yet had an opportunity to prevent or reduce the impact of the fraud. As a result, our participants report that the Fraud exclusion almost never allows a D&O insurer to avoid coverage for a claim.

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

It might be thought that sufficiently frequent re-pricing would amount to monitoring and control moral hazard just as effectively. D&O insurance policies are re-priced once a year, which should be sufficient to monitor the controls, reporting practices, and personnel that constitute the “deep governance” that

116. EXECUTIVE RISK INDEM., INC., EXECUTIVE LIABILITY POLICY III.A.1. Similar language appears in the AIG, Chubb, and Hartford policies. See supra note 42. A related exclusion prevents insurers from making payments to indemnify an insured person against unjust enrichment claims, thus preventing the insured from retaining any such gains. See AIG SPECIMEN POLICY, supra note 14, § 4(a); CHUBB SPECIMEN POLICY, supra note 20, §§ 7-8; HARTFORD SPECIMEN POLICY, supra note 20, § V.I.
117. See supra text accompanying note 45.
118. See supra note 45.
119. See Interview with Monitoring Counsel #1, supra note 39, at 13 (explaining that the “severability of exclusions” means that “there always is an individual for whom the exclusion won’t apply”); see also AIG SPECIMEN POLICY, supra note 14, at 7 (providing that “the facts pertaining to and knowledge possessed by any Insured shall not be imputed to any other Insured Person” for purposes of the dishonest or fraudulent act exclusion). Note that there is no good research on the frequency of out of pocket payments by insiders; this is a topic addressed in our ongoing D&O insurance claims research.
120. For example, the D&O insurers for Enron paid notwithstanding the eventual criminal convictions of corporate officers. Indeed, the Washington Post reported that the D&O insurance payments included $17 million to Jeffrey Skilling’s criminal defense lawyers. See Carrie Johnson, After the Enron Trial, Defense Firm is Stuck with the Tab, WASH. POST, June 16, 2006, at D1.
121. See supra text accompanying notes 82–104.
122. See supra note 52 and accompanying text.
Re-pricing allows the insurer to take any increased hazard (moral or otherwise) into account. Re-pricing might help protect shareholders from moral hazard if there was a mechanism that obligated corporate executives to change their behavior in response to the new price. Price pressures alone, however, may not be enough to induce governance changes, especially when, as we describe at length in our companion article, (1) litigation risk does not correlate perfectly to governance quality, (2) insurers sometimes make mistakes in their governance assessments, and (3) there is not a large marginal difference between the D&O premiums paid by a well-governed firm relative to a poorly-governed firm (in part because of the first two factors).

Public disclosure of D&O pricing and contract terms might increase the leverage of governance-based pricing by providing analysts with a signal of governance quality for capital market participants. But D&O premiums are not publicly disclosed. For these reasons, we doubt that the annual re-pricing of D&O premiums protects shareholders against the moral hazard of D&O insurance.

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

B. THE CORPORATE INSURANCE PUZZLE

As described earlier, most D&O policies offer two kinds of protection—individual coverage for directors and officers and entity-level coverage for the corporation itself—and the vast majority of corporations purchase both. Individual coverage is easy to understand. Because they are risk-averse and eager to protect their personal assets, directors and officers will not serve without individual-level coverage. They could, of course, purchase the coverage themselves, but the managerial labor market appears to have allocated the expense of individual D&O coverage, like any other executive perquisite, to the corporation itself. In any event, the explanation for the individual coverage is

123. See Baker & Griffith, supra note 8.
124. See id.
125. See Griffith, supra note 7.
126. See id. (arguing, on the basis of this reasoning, that they should be).
127. See, e.g., Randy Parr, Directors and Officers Insurance, in D&O LIABILITY INSURANCE 2004: DIRECTORS AND OFFICERS UNDER FIRE 14 (Practicing L. Inst. ed. 2004) (referring to D&O liability insurance and "provid[ing] the protection directors and officers demand and require"); see also Finch, supra note 63, at 880 ("Balancing such potential personal liability is the availability of company funded directors' and officers' insurance . . . .").
128. Commentators recognized long ago that D&O insurance coverage represents a form of compensation for directors and officers. See, e.g., Joseph F. Johnston, Jr., Corporate Indemnification and Liability Insurance for Directors and Officers, 33 BUS. LAW. 1993, 2013 (1978) (stating that the fact that the corporation paid D&O premiums "was nothing more than another form of compensation for the
a simple one, based upon individual risk-aversion and labor market dynamics.

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

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

executives and a way of attracting capable managers). Early D&O policies required individual officers and directors to pay a portion of the premium, usually 10%. See Wallace, More on Sitting Ducks: (Officers and Directors, That Is), INSURANCE, Apr. 16, 1966, at 32, 36 (describing then-typical “ratio of 90% of the premium to the corporation and 10% to the officers and directors”). Insurers have discontinued this aspect of the policy, presumably because individual directors and officers asked for and received corporate payment of the full premium.

129. KARL 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). Due to the limits of publicly available data, these loading costs cannot be computed with precision, but they are reported to be somewhere between twenty and thirty percent. Marc Siegel, The Dilemmas in the D&O Market: Where Do We Go from Here?, Presentation at 2006 D&O Symposium of the Professional Liability Underwriting Society, at slides 3 and 4 (Feb. 1, 2006), http://www.plusweb.org/Downloads/Events/Dilemmas_in_The_DO_Market.ppt (assuming an average expense ratio of 23% for all D&O insurance).

130. 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 INSURANCE 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.”).

131. See generally ELTON ET AL., supra note 17.

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

But perhaps it is necessary to protect undiversified investors? After all, not all investors hold the market portfolio. Those that do not might prefer the protection offered by D&O coverage. Perhaps, but it is a tortured interpretation of fiduciary duty that would have directors seeking to maximize shareholder welfare by purchasing high-cost insurance against a risk that some shareholders have already eliminated in their own portfolios and that all shareholders easily could eliminate. Those that do not eliminate the risk have either chosen not to—and why subsidize them?—or are too unsophisticated to recognize the choice. It is laudable to seek to help unsophisticated investors, but imposing this partial, inefficient, and narrowly targeted cross-subsidy on the rest of the market seems an inappropriate way of doing so.

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

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

In the ensuing conversation with him, we pursued the reasons for this shift.

133. Cf. Zohar Goshen & Gideon Parchamovsky, The Essential Role of Securities Regulation, 55 Duke L.J. 711 (2006) (suggesting that "information traders," because of their important role in maintaining the efficiency of capital markets and their constant exposure to misinformation risk, represent the rare case of non-diversified investors who might justifiably benefit from the compensation provided by securities liability). Goshen and Parchamovsky define "information traders" as investors who "specialize in gathering and analyzing general market and firm-specific information." Id. at 714.


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

136. See Bailey, supra note 28 (reporting that Side A coverage is becoming more prevalent). But see Tillinghast, 2005 Survey, supra note 5, at 47 (reporting that about 2% of all insured participants purchased side A coverage only).

137. Interview with Risk Manager #3, supra note 56, at 3.

138. The transition took place within the last five years. In his words:
He offered several, including the erosion of the value of the coverage through bad actors and the reappearance of allocation issues as well as the inability of his (very large) corporation to purchase limits adequate to cover its possible exposure.\textsuperscript{139} In his words:

What precipitated this? Enron, WorldCom, \ldots all the D\&O things that were going on. If you go back and you look in the press and you talk to people in the industry, what was the value of the insurance that was being purchased, and how was it being eroded? It was being \ldots eroded by bad guys and the potential for corporate indemnification. You know, it became an issue as to who was first in the door looking to have their claims paid. So the bad guys were getting their claims paid because they had defense costs by outside insurers. There were quite a few bad guys that were eroding the good guys' insurance, and then there was the idea, you know, coming out of some of those major financial meltdowns that the judges could potentially go after in bankruptcy proceedings [on the theory that] these policies are assets of the corporation, when in fact the original intent of D\&O insurance was to protect directors and officers, not the corporation. \ldots We basically said we are going to go back to its original purpose.\textsuperscript{140}

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

There were certainly pricing pressures, and when we review our coverages up with the board and the finance committee of the board, you know, we do have price in there, but I don't think it was a price issue. I really think we went back to, what's the intention of the purchase of this insurance product? Who is it protecting? And how do we get the most value out of it for those individuals?\textsuperscript{141}

As alluded to by this risk manager, the purchase of only Side A coverage offers at least three tangible benefits to directors and officers. First, because most D\&O claims are indemnifiable and Side A coverage only responds to non-indemnifiable losses, the insurance for the individual insureds will not be eroded by corporate losses.\textsuperscript{142} Second, because there is no corporate benefit

\textsuperscript{[T]here is probably 25\% or maybe even less of the large corporate buyers have evolved to [Side-A-only coverage]. And again, \ldots this is a relatively recent \ldots occurrence for us. If you look in the rearview mirror, four years ago we were buying insurance similar to the way a lot of our peers still buy it, which is \ldots A, B, C coverages.}

\textit{Id.} at 4.

\textsuperscript{139} On this last point, he said: "the value of the B and C coverage was not nearly as great [as the value of the A coverage], because \ldots the size of the limits that we are purchasing didn't really protect our [balance sheet] adequately." \textit{Id.} at 5.

\textsuperscript{140} \textit{Id.} at 7--8.

\textsuperscript{141} \textit{Id.} at 9.

\textsuperscript{142} See Bailey, \textit{supra} note 28, at 7 (describing a recent case where a corporation settled its securities claim for the limits of its traditional D\&O policy, leaving the directors and officers potentially exposed to an unsettled derivative claim).
from Side A coverage, there is no bankruptcy allocation issue. Finally, insurers may offer Side A coverage without the same carve-outs and exclusions as traditional A-B-C coverage. It is thus somewhat strange that more companies do not purchase Side-A-only coverage.

The following sections seek to offer explanations for this puzzle and for why the D&O insurance that is purchased does not provide the monitoring services that economic theory predicts. Although we are focusing here only on D&O insurance, this inquiry has potentially broad application for the corporate purchase of insurance more generally. We first examine the traditional explanations for corporate insurance, some of which provide a partial explanation for entity-level D&O insurance. We then examine two insurance market failure explanations (suggested by some of the D&O insurance professionals we interviewed) that do not, in our view, explain the pattern we observed. We conclude by explaining why agency costs provide the best explanation.

1. Traditional Solutions to the Corporate Insurance Puzzle

The availability of risk spreading through investment diversification has prompted several economists, starting with Mayers and Smith, to seek to solve the puzzle of corporate insurance. Their explanations include: (1) tax benefits, (2) bankruptcy transaction costs, (3) credit costs, (4) the cost of external capital relative to internal capital, and (5) monitoring services. As we will demonstrate, these rationales may explain the corporate purchase of

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143. See La. World Exposition v. Federal Ins. Co., 832 F.2d 1391, 1401 (5th Cir. 1987) (holding that the proceeds of Side A coverage is not the property of the corporation while not deciding the allocation issues raised by the existence of Side B coverage); see also In re First Cent. Fin. Corp., 238 B.R. 9, 17 (Bankr. E.D.N.Y. 1999) (reviewing case law and noting that Side B and Side C coverage raise allocation issues).

144. Bailey, supra note 28, at 4 ("Since the vast majority of Claims covered under a D&O policy are indemnified by the Company, a Side-A only D&O Policy allows Insurers to afford much broader coverage terms than reasonably possible under a Side-B policy.").


146. See Mayers & Smith, supra note 18, at 289–91, 294–95 (describing and modeling tax incentives for corporate insurance purchases); MacMinn & Garven, supra note 145, at 557–60 (same).

147. See Mayers & Smith, supra note 18, at 284–85; MacMinn & Garven, supra note 145, at 548–55.

148. See Mayers & Smith, supra note 18, at 287 (noting that "[b]ond indentures frequently contain covenants requiring the firm to maintain certain types of insurance coverage"); MacMinn & Garven, supra note 145, at 550–57 (modeling corporate insurance as a means to mitigate agency problems between corporate managers and bondholders).


150. See Mayers & Smith, supra note 18, at 286. See also Mayers & Smith, Underinvestment, supra note 145, at 46 (summarizing the monitoring services).
some forms of insurance, but they cannot adequately explain the pattern of pure risk distribution D&O insurance that we observed.

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

**Bankruptcy.** The bankruptcy explanation turns on the fact that bankruptcy risk leads a corporation's contracting partners to increase their prices. Measures that reduce the risk of bankruptcy therefore have cost-saving benefits across a wide range of corporate activity. Bankruptcy costs are unlikely to explain the corporate protection aspect of D&O insurance, however, because the D&O insurance programs we observed cannot credibly make the difference between a firm going bankrupt and remaining solvent. A corporation seeking bankruptcy protection would have high limits, because it is only the very rare massive claim that threatens most corporations' solvency, not the more routine securities class action. By contrast, D&O insurance programs have low limits relative to worst-case exposure. It thus appears, from this structure of coverage, that corporate managers are not buying D&O insurance to protect shareholders from bankruptcy costs. Even if they were, however, bankruptcy transaction costs could not explain the demand for a pure risk distribution form of insurance.

**Credit costs.** It is obvious why a secured creditor would demand that a corporation purchase insurance covering the asset pledged as security. Mayers

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151. See Rev. Rul. 80-211, 1980-2 C.B. 57 (concluding that even "[a]mounts paid as punitive damages incurred by the taxpayer in the ordinary conduct of its business operations are deductible as an ordinary and necessary business expense under section 162 of the Code").

152. See MacMinn and Garven, supra note 145, at 559–60.

153. See John Core, On the Corporate Demand for Directors' and Officers' Insurance, 64 J. Risk & Ins. 63, 68 n.10 (1997) (arguing that "any tax effects are at most second-order in magnitude").

154. See MacMinn and Garven, supra note 145, at 548–50.

155. See supra note 114 (summarizing relationship between deductibles and asset size); Interview with Risk Manager #3, supra note 56, at 6 ("[T]he most we could purchase for the corporate side was in the 200 to absolute maximum 300 million available. I mean our balance sheet is billions of dollars. . . . [E]xcess of 300 million or whatever insurance we could buy, we were self-assuming that."). By contrast, insurance limits of $1 billion or more are relatively common in the property and general liability insurance programs of large corporations.
and Smith demonstrated theoretically, however, that even unsecured creditors should prefer to lend to an insured corporation. While the economics are technical, the basic intuition is that a serious, uninsured loss destroys equity and therefore increases the debt to equity ratio of the firm. In some circumstances this leads to a conflict of interest between shareholders and bondholders that Mayers and Smith called the "underinvestment problem." In that situation new investment would benefit bondholders but not shareholders. Since the shareholders are in charge, the corporation does not make the investment, even if the investment has a positive net present value. Insurance solves that problem because it reduces the impact of the loss on the debt-to-equity ratio of the firm. As a result, even unsecured creditors will grant better terms to a corporation with insurance, especially if that corporation is highly leveraged. These reduced credit costs may offset insurance loading costs in some highly leveraged corporations. But, once again, these benefits cannot explain the preference for D&O insurance that makes little or no effort to control loss costs either ex ante or ex post.

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

Along with the tax explanation, we find this cost of capital explanation the most compelling of the traditional explanations for the very basic reason that a firm that is in the midst of shareholder litigation is in a disadvantageous position for raising capital. Traditional methods of raising capital—from equity investors or creditors—may not be available in the midst of a large shareholder claim or,

157. Froot et al., supra note 149, at 1631.
158. Froot and colleagues also observed that hedging can provide private benefits to managers and, thus, managers may act as if the cost of external capital is more costly than it is. Id. at 1634. We regard this as an example of an agency cost, an explanation that we address more fully infra, text accompanying notes 174–85.
if capital is available, it may only be available on sub-optimal terms. The cost of external capital, in other words, is likely to be higher than usual in the midst of shareholder litigation.

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

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

Monitoring. Economists have also theorized that shareholders or other corporate stakeholders might want the corporation to purchase insurance because the corporation may not have the economy of scale needed to develop loss prevention or loss management expertise. Mayers and Smith refer to this as the “real

159. For present purposes it is immaterial whether the corporation sets up an internal reserve or, instead, sets up a captive insurance company or a trust. All three options receive essentially the same tax treatment. See generally Richard M. Cieri & Michael J. Riela, Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions, 2 DePaul Bus. & Comm. L.J. 295 (observing the comparable taxability of these three mechanisms). However, “captured” insurance companies may not be classified as being in the business of insurance if they are wholly owned by one corporation. This is due largely to the absence of risk-spreading. As a consequence, unrelated corporations have begun to pool their assets to create group captured insurance companies that would side-step this particular limitation. Id. at 337.

160. This will be especially true for companies that fuel growth by reinvesting cash flows into the business.

161. See generally Richard L. Shockley & Anjan V. Thakor, Bank Loan Commitment Contracts: Data, Theory, and Tests, 29 J. Money Credit & Banking 517 (1997) (theoretically and empirically examining the contract design features of bank loan commitments). Among other differences between loan commitments and D&O insurance policies, “virtually all [loan] commitments contain an escape clause that allows the issuing bank to deny credit if the borrower’s financial condition has changed in a material way.” Id. at 518.
service efficiencies” of insurance. Monitoring is the key to these efficiencies. Shareholders may demand monitoring services from an insurer to counteract tendencies within the firm to underinvest in loss prevention technologies. Similarly, other corporate constituencies, such as employees or bondholders, may demand insurance-based monitoring to control managers’ post-loss opportunistic behavior. Mayers and Smith refer to this as the “bond[ing]” benefit of insurance. As already noted, however, this hypothesis is not supported by our central empirical finding: insurers do not, in fact, monitor their corporate insureds. Demand for monitoring cannot explain the purchase of insurance that in fact provides no monitoring.

2. Market Failure Explanations

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

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

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

162. See Mayers & Smith, supra note 18, at 285.
163. Mayers and Smith use the example of property insurers that require the installation of sprinkler systems to reduce the risk of fire. Id. at 286.
164. See id. at 287–88.
165. Id. See also MacMinn & Garven, supra note 145, at 542–44 (supporting these arguments as sound theoretical bases for corporate insurance).
167. Id. at 34 (concluding that “the knock I have heard in panel discussions, things like that, is that the credit that you get for dropping [B and C Side coverage] is not worth what you are actually getting if you are losing coverage”). Complicating this analysis is the fact that Side-A-only policies may offer broader protection for the directors and officers. See supra text accompanying notes 141–43.
[W]e evaluate it every year. But I would say that . . . maybe 70-80% of large companies still do the A, B and C. We have heard of a few companies just going out and doing a Side A, bankruptcy protection . . . [B]ut we haven't seen it done, because when it all comes down to it, you know, you really are protecting the asset[s] of the corporation . . . You could [buy Side-A-only]. I am not arguing against that. It is a decision you truly go through each year . . . And you think about it, but there is no patent answer for that. It depends on the price.  

Another replied:

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

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

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

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

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

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

Nevertheless, we are inclined to doubt this market failure explanation as well. First, D&O insurance claims are very different from the environmental and products liability claims that led to the reduction in trust. The environmental and products liability claims arose under policies sold years and even decades before the claims arose, at a time when no underwriter could have predicted either their frequency or severity, and, thus, insurance company leaders may have had some justification for thinking that it was reasonable to contest their companies’ responsibility for these claims. By contrast, D&O insurance claims typically relate to recent behavior of a kind that D&O insurance underwriters cannot claim to be a surprise. Second, D&O insurance companies have demonstrated that they are responsive to the market demands of the very sophisticated corporate purchasers of D&O insurance. If corporate buyers wanted D&O insurance that managed the defense costs of shareholder litigation, D&O insurance programs could be restructured to do so. Moreover, these buyers

172. Interview with Associate General Counsel #1 (May 6, 2006) (documentation on file with author).
173. D&O insurance policies are “claims made” policies, meaning that they apply to claims made during the policy period regardless when the underlying injury took place. By contrast, the commercial general liability insurance policies typically apply to injury during the policy period, regardless when the claim eventually is made. See generally Bob Works, Excusing Nonoccurrence of Insurance Policy Conditions in Order to Avoid Disproportionate Forfeiture: Claims-Made Formats as a Test Case, 5 Conn. Ins. L.J. 505, 513–49 (1999) (providing a taxonomy of claims made policies).
174. See infra text accompanying notes 201–03.
could exert market discipline over insurers that earned a reputation for providing an inadequate defense.

3. Agency Costs

If the existing form of Side B and C coverage represents a negative net present value investment from the shareholders' point of view, there may nevertheless be some within the firm who would prefer, for their own reasons, to make the investment. This divergence between the interests of the firm's managers and its owners is an example of agency costs. In this context, there may be two types of agency costs: (a) executive agency costs and (b) risk manager agency costs. Unlike any of the other explanations we have explored, agency costs do explain the pure risk distribution form of D&O insurance that we observed.

This agency cost explanation is a corollary to the moral hazard and related deterrence point that is our main contribution to corporate and securities scholarship. Shareholders would benefit from the increased transparency that is supposed to result from the deterrence provided by securities liability. Insurance purchasing patterns that reduce that deterrence harm shareholders as a whole and, thus, like excessive compensation, represent agency costs that management imposes on shareholders.

a. Executive Agency Costs. Executives, unlike shareholders, are not able to avoid the idiosyncratic business risks generated by the firm they manage since they have a more personal stake—their jobs and their pay packages—in that firm. D&O losses threaten executives in two ways. First, large losses may push the firm towards insolvency (and lead to job loss) or, short of actual insolvency, may make the firm a takeover target (and lead to job loss). Second, even if the losses are not large enough to threaten the financial stability of the firm, losses may have a significant impact on accounting measures of performance and compensation packages tied to those performance measures.

Entity-level D&O insurance helps executives avoid both of these threats. According to this explanation, executives may be motivated to purchase B and C Side coverage to protect their own positions and pay packages in spite of the fact that it may be a negative net present value investment from the shareholders' perspective. In this way, entity-level D&O insurance is essen-

175. See generally Jensen & Meckling, supra note 32, at 5–6 (describing agency costs as the divergence in interests between shareholder principals and manager agents).


177. The investment of human capital, in other words, is not easily diversified. See Mayers & Smith, supra note 18, at 283.

178. See generally Bebchuk & Fried, supra note 176 (detailing defects in the design of executive compensation packages that lead to similarly distorted incentives).

179. See Griffith, supra note 7, at 1172–73.
tially a form of earnings management, allowing managers to avoid shocks to the firm's accounting statements in exchange for an annual premium, paid out of corporate funds. Because managers have a personal incentive to incur this annual expense when their shareholders would prefer that they did not, it is a form of agency cost.\(^{180}\)

Moreover, when the managers select D&O insurance, the insurance they select does not provide monitoring. This, too, represents an agency cost. Buying D&O insurance without monitoring increases the freedom of managers to take financial reporting and other risks that improve accounting measures of performance and, hence, their compensation, but not the long-term value of the firm. If these risks lead to shareholder litigation, D&O insurers step in to pay the claim.

Econometric research on D&O purchasing patterns supports the managerial agency costs explanation. John Chalmers and colleagues studied the relationship between the amount of D&O insurance purchased in connection with an initial public offering and the later price of the stock that was offered, investigating the hypothesis that managers are willing to buy large amounts of D&O coverage at high premiums because they receive all of the benefits of the coverage but bear the costs only in proportion to their fractional ownership of the firm's equity.\(^{181}\) They found a significant negative correlation between the three-year post-IPO stock price performance of the company and the amount of insurance that the company purchased just before issuing the IPO. They concluded "managers choose abnormally high D&O insurance coverage based on their belief that their shares are priced too high."\(^{182}\)

Similarly, Core studied the relationship between director pay and D&O insurance limits in Canadian firms, investigating the hypothesis that more entrenched managers are more likely to purchase D&O insurance.\(^{183}\) (Unlike U.S. firms, Canadian firms are legally required to disclose their D&O insurance limits.) He found that "firms with higher excess director pay . . . are more likely to carry D&O insurance coverage and purchase higher limits," suggesting that managers bundle compensation and insurance because they do not internalize the cost of either.\(^{184}\)

**b. Risk Manager Agency Costs.** Risk manager agency costs exist if the corporation's risk manager has an incentive to purchase D&O insurance notwithstanding the fact that such insurance may be a negative net present value investment from the shareholders' point of view. The basis for this divergence in incentive is obvious—the risk manager may suffer adverse career consequences

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180. Cf. Froot et al., supra note 149, at 1634 (describing potential private benefits to hedging).
182. Id. at 611.
183. Core, supra note 153, at 81.
184. Id.
if she did not buy insurance against a loss that ex post seems costly to the firm. One of the risk managers in our study candidly suggested this explanation:

I guarantee you that no matter what anybody says or anybody tells you, a big loss comes in to a company and it is 100, 200 [million]. You say . . . "I have bankruptcy protection over there, but this 200 million thing against the company, I don’t have anything for it." . . . So there is an element of making sure there is comprehensive protection. 185

From a strictly ex post point of view, insurance against a significant loss may seem like a good idea even if the ex ante value of the insurance is less than its cost. If her superiors will tend to view loss from an ex post point of view, a risk manager may purchase D&O insurance in order to protect her own career regardless of the shareholders’ preferences. This incentive is compounded if there are also executive agency costs within the organization that favor the purchase of comprehensive D&O coverage.

This ex post perspective and compounded incentives help explain the nearly pure risk distribution form of existing D&O insurance, especially the absence of defense cost management. Managers and directors facing securities litigation apparently prefer the maximum autonomy, blank checkbook approach to D&O insurance coverage, and they are not going to be pleased with a risk manager who agreed in advance to hand over the defense to an insurance company, even if that decision might have made sense from an ex ante perspective. The following excerpt from an interview with the head of the claims department in a leading D&O insurer illustrates this point:

They got a D&O policy to pay for it, and the general counsel, the last g-d damn thing that he wants to do—excuse my language—is to walk into the CEO’s office and say, “Oh, I cut their bill in half.” The CEO is going to say, “Wait a second. In other words, I am not getting the best possible defense because you are pissing them off? Oh, I don’t think so. You know, I’ve got a huge house in Greenwich. I want to keep that huge house. I’ve got the mistress. I’ve got the Mercedes. . . . Why the hell are we doing this?” 186

C. THE COMPARATIVE ADVANTAGE PUZZLE

In the last section, we explored why corporations purchase a type of insurance that economic theory suggests they do not need. In this section we explore why insurers do not offer a service—monitoring—that economic theory suggests their corporate purchasers do need. D&O insurers, after all, ought to be among the most trusted suppliers of loss prevention expertise. Alone among all possible providers of loss prevention advice, insurers fund the losses. They are,

186. Interview with Claims Manager #1, supra note 96, at 27.
in other words, bonded to their advice. As Cohen explains, "[L]oss prevention services by an insurance company come with a stronger guarantee than loss prevention services by lawyers. The insurance company bonds its appraisal by agreeing to indemnify the insured for losses that occur; lawyers guarantee only nonnegligent appraisals."\textsuperscript{187}

In addition, insurance companies are less subject to co-option by the client than fee-for-service professionals because the insurer is less dependent on any one client for business.\textsuperscript{188} Moreover, as the one ultimately on the hook for losses, insurers are likely less susceptible to the ideological biases of corporate governance "policy entrepreneurs."\textsuperscript{189}

Nevertheless, according to our sources, corporations largely ignore D&O insurers' occasional loss prevention advice and do not look to D&O insurers for monitoring services of any kind. This is the comparative advantage puzzle: D&O insurers would seem to have a comparative advantage in providing these services, yet they do not provide them. Our analysis of this puzzle focuses first on the institutional barriers to monitoring by D&O insurers, then turns, as in our last section, to an agency cost explanation.

1. Institutional Barriers to Insurance Monitoring

A handful of institutional barriers may prevent D&O insurers from bundling loss prevention services with D&O insurance. These include: (1) a lack of underwriter knowledge and experience, (2) characteristics of securities misinformation losses that may make monitoring futile or prohibitively costly, (3) the public good nature of best practices advice, (4) the layered, excess-of-loss structure of D&O insurance programs, and (5) the insurance underwriting cycle. We consider each of these potential explanations in turn.

Underwriter knowledge and experience. Perhaps an obvious explanation for the D&O insurer's failure to engage in ex ante monitoring is the claim that D&O insurance companies cannot competently monitor because they do not employ people with the necessary knowledge and experience. While we tend to agree that most current D&O insurance personnel currently lack the requisite skill set to be competent monitors of corporate governance, we feel that this

\textsuperscript{187} Cohen, \textit{supra} note 60, at 343.

\textsuperscript{188} As reported in our companion article, no single D&O insurer is willing to sell very high limits to any single corporation, with the result that D&O insurers hold a large portfolio of D&O risks. See Baker & Griffith, \textit{supra} note 8 (reporting $50 million as the largest limit available from any one insurer and noting that in the recent hard market, no insurance company offered a policy larger than $25 million, with most policy limits set at $10 million or less). Corporate governance rating firms, by contrast, may have conflicts of interest because they provide consulting services to corporations. See Rose, \textit{supra} note 19 (noting this conflict of interest with reference to Institutional Shareholder Services).

\textsuperscript{189} See Roberta Romano, \textit{The Sarbanes-Oxley Act and the Making of Quack Corporate Governance}, 114 \textit{Yale L.J.} 1521, 1528--29 (2005) (describing how corporate governance entrepreneurs have advocated governance innovations that make little or no difference in a corporation's susceptibility to risk). Because the insurer ultimately bears corporate governance risk, it is unlikely to be fooled by merely cosmetic governance features.
explanation inverts cause and effect. Accounting firms, law firms, outside directors, and consulting firms are all presently selling compliance and other securities loss prevention services to public corporations. At least some of those professionals would be willing to work for D&O insurers, provided that they were adequately compensated. If there are in fact efficiencies to bundling risk distribution and loss prevention, then a D&O insurer should be able to provide these professionals adequate compensation. Thus, the current knowledge and experience of D&O insurance personnel seems more likely to represent a revealed preference of the managers buying D&O insurance policies than a real institutional barrier to bundling risk distribution and monitoring.

The futility of insurance monitoring. Perhaps D&O insurers do not provide such corporation-specific monitoring because it would not be cost effective—whether because securities claims are random events, or because finance and business risks are so much more important to securities losses than corporate governance risk that monitoring corporate governance is not worth the investment, or because getting sufficiently inside the corporation to provide effective monitoring would be prohibitively expensive even if governance risk really is significant. These are empirical possibilities that we cannot answer definitively. Nevertheless, we offer the following three observations on the basis of our research.

First, the idea that securities lawsuits are random events is a variation of the idea that the merits do not matter in securities litigation. We summarized that debate in our companion article and we hope to contribute to that debate when we report the results of our ongoing research into the securities litigation process. For present purposes we simply note that the continued existence of the private cause of action for securities law violations is predicated on the idea that the merits do matter, D&O insurance underwriters act as if the merits matter, and there is empirical research suggesting the same.

Second, it is certainly possible that financial and business risks so completely


191. See, e.g., Marilyn F. Johnson et al., Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act, J.L. Econ. & Org. (forthcoming), available at http://ssrn.com/abstract=883684 (finding “a significantly greater correlation between litigation and both earnings restatements and abnormal insider selling after the PSLRA.”); see also Baker & Griffith, supra note 8 (explaining that the use of corporate governance factors in D&O insurance risk-based pricing suggests that the merits matter); Stephen J. Choi, The Evidence on Securities Class Actions, 57 Vand. L. Rev. 1465 (2004) (summarizing recent empirical work on the question of whether the merits matter).
dominate corporate governance risk in predicting securities litigation losses that monitoring corporate governance (broadly understood) would not be cost-effective. Indeed, as we reported in our companion Article, D&O insurance underwriters focus extensively on financial factors. Nevertheless, absent public disclosure of D&O insurance prices and other terms—or adequate access to private data—it is impossible to determine the relative importance of finance and corporate governance risk in D&O insurance pricing. Moreover, even if financial and business risks do dominate corporate governance risk in current D&O insurance pricing, that may be the result of D&O insurers not being allowed sufficiently inside the corporation to evaluate the “deep governance” factors that they find most important.

Third, with regard to the expense of getting sufficiently inside the corporation to do effective monitoring, we observe that accounting firms are already deep inside the corporation. For that reason, the most cost-effective way to bundle monitoring and risk distribution may involve a combination of accounting and insurance functions. One possible approach is the Financial Statements Insurance (FSI) concept suggested by Joshua Ronen and elaborated by Lawrence Cunningham. Their idea is for insurance companies to offer financial statements insurance that would guarantee the accuracy of financial statements. This idea has received considerable attention in legal academic writing, but insurers and accounting firms have not embraced the idea. One reason is that the proponents have emphasized the novelty of their idea (a plus for an academic audience, but not for existing firms) and the legal and institutional change required for implementation. In addition, they have predicted that it would lead to dramatic improvements in the accuracy of financial statements that may seem unrealistic to these firms.

192. See Baker & Griffith, supra note 8.
193. See id.
In our view, the concept of bundling monitoring and risk distribution is simpler and less novel than they suggest. At least since Mayers and Smith, economists have understood that monitoring can be an important benefit that corporate insurance provides to shareholders, and the obvious candidates to perform monitoring in the D&O insurance context are the accountants who are already deep inside the corporation. Accounting firms already provide a limited amount of "insurance" (in the form of professional liability), and D&O insurance companies already provide a limited guarantee of the financial statements (in the form of coverage for securities violations related to inaccuracies in the statements). The challenge is to identify incremental ways to bring these two functions closer together, without the need for legal reform or dramatic changes in existing institutions.

Developing a realistic set of incremental steps requires further work, including consultation with experts in the accounting industry. Nevertheless, to illustrate the kind of innovation we have in mind, we note that an accounting firm could agree by contract to provide a warranty that a particular financial statement does not contain material misrepresentations. The warranty could be drafted so that it provides protection that is equivalent to existing D&O insurance. For example, the warranty could be limited to a specified dollar amount (recognizing that the firm would remain potentially subject to additional liability on a traditional malpractice basis), and the warranty could be made subject to conditions that would be similar to the exclusions in D&O insurance policies. The firm could obtain contractual liability insurance coverage from an insurer that would indemnify the firm for any warranty payments. From an underwriting perspective, this contractual liability insurance coverage would be similar to D&O insurance and thus could be offered by D&O insurance companies with relatively little change in their operations. This limited warranty would bring the monitoring and risk distribution functions closer together without the need for legal change.\(^{196}\)

The public good nature of best practices advice. Some loss prevention advice comes in the form of information about best practices. The loss prevention guide we described in the empirical section of this Article is a good example.\(^{197}\) Recall that the guide contained information about the Private Securities Liability Reform Act, analyst communications, insider trading, and bad news disclosure, among other topics. Best practices information of this sort is a public good, with the result that an insurance company that invests in developing this

\(^{196}\) Because the accounting firm would simply be providing a warranty of the audit, we do not believe that this warranty would violate the Sarbanes-Oxley prohibition on the provision of nonaudit services. See 15 U.S.C. §78j–h (2000 & Supp. 2004). The warranty would not contravene the three principles that the SEC has stated that it will use in defining nonaudit services: "an auditor cannot (1) audit his or her own work, (2) perform management functions, or (3) act as an advocate for the client." Strengthening the Commission's Requirements Regarding Auditor Independence, 67 Fed. Reg. 76,780, 76,783 (Dec. 13, 2002) (to be codified at 17 C.F.R. pts. 210, 240, 249, 274).

\(^{197}\) See supra text accompanying notes 71–76.
information cannot capture the full return from that investment. For this reason, individual insurers are not the best institutions to develop and disseminate best practices information. An individual insurer's comparative advantage comes in intrusive, detailed monitoring that is specific to the particular corporation and that cannot be duplicated without corporation-specific investments.

The layered, excess-of-loss structure of D&O insurance programs. D&O insurance programs consist of layers of insurance coverage provided by different insurance companies on an “excess of loss” basis (meaning that each insurer becomes responsible for a claim only after all of the lower layers of insurance are exhausted). This structure raises concerns about the fidelity of insurers' interests to those of the policyholder at the point of claim. If the insurer with the first layer at risk bears the entire defense burden, then the policyholder may be concerned that the insurer will shirk in the defense of the claim—because all that insurer has at risk is the limits of the policy it sold to the policyholder.

There is an alternative way to structure an insurance program that would alleviate this concern: the “quota share” structure. In a quota share structure, each insurer is responsible for a percentage of the total insurance program limits, and one insurer (or claims management company) manages claims on behalf of all of the insurers in the program. This structure aligns the interests of each insurer with those of the total program and, subject to the risk of liability in excess of the total limits, more closely aligns the insurers’ interests with those of the policyholder. The existence of this alternative structure means that a corporation’s choice to employ the layered, excess of loss D&O insurance arrangement is also a revealed preference, indicating that managers do not want D&O insurers taking a more active role in the management of defense costs or litigation.

The insurance underwriting cycle. The insurance underwriting cycle provides

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198. A public good will not assure its own supply because individuals fail to contribute to its production. Lighthouses are the classic example. Because one person’s consumption of the light does not reduce the resource available for others and the light cannot be parsed and given only to those who pay, an individual may reason that he harms no one by making use of the light without paying for it. Accordingly, a variety of institutions have arisen to require the beneficiaries of the lighthouse to contribute to the cost. See generally R.H. Coase, The Lighthouse in Economics, 17 J.L. & Econ. 357 (1974) (providing institutional and historical account that confirms the public good nature of the lighthouse but does not support the claim by other economists that a lighthouse is a service which can only be supplied by the government).

199. See Baker & Griffith, supra note 8.

200. See Baker, supra note 85, at 114–18 (explaining the low limits conflict).

201. The excess of loss structure might similarly be misunderstood to be an obstacle to monitoring ex ante because, as in the ex post situation, the benefits of the monitoring would accrue to the insurance program as a whole while the costs would likely be imposed on a single monitoring insurer (most likely the insurer first on the risk). Yet insurers would predictably incur ex ante monitoring costs in all cases, so the insurer responsible for monitoring can demand a larger share of the total D&O insurance program premium commensurate with that obligation. Moreover, in contrast to the ex post situation, there is little or no opportunity for the ex ante monitoring insurer to attempt an opportunistic breach because that insurer can easily be replaced. (The ex post situation presents an opportunity for opportunistic breach because, after a loss, it is too late to replace the misbehaving insurer. See Works,
one final potential explanation for the fact that monitoring and risk distribution are not provided as a bundled product. To explain, we begin with a quote from a participant from a leading reinsurance company whom we asked to read our companion Article to verify that we had accurately described the D&O insurance underwriting process. He said that we had, but added the following observation: "This is all theater around a price list. And what is the price list? At one moment there is a Happy Hour and everything is half price."\202 In other words, although insurers may attempt to price on the basis of risk, there are market realities that can lead to dramatic price cuts that have little or nothing to do with the risk of the particular corporation. The underwriting cycle is one reason for such "Happy Hours."\203

The insurance underwriting cycle affects many aspects of the insurance relationship, not just price. In soft market conditions, insurers not only compete on price, they also compete on contract terms, underwriting speed, and other aspects of the insurance buying process that make them easy to deal with.\204 Reducing the intrusiveness of their monitoring could become a competitive tool, reducing the ability of D&O insurers to serve as trusted monitors. With that said, however, if monitoring were to become an explicit and valued feature of the D&O insurance product, market discipline should limit departures from an industry standard of monitoring. No one complains when they have to pay a lower price, but plenty of people complain when service is of low quality.

2. Agency Costs Again

As the preceding discussion makes clear, there is some logic and a great deal of experience that suggests it would be difficult for D&O insurers to bundle risk distribution and monitoring services. Nevertheless, we remain convinced that agency costs are, at the very least, an important part of the explanation for the pure risk distribution form of insurance that we observed. When an accounting firm, a law firm, an outside director, or a consulting firm provides securities loss prevention advice, the downside is the potential for a loss that—in the vast majority of cases—will be insured. When that advice is provided as part of a bundled package of monitoring and risk distribution services, however, the

\textit{supra} note 173, at 554–56, 562–70 (discussing the risk of opportunistic breach and potential control mechanisms)).

202. E-mail from Sean Griffith, Associate Professor of Law, Fordham Law School, to Tom Baker, Connecticut Mutual Professor of Law, University of Connecticut School of Law, (June 22, 2006, 6:15:08 EST).

203. \textit{See} Baker, \textit{supra} note 67 (synthesizing economic literature on the insurance underwriting cycle); Fitzpatrick, \textit{supra} note 170 (providing a participant observation account of a behavioral explanation for the underwriting cycle) (note that this author was at the time the Chief Underwriter for Chubb’s specialty lines insurance business, one of the leading providers of D&O insurance); Matthew Dolan, \textit{Repeating the Sins of Market Cycles}, Insights, Oct. 2003, http://www.onebeaconpro.com/insights/insights_vol2_sp.pdf (providing a participant observation account of the underwriting cycle) (note that this author was a former Chubb underwriter and, at the time, the CEO of a specialty lines insurer active in the D&O business).

downside is much bigger: ignoring that advice could lead to an uninsured loss for the corporation.\textsuperscript{205} If taking the advice is likely to have no impact, or a positive impact, on share prices, then a manager whose compensation is linked to those share prices should be willing to take it. But in at least some circumstances, the advice will be bad tasting medicine—a disclosure, a revenue recognition decision, or some other accounting judgment that means that the company will not “make the numbers” for this quarter and, thus, share prices will decline. In that case, the manager may prefer not to take the advice. Linking that advice to D&O insurance protection—so that ignoring the advice means that there is no insurance for any resulting loss—would significantly constrain the manager’s autonomy. Who wants that? The answer, we have argued, is the shareholders.

CONCLUSION

In order for shareholders to benefit from entity-level D&O coverage, there must be some benefit to the coverage other than pure risk distribution, which shareholders could accomplish more efficiently through portfolio diversification. Although some plausible explanations have been suggested—including offsetting tax advantages and the benefits of low-cost contingent financing—each such explanation is only partial and is unlikely to fully justify the extent of corporate protection D&O insurance that presently is purchased. None of these explanations accounts for the pure risk distribution form of D&O insurance that we observed. Any benefit offered by, for example, low-cost contingent financing thus must overcome not only the insurer’s loading fees, but also the cost of moral hazard associated with this form of pure risk distribution.

We are therefore left with only one satisfactory explanation for the form of D&O insurance that we observed: agency costs.\textsuperscript{206} Managers do not want insurers monitoring their decisions ex ante and they do not want them managing their defense ex post. Both monitoring and defense management would reduce managers’ autonomy and, relatedly, their ability to profit at the shareholders’ expense.

Even if, as we doubt, shareholder litigation were a purely random event—unrelated to corporate governance and therefore impossible for an insurer to minimize through ex ante loss prevention efforts—insurers could still reduce the costs of shareholder litigation through ex post loss minimization efforts. Our research reveals not only that they fail to do so, but also that D&O insurance, as

\textsuperscript{205} We are not suggesting that Side A coverage be tightly linked to monitoring services. Individual loss aversion provides sufficient justification for Side A coverage; obligating individual directors and officers to follow the insurance company’s loss prevention advice on pain of losing their insurance coverage could well lead to behavior that was too cautious from the shareholders’ perspective.

\textsuperscript{206} Habit may also be an explanation, but the profit motive would likely change this habit absent the agency cost problem. See, e.g., M. Martin Boyer, Is the Demand for Corporate Insurance a Habit? Evidence of Organizational Inertia from Directors’ and Officers’ Insurance (CIRANO Working Papers, Paper No. 2004s–33, 2004).
currently structured, affords little opportunity to do so. Thus, our research strongly suggests that the prevailing form of D&O insurance benefits management at the shareholders' expense. Only firms that purchase Side-A-only coverage, a relatively rare coverage package, are not susceptible to this charge.

The “missing monitor” in directors’ and officers’ insurance stands in contrast to insurers’ loss prevention and management activities in many other lines of insurance. Sociological research has documented “insurance as governance” in a wide variety of contexts, and D&O underwriters and brokers who are familiar with the non-profit and private company D&O markets reported to us that insurers regularly engage in loss prevention and loss management. Thus, our research suggests that there is a structural inequality across fields of insurance.

While we are reluctant to create a general theory for this inequality based on the investigation of a single insurance field, to us the obvious explanation here lies in corporate officials’ control over corporate resources. Top executives in public corporations are able to purchase income-smoothing insurance without ceding any governance authority to insurers because this purchase, like all such decisions, is insulated from shareholder challenge by the business judgment rule. Insurers are willing to sell this coverage because, in most markets, they can do so profitably; they cannot be blamed for providing a product that customers are eager to buy. Most basically, corporate governance arrangements that cannot place reasonable limits on CEO compensation can hardly be expected to place reasonable limits on a far less visible (and less expensive) insurance product that is not widely understood.

With that said, investors and outside directors that wish to rein in agency costs should consider turning their attention to entity-level D&O insurance. With their attention thus focused, the choice is plain. Unless and until they can demonstrate that entity-level coverage provides the cheapest form of contingent financing for securities liability losses—and that such contingent financing is in their shareholders’ interests—public corporations should purchase only Side A coverage. And they should push for the creation of a bundled package of monitoring and risk distribution services that D&O insurers may be uniquely positioned to provide.

207. See sources cited supra notes 11 and 62.