Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market

Tom Baker† *and Sean J. Griffith*††

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

In this Article, we report the results of an empirical study of the D&O underwriting process. Drawing upon in-depth interviews with underwriters, actuaries, brokers, lawyers, and corporate risk managers, we find that insurers seek to price D&O policies according to the risk posed by each prospective insured and that underwriters focus on corporate governance in assessing risk. Our findings have important implications for several open issues in corporate and securities law. First, individual risk rating may preserve the deterrence function of corporate and securities law by forcing worse-governed firms to pay higher D&O premiums than better-governed firms. Second, the importance of corporate governance in D&O underwriting provides evidence that the merits do matter in corporate and securities litigation. And, third, our findings suggest that what matters in corporate governance are "deep governance" variables such as "culture" and "character," rather than the formal governance structures that are typically studied. In addition, by joining the theoretical insights of economic analysis to sociological research methods, this Article provides a model for a new form of corporate and securities law scholarship that is both theoretically informed and empirically grounded.

INTRODUCTION

Liability insurers bankroll shareholder litigation in the United States. Directors' and officers' (D&O) liability insurance policies cover the risk of shareholder litigation.[1] Nearly all public corporations purchase D&O policies.[2] And nearly all shareholder litigation settles

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† Connecticut Mutual Professor and Director, Insurance Law Center, University of Connecticut School of Law.

†† Associate Professor of Law, Fordham Law School. For their comments and suggestions on earlier drafts, the authors thank Phillip Blumberg, Anne Dailey, Sean Fitzpatrick, Louis Kaplow, Sachin Pandya, Jeremy Paul, Larry Ribstein, Steve Shavell, Peter Siegelman, Paul Vaaler, Carol Weisbrod, and workshop participants at Harvard Law School, the University of Connecticut School of Law, and the University of Illinois College of Law. For excellent research assistance, thanks to Tim Burns, Josh Dobiak, and Yan Hong. The viewpoints and any errors expressed herein are the authors' alone.

1 On the coverage of D&O policies, see Part II.B.1.

2 See Tillinghast Towers Perrin, *2005 Directors and Officers Liability Survey* 20 fig 21 (2006) (reporting that 100 percent of public company respondents in both the U.S. and Canada

within the limits of these policies.[3] As a result, the D&O insurer serves as an intermediary between injured shareholders and the managers who harmed them. This intermediary role has important implications for corporate governance that have been largely overlooked by corporate and securities law scholars.[4]

The primary goal of liability rules in corporate and securities law, it is often said, is to deter corporate officers and directors from engaging in conduct harmful to their shareholders.[5] Yet it is typically a third-party insurer that satisfies these liabilities under the terms of the corporation's D&O policy.[6] The deterrence goals of corporate and securi-

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purchased D&O insurance). Prior surveys report slightly lower percentages. The annual Tillinghast D&O survey is based on a nonrandom, self-selecting sample of companies. It is also the only systematic source of information on D&O insurance purchasing patterns in the U.S. We therefore draw upon it as a source of aggregate data in spite of its methodological weaknesses.

3 See, for example, James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 Ariz L Rev 497, 512 (1997) ("[A]pproximately 96% of securities class action settlements are within the typical insurance coverage, with the insurance proceeds often being the sole source of settlement funds."). Using U.S. data, Cornerstone Research reports that "over 65% of all [securities class action] settlements in 2004 were for less than $10 million," a figure within the policy limits of most publicly traded corporations, and that only seven settlements were larger than $100 million. See Laura E. Simmons and Ellen M. Ryan, *Post-Reform Act Securities Settlements: Updated through December 2004* 3 (Cornerstone Research 2005). Small-cap companies typically have D&O insurance policies in excess of $20 million, and large-cap companies typically have D&O insurance policy limits in excess of $100 million. See Tillinghast, *2005 Survey* at 29 table 17C (cited in note 2). There may be a recent trend in the U.S. toward increasing (but still small) numbers of settlements above the D&O policy limits. See Elaine Buckberg, Todd Foster, and Ronald I. Miller, *Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard?* 1 (NERA Economic Consulting 2005) (noting that in both the WorldCom and the then-pending Enron case, directors were making settlement payments out of their personal assets). Recent research demonstrates that outside directors almost never have to use their own funds. See Bernard S. Black, Brian R. Cheffins, and Michael Klausner, *Outside Director Liability*, 58 Stan L Rev 1055, 1059–60 (2006) ("Since 1980, outside directors have only once made personal payments after a trial.").

4 But see Black, Cheffins, and Klausner, 58 Stan L Rev at 1056. See also generally Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 Emory L J 1155 (1990) (studying the effect of the D&O insurance crisis on corporate governance); Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 Del J Corp L 1 (1989) (exploring the causes of the D&O insurance market crisis of the mid 1980s).

5 See Reinier Kraakman, Hyun Park, and Steven Shavell, *When Are Shareholder Suits in Shareholder Interests?*, 82 Georgetown L J 1733, 1738 (1994) (modeling when shareholder litigation should and should not be pursued). In this Article, we adopt the standard assumptions of mainstream corporate and securities law scholarship—that the corporation is designed to maximize shareholder welfare (as opposed to some other constituency) and that deterrence is affected principally through the costs of liability rules. See Stephen M. Bainbridge, *Corporation Law and Economics* 28 (Foundation 2002). These assumptions have been critiqued. See generally, for example, Lawrence A. Mitchell, ed, *Progressive Corporate Law* (Westview 1995). But that debate is beyond the scope of this Article.

6 See Sean J. Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies*, 154 U Pa L Rev 1147, 1149–50 (2006) (describing the intermediary role of the D&O insurer and arguing for public disclosure of D&O insurance policy premiums and contract provisions).

ties liability are thus achieved indirectly, through an insurance intermediary, if indeed they are achieved at all.[7]

The D&O insurer has several means of reintroducing the deterrence function of corporate and securities law and, because it is the one ultimately footing the bill, ample incentive to do so. First, D&O insurers may screen their risk pools, rejecting firms with the worst corporate governance practices and increasing the insurance premiums of firms with higher liability risk. Second, D&O insurers may monitor the governance practices of their corporate insureds and seek to improve them by recommending changes, either as a condition to receiving a policy or in exchange for a reduction in premiums.[8] Third, D&O insurers may manage the defense and settlement of shareholder claims, fighting frivolous claims, managing defense costs, and withholding insurance benefits from directors or officers who have engaged in actual fraud.[9]

This Article is devoted to the first strategy for reintroducing the content of corporate and securities law—the underwriting process. Its core inquiry is how, in that process, D&O underwriters *transfer* the impact of the law and whether, in doing so, they also *transform* it. This is an empirical question. To answer it, we interviewed insurance market participants, including underwriters, actuaries, brokers, lawyers, and corporate risk managers, asking such questions as how underwriters evaluate the D&O liability risk of public corporations, what attributes they look for, and how these factors are taken into account in pricing. We also allowed our participants simply to talk, to describe the underwriting process, to tell us what they find interesting or troubling, and to illustrate their explanations with stories and anecdotes.

Our findings shed light on several important corporate and securities law issues. First, we find that D&O insurers seek to price policies according to the risk posed by each corporate insured and that, in doing so, they make a detailed inquiry into the corporate governance practices of the prospective insured. The underwriting process thus

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7 The emotional impact of shareholder litigation and its reputational consequences, of course, will affect directors and officers directly, but essentially all financial consequences are mediated by the D&O insurer. See Black, Cheffins, and Klausner, 58 Stan L Rev at 1056 (cited in note 3) ("The principal threats to outside directors . . . are the time, aggravation, and potential harm to reputation that a lawsuit can entail.").

8 See Tom Baker and Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' and Officers' Liability Insurer*, 95 Georgetown L J (forthcoming 2007) (reporting that D&O insurers do not provide governance services and addressing the related puzzles of why corporations buy D&O insurance and how insurers control moral hazard).

9 See Tom Baker and Sean J. Griffith, *The Defense and Settlement of Shareholder Litigation* (unpublished working paper 2006) (studying the role of D&O insurance in the defense and settlement of shareholder litigation).

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

Our research also belongs to a tradition in legal scholarship that seeks to comprehend the role of liability insurance in legal regulation.[10] When the content of legal rules is transmitted through liability insurance intermediaries—as, for example, in accident law, medical malpractice, and products liability—we cannot understand how the law ultimately works until we first understand how the insurance intermediary works: how it packages the liability risk, spreads the costs, and *transforms* the law as it *transfers* the risk. Torts scholars have long appreciated this role, but ours is the first empirical research project to offer a detailed study of the role of liability insurance in corporate governance. Our aim is to learn what D&O insurance can teach us about corporate and securities law in action.

The Article proceeds as follows: Part I describes our empirical methods. Part II provides a brief background, both on shareholder litigation and D&O insurance. Part III reports our findings on what matters to D&O insurance underwriters when they assess D&O insurance risk, how they gather that information, and how they translate their risk assessments into prices. Part IV applies our findings to several open issues in corporate and securities law scholarship.

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10 The foundational empirical study is H. Laurence Ross, *Settled out of Court: The Social Process of Insurance Claims Adjustments* (Aldine 1970). See also generally Tom Baker, *Liability Insurance as Tort Regulation: Six Ways that Liability Insurance Shapes Tort Law in Action*, in Gerhard Wagner, ed, *Tort Law and Liability Insurance* 295 (Springer 2006), also published in 12 Conn Ins L J 1 (2005–2006).

I. RESEARCH METHOD

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

The economic approach to the study of liability and insurance is likely to be the one most familiar to many legal scholars. The classical economic approach to liability insurance has been to view it as a means to further the deterrence function of law by reducing either the cost of prevention or expected harm, or both.[11] In addition to this approach, institutional economists studying insurance have emphasized the comparative advantages of liability insurance over other loss-prevention institutions.[12] Thus, one might expect liability insurance to serve a governance role not only because insurers assume responsibility for losses but also because this assumption of responsibility makes them more credible providers of loss-prevention services than alternative governance institutions.

The second major approach is the sociology of risk and insurance. Researchers have used sociological tools—especially qualitative interviews and participant observation—to explore the governance role of insurance institutions.[13] Epitomized by the recent work of Richard Ericson, Aaron Doyle, and Dean Barry,[14] this approach offers a nu-

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11 See generally Steven Shavell, *The Economic Analysis of Accident Law* (Harvard 1987).

12 See, for example, George M. Cohen, *Legal Malpractice Insurance and Loss Prevention: A Comparative Analysis*, 4 Conn Ins L J 305, 343–44 (1997–1998). He observes that liability insurers in effect guarantee their loss-prevention advice by assuming responsibility for the liability losses that result. This bundling of loss-prevention and risk-distribution services gives liability insurers an incentive to get the loss prevention right and, thus, should make their loss-prevention services more valuable than those of other loss-prevention services providers, such as experts, who do not assume any of the risk.

13 For a review of this literature through 2001, see Tom Baker and Jonathan Simon, *Embracing Risk*, in Tom Baker and Jonathan Simon, eds, *Embracing Risk: The Changing Culture of Insurance and Responsibility* 1, 7–17 (Chicago 2002) (analyzing changes in the way individuals and institutions conceptualize risk and insurance). For a general discussion, see Richard V. Ericson and Aaron Doyle, *Uncertain Business: Risk, Insurance, and the Limits of Knowledge* (Toronto 2004) (contrasting uncertainty in four fields of insurance and how the insurance industry plays different roles in each field); Richard V. Ericson, Aaron Doyle, and Dean Barry, *Insurance as Governance* (Toronto 2003); Richard V. Ericson and Aaron Doyle, eds, *Risk and Morality* (Toronto 2003). See also, for example, Tom Baker and Thomas O. Farrish, *Liability Insurance and the Regulation of Firearms*, in Timothy D. Lytton, ed, *Suing the Gun Industry: A Battle at the Crossroads of Gun Control and Mass Torts* 292, 312 (Michigan 2005) (finding, in part through interviews with underwriters, that liability insurers practiced "selective exclusion ... [keeping] the costs of gun violence out from under the insurance umbrella").

14 See generally Ericson, Doyle, and Barry, *Insurance as Governance* (cited in note 13) (offering an institutionally informed account of the governance role of a variety of forms of first party

anced view inside a field that quantitative data cannot provide.[15] While qualitative research of this sort does not provide conclusive evidence regarding the prevalence or extent of the practices observed, it can be used to frame more systematic quantitative analysis that may provide that evidence.[16] In the meantime, the persuasive power of qualitative research depends, like traditional doctrinal and policy arguments, on the reader's response to the coherence and plausibility of the analysis.

Our research seeks to join these two paths, analyzing the role of D&O insurance in corporate governance in a way that is both theoretically informed and empirically grounded. To gather our data, we interviewed, observed, and to a small extent even participated in the professional development of D&O insurance specialists. Our goal was to test the predictions of economic theory regarding the relationship between D&O insurance and corporate governance in the U.S., a relationship that has not been studied previously and that is not amenable to quantitative empirical research for at least two reasons. First, the relevant quantitative data concerning D&O insurance (pricing and limits) are not publicly available.[17] And, second, the deep governance factors that, as we will report, matter so much to D&O insurance underwriters are neither adequately specified nor publicly available.

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insurance). See also Ericson and Doyle, *Uncertain Business* at 5 (cited in note 13) (describing the underappreciated prominence of uncertainty, as opposed to risk, in the insurance business).

15 The techniques are, as noted, sociological. But they may be most familiar to legal scholars in the law and norms literature. See generally Robert C. Ellickson, *Order without Law: How Neighbors Settle Disputes* (Harvard 1991) (finding, primarily through field interviews, that neighbors in Shasta County, California, resolve most conflicts through the use of informal norms, rather than formal legal rules); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions*, 99 Mich L Rev 1724, 1725 (2001) (examining, through a detailed case study of the cotton industry, how private legal systems can reduce costs); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J Legal Stud 115 (1992) (describing the private legal system at work in the diamond industry).

16 See, for example, Kathryn Zeiler, et al, *Physicians' Insurance Limits and Malpractice Payments: Evidence from Texas Closed Claims, 1990–2003*, Journal of Legal Studies (forthcoming) ("[P]hysicians rarely paid out of their own pockets to satisfy malpractice claims."), confirming qualitative reports in Tom Baker, *Blood Money, New Money, and the Moral Economy of Tort Law in Action*, 35 L & Socy Rev 275, 314 (2001) ("[T]here is a norm among tort practitioners that tort litigation is *supposed to be* primarily about collecting insurance money."). See also Jonathan Klick and Catherine M. Sharkey, *The Fungibility of Damage Awards: Punitive Damage Caps and Substitution* 18 (FSU College of Law, Law and Economics Paper No 912256, June 2006), online at http://ssrn.com/abstract=912256 (visited Apr 12, 2007), confirming the phenomenon of "transforming punishment into compensation" reported on the basis of qualitative research in Tom Baker, *Transforming Punishment into Compensation: In the Shadow of Punitive Damages*, 1998 Wis L Rev 211.

17 See Griffith, 154 U Pa L Rev at 1150 (cited in note 6) (arguing for public disclosure of D&O insurance policy premiums and contract provisions). See also note 195 (describing existing quantitative research on this question).

We conducted in-depth, semistructured interviews with forty-one D&O professionals from late 2004 to early 2006.[18] We identified prospective interviewees by beginning with references from leaders of the Professional Liability Underwriting Society,[19] then proceeded outward to references from the initial interviewees. Our interviewees included: twenty-one underwriters from fourteen companies (including primary, excess, and reinsurance underwriters); three D&O actuaries from three companies (two of whom were the chief professional lines actuaries in their firms); six brokers from six brokerage houses; four risk managers employed by publicly traded corporations to purchase their insurance coverage; three lawyers who advise publicly traded corporations on the purchase of D&O insurance; and four professionals involved in the D&O claims process (two claims managers, one monitoring counsel, and one claims specialist from a brokerage house).[20]

Because the D&O insurance market is concentrated at the top—two insurers (AIG and Chubb) together account for more than half of the market for primary insurance by premium volume—and because the market is intermediated through the personal connections of a few brokerage firms, we are confident that we can accurately describe D&O insurance practices based on a number of interviews that may seem very small to researchers used to working with large quantitative data sets.[21]

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

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18 Pursuant to a research protocol approved by the Institutional Review Board of the University of Connecticut, we interviewed the participants under a promise of confidentiality. The interviews were recorded and transcribed, and participant identifying information was removed from the transcripts. Copies of the transcripts were provided to the editors of the University of Chicago Law Review for verification and returned to us.

19 The Professional Liability Underwriting Society is an association of specialists, including underwriters, brokers, consultants, and advisors in the professional lines insurance market. The Society's website is available at http://www.plusweb.org (visited Apr 12, 2007).

20 These roles are described in Part II.B.2. In addition, we attended six conferences for D&O professionals and engaged in many informal conversations, supplementing our interviews with industry documents as well as regular reading of trade and industry publications.

21 See, for example, Tillinghast, *2005 Survey* at 85 table 70 (cited in note 2).

II. D&O INSURANCE AND SHAREHOLDER LITIGATION

D&O insurance protects corporate directors and officers and the corporation itself from liabilities arising as a result of the conduct of directors and officers in their official capacity.[22] For private or nonprofit corporations, employment-related claims are the most common source of D&O liabilities.[23] For public corporations, however, the dominant source of D&O risk, both in terms of claims brought and liability exposure, is shareholder litigation.[24] Because our research exclusively examines D&O insurance for public corporations, we treat the central purpose of D&O insurance as providing coverage against shareholder litigation.

This Part provides a brief overview of covered claims and the structure of D&O coverage. Part II.A describes the basic types of shareholder claims and the principal liability exposures arising from them. Part II.B describes the core features of D&O policies. We invite readers already familiar with these matters to read selectively or to skip ahead to the next Part.

A. Shareholder Litigation—Principal Liability Exposures

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

A rough estimate of frequency—dividing all shareholder class actions by all publicly traded companies—suggests that public companies have about a 2 percent chance of being sued in a shareholder

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22 See, for example, definitions of "wrongful conduct" in the following policies: *AIG Specimen Policy 75011* § 2(z) (Feb 2002) (providing coverage for "any actual breach of duty, neglect, error, misstatement, misleading statement, omission or act ... by such Executive in his or her capacity as such or any matter claimed against such Executive solely by reason of his or her status as such"); *Chubb Specimen Policy 14-02-7303* § 5 (Nov 2002), online at http://www.chubb.com/businesses/csi/chubb2373.pdf (visited Apr 12, 2007) ("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, Directors, Officers and Company Liability Policy, Specimen DO 00 R292 00 0696* § IV(O)(2), online at http://www.hfpinsurance.com/forms/nj85.pdf (visited Apr 12, 2007) (defining coverage to include "any matter claimed against the Directors and Officers solely by reason of their serving in such capacity").

23 See Tillinghast, *2005 Survey* at 5 (cited in note 2) (reporting that "92% of the claims brought against nonprofit [participating companies] ... were brought by employees").

24 See id (reporting that "52% of the claims against [participating] public [companies] were brought by shareholders"). See also *Interview with D&O Advisor, Outside Counsel* (unpublished confidential transcript 2004) (confirming that for public companies, shareholder litigation is by far the larger liability risk under a D&O policy).

class action in any given year.[25] The exposure for some companies, of course, is much higher. Large companies tend to be sued more often than small ones.[26] Companies in certain industries tend to be sued more than others.[27] And Nasdaq companies are sued more often than NYSE companies.[28]

A rough estimate of severity can be taken by examining settlement amounts.[29] The numbers are not small. Average settlement values of shareholder class actions exceeded $24 million in 2005, up from $19 million in 2004.[30] The average settlement value for the years 2002–2005 was $22.3 million, significantly higher than the average settlement value of $13.3 million for the years 1996–2001.[31] Comparing median settlement values reveals a significant skew in these numbers. Median settlements in 2005 were $7 million, and the median annual settlement for the period 2002–2005 was $5.8 million, compared to $4.6 million for the period 1996–2001.[32] Shareholder suits are thus characterized by

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25 Cornerstone Research, *Securities Class Action Filings: 2005, A Year in Review* 4 (2006), online at http://securities.stanford.edu/clearinghouse_research/2005_YIR/2006012302.pdf (visited Apr 12, 2007) (estimating susceptibility to a federal securities class action for "companies listed on the NYSE, Nasdaq, and Amex" at the start of 2005 at 2.4 percent). See also Ronald I. Miller, Todd Foster, and Elaine Buckberg, *Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, is Stabilization Ahead?* 3 (NERA Economic Consulting 2006), online at http://www.nera.com/image/BRO_RecentTrends2006_SEC979_PPB-FINAL.pdf (visited Apr 12, 2007) (estimating susceptibility of all publicly traded corporations in 2005 at 1.9 percent).

26 See Tillinghast, *2005 Survey* at 99 (cited in note 2).

27 Which industries are sued most often fluctuates somewhat from year to year, suggesting a scandal *du jour* pattern in securities litigation. In 2005, the three industrial sectors receiving the most securities class action filings were consumer noncyclical, consumer cyclical, and finance. The year before, however, the top three industries in terms of filings were consumer noncyclical, technology, and communications. Cornerstone Research, *Securities Class Action Filings* at 14 (cited in note 25).

28 Id at 12 (stating that between 1996 and 2005, "there have been more class action filings against Nasdaq firms than against NYSE/Amex firms").

29 Because the vast majority of shareholder claims are either settled or dismissed, settlement amounts may be a fair measure of the value of a claim. Settlement values, however, are a poor measure of the total cost of shareholder litigation since they do not include defense costs, which account for a large, but not well documented, portion of D&O loss costs. Because D&O insurers reimburse policyholders for their defense costs as part of the indemnity coverage (as opposed to providing a defense and paying for that defense in addition to the indemnity coverage), the loss data that insurers file with regulators do not distinguish between settlement payments and defense costs. At one industry conference we attended, lawyers and claims managers disputed the total extent of the defense costs, but agreed that defense costs were at least 25 percent of a typical class action settlement. A claims manager reported that in recent years defense costs that were 50 percent or even 100 percent of the settlement amounts were increasingly common. Of course when a case is dismissed without payment the defense costs are the only covered losses.

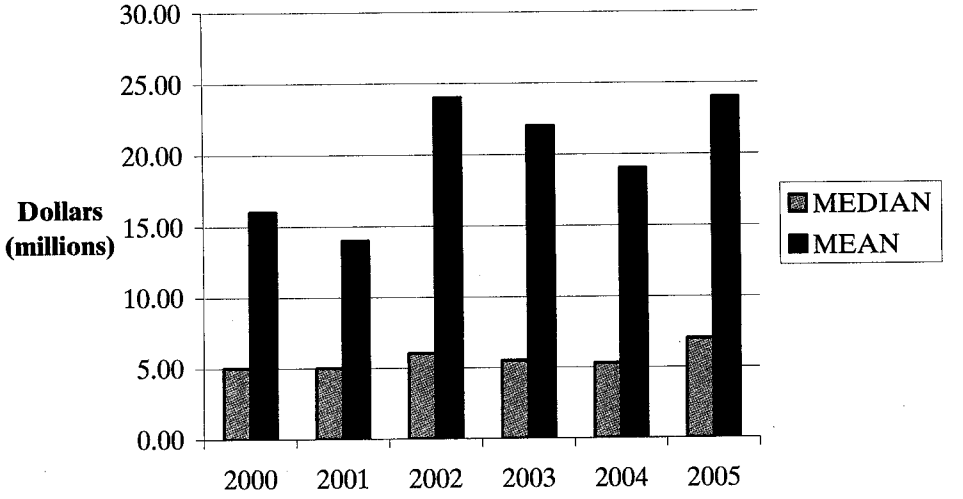
30 Miller, Foster, and Buckberg, *Recent Trends in Shareholder Class Action Litigation* at 5 (cited in note 25).

31 Id.

32 Id.

a handful of very large settlements, while the typical case settles for a considerably lower amount.[33]

FIGURE 1: MEDIAN AND MEAN SECURITIES LITIGATION SETTLEMENTS, 2000–2005



Source: Miller, Foster, and Buckberg, *Recent Trends in Shareholder Class Action Litigation* at 5 (cited in note 25).

Doctrinally, shareholder suits include both corporate fiduciary duty claims, whether derivative or direct,[34] and securities law claims.[35] The possible grounds for complaints are many.[36] However, the basic concern underlying all such claims is a divergence between managerial conduct and shareholder welfare—the problem, in other words, of agency costs.[37] Whether the claim is that managers looted the company

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33 Lower, but by no means insignificant. In 2005, only 27 percent of settlements were below $3 million, compared to 45 percent in 1996. Id.

34 See Robert B. Thompson and Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 Vand L Rev 133, 137 (2004) (finding that approximately 80 percent 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 percent of fiduciary duty claims over the same period were derivative suits).

35 Securities litigation arises under both the Securities Act of 1933, 15 USC §§ 77a et seq (2000), and the Securities Exchange Act of 1934, 15 USC §§ 78a et seq (2000).

36 See, for example, William E. Knepper and Dan A. Bailey, *Liability of Corporate Officers and Directors* § 17.02 at 17-3 to 17-10 (Bender 7th ed 2003) (listing 170 possible grounds for liability in shareholder litigation).

37 See generally Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J Fin Econ 305 (1976) (identifying the divergence in interests between shareholder principals and manager agents as a central feature of the corporate form). See also Robert B. Thompson and Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 Vand L Rev 859, 903 (2003) (arguing that

or negligently managed it or lied to investors in order to inflate their own compensation packages, the basic concern is that management has sought to serve its own interests rather than the interests of its investors.[38] Of all the litigation that such conduct can generate, securities law claims represent by far the greatest liability risk.[39]

Securities law claims, whether brought as an enforcement action by the Securities and Exchange Commission[40] or by private plaintiffs through the class action mechanism,[41] are typically framed around a misrepresentation. Most often, a company releases false or misleading information that has the effect of inflating its share price and inducing investors to buy; when the information is later revealed as false, the company's share price drops and all investors who bought in at the artificially high price lose a portion of their investment.[42] The securities laws create several causes of action for such situations, the most important of which is Rule 10b-5 under § 10(b) of the Exchange Act.[43]

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the basic corporate governance concern—the divergence between managerial interests and shareholder welfare—has become a common underlying basis in securities fraud claims).

38 Misstatements designed to keep the firm afloat, as opposed to those designed merely to pad executive pay packages, may not seem to arise from agency costs because they arguably benefit the firm. However, any benefit to current shareholders—through, for example, overstated earnings—comes at the expense of future shareholders, those who buy in under the misrepresentation and therefore pay too much for their shares and also those who fail to sell prior to the corrective disclosure. This reveals a temporal conflict between investors generally. See generally Steven L. Schwarcz, *Temporal Perspectives: Resolving the Conflict between Current and Future Investors*, 89 Minn L Rev 1044 (2005). But the securities laws do not excuse fraud designed to benefit one class of investors (current shareholders) over another (prospective shareholders). Instead, the securities laws adopt an ex ante perspective in order to curb managerial conduct harmful to the investor class generally. See, for example, *Pommer v Medtest Corp*, 961 F2d 620, 623 (7th Cir 1992) ("The securities laws approach matters from an ex ante perspective: just as a statement true when made does not become fraudulent because things unexpectedly go wrong, so a statement materially false when made does not become acceptable because it happens to come true.").

39 See Tom Baker and Sean J. Griffith, *D&O Interviews*, Counsel #1 at 10 (unpublished confidential transcripts 2005) (on file with authors) ("The big exposure to D&O, as I am sure you know, is that number one head and shoulders above everything else is securities class actions."). See also id, Counsel #3 at 5 ("[S]ecurities litigation outweighs derivative litigation by far."). The protocols for these interviews are explained in note 18.

40 See 15 USC §§ 77s–77t, 78u(a), (d) (2000) (empowering the SEC to investigate and seek injunctive relief for violations of the Securities and Exchange Acts).

41 See, for example, *Herman & McLean v Huddleston*, 459 US 375, 380 (1983) ("[A] private right of action under Section 10(b) . . . and . . . Rule 10b-5 has been consistently recognized for more than 35 years. The existence of this implied remedy is simply beyond peradventure."). See also generally John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 Md L Rev 215 (1983) (describing and critiquing private enforcement of the securities laws).

42 See generally Louis Loss and Joel Seligman, 9 *Securities Regulation* 4114–54 (Aspen 3d ed 2004) (discussing typical patterns in securities litigation).

43 15 USC § 77l (2000); 17 CFR § 240.10b-5 (2006). 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 any security." Id. See also *Blue Chip Stamps v Manor Drug Stores*, 421 US 723, 753–55 (1975). Rule 10b-5 plaintiffs must show materiality, scienter, causation, and reliance. In

Sections 11 and 12(2) of the Securities Act are a distant second and third, respectively.[44] In 2005, 93 percent of securities class actions alleged violations of Rule 10b-5.[45] Only 9 percent alleged a § 11 violation, and only 5 percent alleged a § 12(2) claim.[46]

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

B. The Anatomy of D&O Insurance

D&O liability insurance coverage evolved from basic corporate liability policies but was not commonly purchased by U.S. corporations until the early- to mid-1960s.[48] Although it was initially unclear whether corporations would be legally permitted to insure directors and officers against losses that the corporation could not legally indemnify,[49] the question was settled when state legislatures enacted statutes expressly permitting D&O insurance regardless of whether the loss was one that the corporation itself could indemnify.[50] This Part

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practice, however, these elements tend to blend together, at least for actively traded securities. See *Basic Inc v Levinson*, 485 US 224, 230–33, 241–48, 261 (1988) (discussing the elements of a 10b-5 claim and establishing the presumption of reliance on the basis of a "fraud on the market" theory).

44 15 USC §§ 77k, 77l(a)(2) (2000). Section 11 claims involve misrepresentations made by the issuer, underwriter, auditors, or attorneys involved in a registered public offering of securities and, unlike 10b-5 claims, do not require a plaintiff to show scienter, causation, or reliance. Section 11 defendants, however, have mechanisms at their disposal to rebut scienter and reliance and to reduce or eliminate damages by disproving causation. Loss and Seligman, 9 *Securities Regulation* at 4258–62 (cited in note 42).

45 Cornerstone Research, *Securities Class Action Filings* at 16–17 (cited in note 25).

46 Id.

47 See Thompson and Sale, 56 Vand L Rev at 903–04 (cited in note 37) ("[T]he state law default norm centralizes corporate power in the hands of management—more specifically, directors—and these forms of litigation check the abuse of that position.").

48 See Joseph F. Johnston, Jr., *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 Bus Law 1993, 2012 (1978).

49 See Joseph W. Bishop, Jr., *New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability*, 22 Bus Law 92, 106–07 (1966) (analyzing, based on the then-current state of the law, whether insurance companies could legally offer D&O coverage to corporations for risks for which the insurer could not directly indemnify the director). Although corporate indemnification is broadly permitted under the law of most states, many states, including Delaware, do not permit indemnification for amounts paid in settlement of derivative claims. See 8 Del Code Ann § 145(a) (2001) (permitting indemnification for expenses, judgments, and settlements, except for those actions "by or in the right of the corporation"). Although the SEC has long maintained that indemnification for securities law claims is contrary to public policy, it is firmly established that the settlement of federal securities law claims may be paid for through indemnification or insurance. See, for example, *Raychem Corp v Federal Ins Co*, 853 F Supp 1170, 1177–78 (ND Cal 1994) (holding indemnification permissible under both federal and Delaware law).

50 For example, Delaware General Corporation Law § 145(g) provides:

first discusses typical coverage terms, then the basic structure of the market for D&O insurance.

1. Coverage.

A typical D&O policy sold to a publicly traded corporation contains three different types of coverage. First, there is coverage to protect individual managers from the risk of shareholder litigation.[51] This type of coverage is typically referred to by industry professionals as "Side A" coverage, and we believe it is what most nonspecialists think of as D&O insurance. However, D&O policies also contain two other, less widely known types of coverage. The second type, referred to within the industry as "Side B" coverage, reimburses the corporation for its indemnification payments to officers and directors.[52] And the third, "Side C" coverage, protects the corporation from the risk of shareholder litigation to which the corporate entity itself is a party.[53]

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

8 Del Code Ann § 145(g). See also Joseph Warren Bishop, Jr., *The Law of Corporate Officers and Directors: Indemnification and Insurance* § 8.1 at 8-2 (West Supp Nov 2006) ("All states authorize the corporation to purchase and maintain insurance on behalf of directors and officers against liabilities incurred in such capacities, whether or not the corporation would have the power to indemnify against such liabilities.").

[51] 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, for example, *Hartford Specimen Policy* at § I(A) (cited in note 22); *Chubb Specimen Policy* at § 1 (cited in note 22); *AIG Specimen Policy* at § 1 (cited in note 22).

[52] 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 at § I(B). See also *Chubb Specimen Policy* at § 2; *AIG Specimen Policy* at § 1 Coverage B. Policies typically deem indemnification to be required in every situation where it is legally permitted, thus preventing the corporation from opportunistically pushing the obligation to the insurer by simply refusing to indemnify its directors and officers. See *Hartford Specimen Policy* at § VI(F) (providing that if a corporation is legally permitted to indemnify its officers and directors, its organizational documents will be deemed to require it to do so). See also *Chubb Specimen Policy* at § 14; *AIG Specimen Policy* at § 6.

[53] 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* at § I(C). See also *Chubb Specimen Policy* at § 3; *AIG Specimen Policy* at § 1 Coverage B(i). A securities claim is defined in the policy to include claims by securities holders alleging a violation of the Securities Act or the Exchange Act or rules and regulations promulgated pursuant to either act as well as similar state laws and includes claims "aris[ing] from the purchase or sale of, or offer to purchase or sell,

Side A coverage typically includes no retention (deductible) or co-insurance amount.[54] Sides B and C, however, do.[55] Covered losses include compensatory damages, settlement amounts, and legal fees incurred in defense of claims arising as a result of the official acts of directors and officers—principally including, as described above, shareholder litigation.[56]

D&O policies have three principal exclusions: (1) the "Fraud" exclusion for claims involving actual fraud or personal enrichment, (2) the "Prior Claims" exclusion for claims either noticed or pending prior to the commencement of the policy period, and (3) the "Insured v. Insured" exclusion for litigation between insured persons.[57] The Fraud exclusion prevents insureds from receiving insurance benefits when they have actually committed a wrongful act, often defined as a "dishonest or fraudulent act or omission or any criminal act or omission or any willful violation of any statute, rule or law."[58] Whether an act comes within the Fraud exclusion depends upon the wording of the policy, which may require "final adjudication" of the fraudulent act or merely evidence that the fraudulent act has "in fact" occurred.[59] The

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any Security issued by the Company," regardless of whether the transaction is with the company or over the open market. *Hartford Specimen Policy* at § IV(M). See also *Chubb Specimen Policy* at § 5 "Securities Claim"; *AIG Specimen Policy* at § 2(x). If the company purchases Side C coverage, the definitions of "securities claim," "loss," and "wrongful act" expand to include the company and not just the directors and officers. *Chubb Specimen Policy* at § 3.

54 See Tillinghast, *2005 Survey* at 52 (cited in note 2) (reporting that 98 percent of U.S. respondents who purchased D&O insurance had no deductible associated with their Side A coverage).

55 For further discussion of the types of coverage and the puzzles and problems created by each, see Baker and Griffith, 95 Georgetown L J (forthcoming 2007) (cited in note 8); Griffith, 154 U Pa L Rev at 1162–68 (cited in note 6).

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

57 See *AIG Specimen Policy* at § 4(b)–(c), (e)–(f), (i)–(j); *Chubb Specimen Policy* at §§ 6(a)–(c), 7–8; *Hartford Specimen Policy* at §§ IV(i)–(j), V(C)–(D).

58 Executive Risk Indemnity, Inc., *Broad Form Directors and Officers Liability Insurance* III.A.3. Similar language appears in both the AIG, Chubb, and Hartford policies. See also note 62. 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* at § 4(a); *Chubb Specimen Policy* at § 7–8; *Hartford Specimen Policy* at § V(I).

59 Insureds typically seek to include "final adjudication" language to clarify that the actual fraud only applies if there has been a final adjudication of actual wrongdoing by the insured, while the insurer may seek less strict "in fact" language, setting a lower threshold for the deter-

Prior Claims exclusion carves out any claims noticed or pending prior to the commencement of the current policy, which ordinarily would be covered under a prior policy.[60] Finally, the Insured v. Insured exclusion withholds insurance proceeds for losses stemming from litigation between insured parties, such as directors suing the corporation or the officers or the corporation suing an officer or director.[61] Other common exclusions remove peripheral claims—such as environmental claims, ERISA claims, claims alleging bodily injury or emotional distress, and claims arising from service to other organizations[62]—from the scope of coverage, leaving shareholder litigation as the principal covered risk.[63]

The discussion above captures several key terms of D&O policies, but it is worth noting that coverage terms can be negotiated and therefore are difficult to generalize. Both buyers and sellers are highly sophisticated and have legal expertise at their disposal. Moreover, there is no standardized form to this line of insurance.[64] Shopping for coverage thus requires comparing, and to some degree negotiating, both prices and terms. Nevertheless, all D&O policies have the effect of shifting the risk of shareholder litigation from individual directors and officers and the corporation they manage to a third-party insurer. When shareholders sue their officers or directors, it is usually an insurer that pays.[65]

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mination of actual fraud and, therefore, applicability of the exclusion. See *D&O Interviews*, Counsel #3 at 2–3 (cited in note 39).

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

61 See, for example, *Fidelity & Deposit Co of Maryland v Zandstra*, 756 F Supp 429, 431–32 (ND Cal 1990). Like the family member exclusion in homeowners' insurance policies, the purpose is to avoid collusive litigation. See Robert H. Jerry II, *Understanding Insurance Law* 1030 (Bender 3d ed 2002). Derivative litigation, when successfully maintained independent of the board—as for example, when demand has been excused—is carved out of the exclusion, with the effect that the Insured v. Insured provision operates to exclude from coverage only those actions that are willfully maintained by insured persons. See generally *Zapata v Maldonado*, 430 A2d 779 (Del 1981) (discussing the demand mechanism in derivative litigation).

62 See *AIG Specimen Policy* at § 4(g)–(h), (k), (m); *Chubb Specimen Policy* at § 6(d)–(h); *Hartford Specimen Policy* at § V(A), (F)–(G).

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

64 See generally, for example, Susan J. Miller and Philip Lefebvre, *Miller's Standard Insurance Policies Annotated* (1997) (collecting clause-by-clause case citations to a variety of standard insurance policies published by the Insurance Services Office, Inc).

65 See note 3.

2. The market for D&O insurance.

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

The buyers of D&O insurance that we focused on in this study are publicly traded corporations.[66] The most commonly cited reason for the purchase of D&O insurance is the recruitment and retention of qualified officers and directors.[67] Corporations are eager to assure their officers and directors that their personal assets will not be at risk as a result of accepting a board seat or other position with the company.[68] However, as we discuss at length elsewhere, this explanation only applies to the purchase of one of the three lines of coverage—Side A coverage—in a typical D&O policy.[69] The actual purchase of D&O insurance, at least for larger corporations, is likely to be handled by the company's "risk manager," a management position that typically reports to the treasurer or chief financial officer.[70] As we describe below, however, decisions on D&O insurance and assistance in the marketing of the company to prospective underwriters often involve the firm's legal department and top-level management.[71]

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66 As we noted above, D&O insurance is also purchased by private and nonprofit corporations, but the insurance market for these organizations is distinct from the market for public corporations and therefore outside of the scope of this research. See note 23 and accompanying text.

67 D&O insurance can help corporations recruit and retain well-qualified directors:

> The insurance crisis of the mid-1980s highlighted the exposure of corporate D&Os . . . . Without adequate resources to defend increasing litigation and to protect their personal assets from bankruptcy, directors of major corporations threatened mass defections from boardroom [sic] across America. Thus, some of the most talented candidates for D&O positions became unwilling to take key leading roles within the corporate structure.

Terrence G. Stolly, Comment, *Scienter Under the Private Securities Litigation Reform Act of 1995: Unexpected Implications on Director and Officer Liability and D&O Insurance*, 29 Cap U L Rev 545, 578–79 (2001). See also Tillinghast, *2005 Survey* at 3 (cited in note 2) (reporting that in 2005 approximately 50 percent of for-profit survey respondents had received an inquiry from directors about the company's D&O coverage).

68 See Black, Cheffins, and Klausner, 58 Stan L Rev at 1140 (cited in note 3) (positing that a high level of risk "could well deter good candidates from serving").

69 See Part II.B.1. See also Baker and Griffith, 95 Georgetown L J (forthcoming 2007) (cited in note 8); Griffith, 154 U Pa L Rev at 1162–68 (cited in note 6).

70 The risk manager is responsible for all of a company's insurance lines. Our participants reported that in some cases the chief financial officer of a corporation may handle the insurance purchasing directly. See, for example, *D&O Interviews*, Risk Manager #2 at 13 (cited in note 39).

71 See note 108 and accompanying text.

The amount of D&O insurance purchased correlates with the market capitalization of the corporate buyer.[72] According to Tillinghast, in 2005, small-cap companies—defined here as those with market capitalizations between $400 million and $1 billion—purchased an average of $28.25 million in D&O coverage limits.[73] Mid-cap companies—those with market capitalizations between $1 billion and $10 billion—purchased an average of $64 million in limits.[74] And large-cap companies—those with market capitalization in excess of $10 billion—purchased an average of $157.69 million in D&O coverage.[75] The largest available coverage limit mentioned by the participants in our study was $300 million.[76]

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

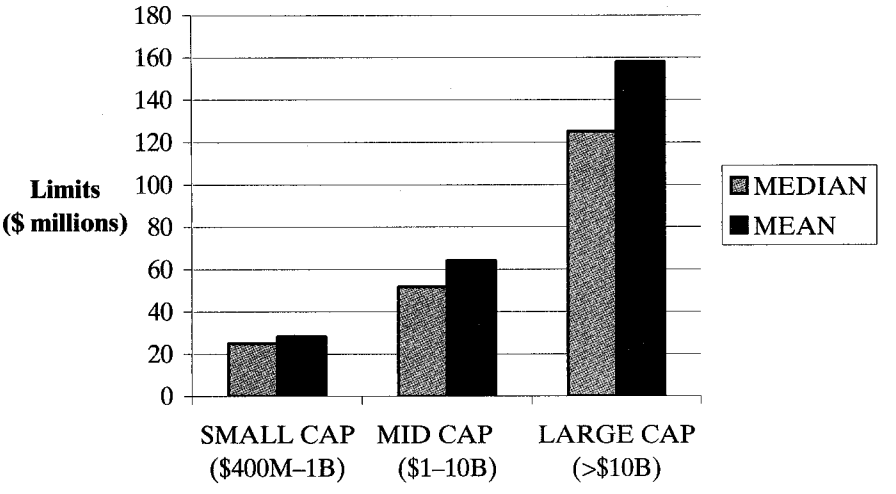
73 See Tillinghast, *2005 Survey* at 29 table 17C (cited in note 2).

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

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

76 See *D&O Interviews*, Risk Manager #3 at 6 (cited in note 39). See also id, Underwriter #13 at 37–38.

FIGURE 2: ANNUAL D&O POLICY LIMITS BY MARKET CAPITALIZATION CATEGORY



Source: Tillinghast, *2005 Survey* at 29 table 17C (cited in note 2) (2005 data). We derived the "Mid Cap" category as a weighted average of three market capitalization classes reported by Tillinghast. See note 74.

In general, no one insurer is willing to underwrite the entire limits purchased by any one corporation. This is especially true for the high-limit policies purchased by large- and mid-cap companies. Our participants reported that $50 million was the largest limit available in the late 1990s from a single insurer and noted that, in the late 2005 market, few insurance carriers were offering a policy larger than $25 million and that most policies had limits of $10 million or less.[77] As a result of these constraints, corporations must purchase several D&O policies in order to reach the aggregate amount of insurance they desire. D&O insurance packages are thus said to come in "towers"—that is, separate layers of insurance policies stacked to reach a desired total amount of coverage.

The bottom layer of a D&O tower is called the "primary policy," and the insurance company offering that policy is referred to as the "primary insurer." Primary insurers have the closest relationship with the policyholder. Because the primary insurer's policy is the first to respond to a covered loss and therefore is the most likely to incur a payment obligation, the primary insurer charges a higher premium

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77 See, for example, *D&O Interviews*, Actuary #3 at 10 (cited in note 39).

than those higher up in the tower of coverage. The market for primary insurance is dominated by a small number of companies, most significantly AIG and Chubb.[78]

Excess insurers—those higher up in the tower—become responsible for covered losses on a layer-by-layer basis as the limits of each underlying policy become exhausted by loss payments.[79] Excess policies typically are sold on a "following form" basis, meaning that the contract terms (other than limits and price) in the excess policy are the same as those in the underlying policy. Because all excess policies are less likely to respond to a covered loss than the primary policy and each successive layer of excess insurance is less likely to respond to a claim than the layer immediately beneath it, the premiums associated with excess policies are lower the higher the policy is situated in the tower of coverage. As a result, the total premium that a corporate insured pays for its D&O coverage will be a blended amount of several distinct premiums paid to separate insurance companies.[80] The higher the limits a corporation buys, the more companies that are likely to make up the tower of coverage.

It is brokers who assemble these towers of coverage. The D&O market, like the corporate insurance market generally, is brokered. The largest retail insurance brokers—Marsh, Aon, Willis, and other national or large regional brokers—have in-house D&O specialists, while smaller brokerage firms may use a specialist wholesale broker (a broker's broker) to shop for and assemble a client's D&O coverage. Recent investigations into the insurance brokerage industry suggest that there are opportunities for brokers to abuse their role.[81] Whether any such conduct took place in brokerage firms' D&O lines is beyond

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78 According to Tillinghast, in 2005 AIG and Chubb together controlled 53 percent of the total U.S. market measured by premium volume and 36 percent of the total U.S. market by policy count. Tillinghast, *2005 Survey* at 86 figs 36 and 37 (2006) (cited in note 2).

79 Although the claims process is outside the scope of this article, it is worth noting that a settlement that involves multiple layers—commonly the case in a low frequency, high severity line of insurance like public D&O—requires consent from all the insurers. See Black, Cheffins, and Klausner, 58 Stan L Rev at 1100 & n 149 (cited in note 3) ("Under the terms of D&O policies, the insurer's consent to a settlement is required for funds to be available.... [A]n insurer might resist a settlement [because] multiple insurers with different layers of coverage cannot agree on how to handle the case."). Insurance law has mechanisms that address the hold-up problem presented by settlements involving multiple insurers.

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

81 See Sean Fitzpatrick, *The Small Laws: Eliot Spitzer and the Way to Insurance Market Reform*, 74 Fordham L Rev 3041, 3043–49 (2006) (analyzing the development of unethical business "steering" and outright bid rigging in the excess casualty insurance markets). See also generally Daniel Schwarcz, *Beyond Disclosure: The Case for Banning Contingent Commissions*, 25 Yale L & Policy Rev (forthcoming 2007).

the scope of this research. What we can report, however, is that a substantial role for brokers in the D&O market seems inescapable as a result of: (1) the nonuniform nature of D&O insurance policies; (2) the need to assemble a tower of coverage from the policies of many different insurance companies; and (3) the need for a trusted intermediary to convey information between buyer and seller.

Rounding out our list of the main participants in the D&O market are reinsurers. Not every D&O insurer uses reinsurance—our participants reported, in fact, that at least some of the market leaders did not use it at all during the period of our study—but many do.[82] Reinsurers insure the risks undertaken by insurance companies, effectively providing a further means of risk spreading.[83] Reinsurance also provides new entrants with an easy means of accessing the D&O insurance market and established insurers with a quick means of increasing their D&O exposure. Similarly, the easiest way for an insurance company to reduce its D&O exposure without eliminating existing customers is to reinsure a larger share of its business.

3. Market cycles.

No description of the D&O insurance market would be complete without some mention of the insurance underwriting cycle. For reasons that have yet to be fully explained, insurance markets follow a boom and bust pattern that is similar to, but not closely correlated with, other business cycles.[84] More specifically, the underwriting cycle refers to the tendency of premiums and restrictions on coverage and underwriting to rise and fall as insurers tighten their standards in response to the loss of capital or, alternately, loosen their standards in

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[82] Our participants reported that most of the leading global and domestic reinsurance companies active in the U.S. liability insurance market have provided D&O reinsurance in the recent past and that D&O reinsurance is also offered by some Lloyds syndicates and by several of the newer, Bermuda-based reinsurers. See, for example, *D&O Interviews*, Underwriter #9 at 27–29 (cited in note 39).

[83] D&O reinsurance, like reinsurance generally, may be provided on either a *treaty* or a *facultative* basis. In treaty reinsurance, the reinsurer assumes a portion of all risks underwritten by the insurer within a defined category, such as public company D&O, and therefore evaluates the insurer's risk portfolio as a whole. In facultative reinsurance, the reinsurers assume a portion of a particular policy and therefore underwrite each risk individually, typically on an excess-of-loss basis. See generally Stanford Miller, *The Working Excess of Loss Treaty in Property Insurance*, in Robert W. Strain, ed, *Reinsurance* 161 (College of Insurance 1980).

[84] For a detailed examination of the underwriting cycle that reviews the literature, see generally Tom Baker, *Medical Malpractice and the Insurance Underwriting Cycle*, 54 DePaul L Rev 393 (2005) (describing the underwriting cycle as applied to medical malpractice). For a claim that the underwriting cycle is correlated with interest movements, see generally Robert T. McGee, *The Cycle in Property/Casualty Reinsurance*, 11 Fed Res Bank NY Q Rev 22 (1986) (describing the link between interest rates and insurance cycles, and closely examining the period from 1975 to 1984).

order to maintain or grow market share when new capital enters the market.[85] The tightening of underwriting standards accompanies a "hard market" in which premiums and, after a lag, underwriting profits, rise.[86] Increased underwriting profits, of course, spur competition, whether from new entrants or established companies seeking to increase market share, and competition leads to another "soft market" of loosening of underwriting standards and declining profits. The process is described as cyclical because each market condition contains the seed to generate the other.[87]

All aspects of underwriting are affected by the cycle. In a hard market, underwriters become more selective, more interested in higher attachment points, less willing to offer high limits, less willing to negotiate contract terms, and able to command dramatically higher prices for what amounts to less coverage. The D&O insurance market went through this "hard" phase in the mid-1980s and again in 2001–2003.[88] More recently, the D&O insurance market has been shifting to the "soft" phase.[89]

The underwriting cycle has significant consequences for the research reported in this Article. Because of the cycle, no snapshot of the underwriting process can present an adequate basis for understanding insurance underwriting over time. Our snapshot of the underwriting process took place at a transition period when the under-

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85 See, for example, Scott E. Harrington, *Tort Liability, Insurance Rates, and the Insurance Cycle*, in Robert E. Litan and Richard Herring, eds, *Brookings-Wharton Papers on Financial Services: 2004* 97, 107–08 (Brookings Institution 2004). Some economists have recently suggested that the pattern is more variable and random than the term "cycle" implies. See generally Anne Gron and Andrew Winton, *Risk Overhang and Market Behavior*, 74 J Bus 591 (2001) (comparing the liability insurance crisis of the 1980s with the catastrophe insurance crisis of the 1990s to suggest that the "risk overhang," or time an insurer was left with outstanding liability to claims, affected the duration of the crises in question). Nevertheless, the concept of a "cycle" is so firmly established within the industry that we will continue to use the term. See, for example, Matthew Dolan, *Repeating the Sins of Market Cycles*, 2 Insights 1 (2003), online at http://www.onebeaconpro.com/insights/insights_vol2_sp.pdf (visited Apr 12, 2007) ("Today, [medical malpractice] is in the midst of a 'hard market' cycle.").

86 The lag occurs because, at the start of a hard market, insurers increase the reserves set aside to pay claims under policies previously sold, suppressing profits for a least one year. See Baker, 54 DePaul L Rev at 400 (cited in note 84).

87 See Sean M. Fitzpatrick, *Fear is the Key: A Behavioral Guide to Underwriting Cycles*, 10 Conn Ins L J 255, 256 (2003–2004) (analyzing the role that underwriters, claims analysts, and actuaries play in creating the underwriting cycle). One of our participants reported, "It is funny how you find sometimes that questions either go away or they are not as substantial as they were maybe in a harder insurance market where the premiums were higher and there is less capacity." *D&O Interviews*, Underwriter #14 at 17 (cited in note 39).

88 See Roberta Romano, 14 Del J Corp L at 1–2 (cited in note 4).

89 See *D&O Interviews*, Underwriter #4 at 4 (cited in note 39) (asserting that pricing is now "pretty much inadequate across the sectors"). See also Tillinghast, *2005 Survey* at 3 ("[T]he market for D&O coverage has continued to soften.").

writing practices of the hard market were largely still in place but prices were beginning to soften. Although we tried to compensate for this snapshot by asking our participants to take a historical view and not to focus only on the very recent past, it is possible that our research overemphasizes practices more prevalent in a particular phase of the underwriting cycle.[90] In a soft market, for example, D&O insurers may be less selective and may give discounts that reduce the differences in risk bases among insureds.

III. UNDERWRITING AND RISK ASSESSMENT

Underwriting is the collective process that insurers use to decide whether or not to offer coverage to a prospective insured and, if so, at what amounts, at which layer of the tower, and, of course, at what price.[91] Each of these basic underwriting decisions depends upon the insurer's assessment of the risk posed by the prospective insured. This risk assessment is the most critical aspect of the underwriting process and the subject of this Part.

A. Assessing the Risk of Shareholder Litigation

The underwriters we interviewed all had their own method of assessing D&O risk, the precise details of which they were typically unwilling to share.[92] Some claimed that their underwriting process was driven by a mathematical model,[93] while others described hashing out these decisions in discussion with colleagues around a large table.[94] All of the underwriters we talked to, however, emphasized the importance

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90 See *D&O Interviews*, Broker #2 at 22 ("In a soft market, you are more likely to be able to find an insurance company that will take the chance and write the policy, you know, write coverage with prior acts, maybe even off the continuity and not require a warranty application. You know, in the soft market right now one of the things that we are finding is that companies are willing to offer nonrescindable Side A coverage. That is really something that has just sort of happened within the last, you know, maybe 2, 3, 4 months").

91 One of our participants abbreviated these basic underwriting tools with the acronym "SLAP"—Selection (of risk), Limits (of coverage), Attachment point (within the tower), and Pricing (of the policy). See *D&O Interviews*, Underwriter #9 at 9–11 (cited in note 39).

92 One joked, "I would have to kill you if I told you." *D&O Interviews*, Underwriter #2 at 8 (cited in note 39). In the words of another, "[W]e spend a lot of time studying [what factors correlate to D&O risk]. We know quite well, but again it is private." Id, Underwriter #4 at 3.

93 Id, Underwriter #8 at 11–12 (discussing quantitative methods of analyzing tolerances to stock volatility).

94 In the words of a former line underwriter:

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

Id, Underwriter #6 at 24–25.

of individual risk rating. This surprised us somewhat since, by analogy to portfolio theory, we expected at least some insurers to take an index approach and seek to diversify their risks by underwriting a portion of the entire D&O market.[95] None did. In fact, one of the underwriters we interviewed sharply rebuffed the suggestion:

> That is not enlightened thinking. If you followed that through to the end, why wouldn't you just simply regress to the mean . . . ? I mean, if your actuary assumes that you are just going to do average and he is going to make you price the business for average, right, how do you get more aggressive on the better business?[96]

Every underwriter in our sample sought to underwrite "better business"—that is, better D&O risks. One participant candidly described his firm's goal to "out-select [its] peers."[97]

Some underwriters described moving toward a more portfolio-based approach, in which their firms attempt to balance their exposure by industry sector and market cap.[98] But these insurers still stress risk selection.[99] In other words, even as insurers seek to spread their exposures, they nevertheless take care in the design of their risk pools and select insureds on the basis of individual risk characteristics. D&O insurance companies have strong incentives—avoiding losses and out-selecting competitors—to assess the risk of shareholder litigation accurately. Thus, if we want to understand shareholder litigation risk, D&O insurance underwriting practices are a good place to start. And if we want to find the annualized present value of shareholder litiga-

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95 See generally Edwin J. Elton, et al, *Modern Portfolio Theory and Investment Analysis* (John Wiley 6th ed 2003). Applying the lesson of portfolio theory, an underwriter might seek to underwrite a thin sliver of each risk and thus participate in the returns of the D&O market as a whole.

96 *D&O Interviews*, Underwriter #15 at 31 (cited in note 39).

97 Id, Underwriter #8 at 35. Whether, in fact, this can be done or whether, instead, D&O underwriters simply succumb to the Lake Woebegone illusion—where all the children are above average—we leave for another day. More generally, we discuss reasons to doubt underwriters' ability accurately to predict D&O risk. See note 172 and accompanying text.

98 Several participants did describe their "limit management" strategy—that is, reducing the insurer's exposure to any one D&O risk by reducing the maximum limits available to any one insured. See, for example, *D&O Interviews*, Actuary #3 at 13 ("[W]hat we try to stress in our portfolio is diversification by industry, diversification by size, and . . . laying a good limits management strategy on top of all that."), Underwriter #1 at 8–9 (reporting a strategy of risk pool diversification by industry), Underwriter #9 at 24 ("[Portfolio underwriting in D&O], which is stepping away from an individual risk and looking at a portfolio risk, is also merging into yet other corporate finance concepts.") (cited in note 39).

99 See id, Actuary #3 at 13–14 (stating that "most underwriters still feel that selection is important" and describing the insurer's efforts, within a given risk category, "to pick the best in class within that industry").

tion risk for any particular corporation, D&O insurance premiums are the only place to look.[100]

In making their risk assessments, underwriters look to three principal sources of information about the prospective insured.[101] First, there is an application process through which underwriters elicit basic information, including the experience of covered officers and directors and the claims history of the corporation,[102] plans for acquisitions or securities issuances,[103] and whether any prospective insured has "prior knowledge" of acts or omissions likely to give rise to a claim.[104] The written application also contains an important bonding mechanism: forcing the prospective insured to commit to the veracity of all written statements and documents furnished in connection with the application.[105] Because an applicant furnishing untrue information creates the basis for a subsequent rescission action, the credibility of information provided through the application is enhanced.[106]

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100 See also Griffith, 154 U Pa L Rev at 1182–85 (cited in note 6) (arguing for public disclosure of D&O insurance premiums and other policy terms on this basis).

101 *D&O Interviews*, Underwriter #9, Seminar Tapes 1 & 2 at 29–30 (cited in note 39) (describing the importance of "applications ... [and] specialized questionnaires often-times focused on specific industry categories" as well as "meetings in which underwriters are posing questions to officers of the company in regard to business practices, in regard to their current activities, and in regard to their future plans").

102 Applicants are asked both to describe any claims activity under a previous carrier and whether any covered individual has ever been involved in securities or antitrust litigation, criminal or administrative actions, derivative claims, or such representative proceedings. See, for example, Chubb Group of Insurance Companies, *D&O Elite Directors and Officers Liability Insurance Application 033307* § II.5 (2003), online at http://www.chubb.com/businesses/csi/chubb3495.pdf (visited Apr 12, 2007); AIG, *D&O First Main Form Application 8116* § VI (2003), online at http://www.aignationalunion.com/nationalunion/public/natfiledownload/0,2138,1873,00.pdf (visited Apr 12, 2007).

103 The Hartford, *Proposal for Directors, Officers, and Company Liability Insurance DO 00 R288* § 3 (2003), online at http://www.hfpinsurance.com/apps/do00r288.pdf (visited Apr 12, 2007); *Chubb D&O Elite Application* at § II.4; *AIG D&O First Main Application* at §§ IV, V.

104 See *Chubb D&O Elite Application* at § II.6; *Hartford D&O Proposal* at § 1.5(b) (cited in note 103). This representation in the application typically interacts with the Prior Claims exclusion to exclude or limit the insurer's exposure to such claims. See sources cited in note 62 and accompanying text.

105 For example, a Chubb D&O application provides:

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

Chubb D&O Elite Application at § V.

106 Basic attachments called for in the application and thereby captured in the bonding mechanism include organizational documents, recent SEC filings, and copies of any correspondence between outside auditors and management, as well as prior D&O policies. See, for exam-

Second, underwriters conduct their own independent research. They use a wide variety of publicly available data sources including SEC filings, Bloomberg reports, analyst ratings, corporate governance reviews from specialized providers such as the Corporate Library, and industry-specific forensic accounting studies that identify potential problem areas for further inquiry.[107]

In addition to this publicly available data, underwriters have access to private information through a series of meetings with the prospective insured's senior managers—often the chief financial officer or treasurer—as well as members of the accounting and legal departments and occasionally, for smaller or exceptionally risky companies, the chief executive officer.[108] At these "underwriters' meetings," prospective insureds present information about their business model, strategies, and risks while underwriters ask questions and gather further information.[109] As one corporate risk manager described the goal of the presentation: "We don't buy insurance. We sell risk."[110] Much of the information gathered during the underwriters' meeting and in any subsequent inquires may not be publicly available.[111] It is therefore customary in the underwriting process for underwriters to enter into

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ple, *Chubb D&O Elite Application* at § II.1; *AIG Application* at §§ IV, V. The bonding mechanism would also capture written answers to interrogatories and any other information provided in connection with the underwriting process. However, one attorney noted that it is difficult for insurers to win rescission cases—pointing out that attempts to rescind against Dennis Kozlowski (Tyco) and Richard Scrushy (HealthSouth) had failed. The rescission threat therefore may be an empty one, substantially weakening the bonding mechanism. *D&O Interviews*, Counsel # 2 at 9–10 (cited in note 39).

107 See, for example, *D&O Interviews*, Actuary #1 at 25, Underwriter #7 at 16–17, Underwriter #8 at 19–20, Underwriter #9 at 14–16, Underwriter #12 at 8, Underwriter #10 at 3, 55 (cited in note 39).

108 Id, Broker #5 at 11–12.

109 Describing the underwriters' meeting, one broker said:

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

Id, Broker #2 at 16–17.

110 Id, Risk Manager #4 at 7 (elaborating further that "[t]he best way to sell risk is to bring evidence to them ... to reduce any uncertainty about your risk").

111 As a risk manager described the process: "[The underwriters] look at [the publicly available information] side by side by what is the account telling us in terms of what they are doing, and where is the evidence that they are actually doing it." Id, Risk Manager #4 at 13.

nondisclosure agreements with prospective insureds,[112] thus permitting a free exchange of otherwise unavailable information.[113]

Participants in our study repeatedly described the underwriting process as onerous and detail oriented.[114] This begs the critical question of what information underwriters seek to gather during this process: What do underwriters ask for? What information do they value most? What do they believe best predicts the risk of shareholder litigation?

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

> We look at the industry that the company operates in trying to figure out if we are in a mature industry, a growth industry, a start up section of the industry, whatever. Are we working with proven technology, new technology, proven consumer goods, new consumer goods?
>
> . . .
>
> We look at the history of the company and see if M&A is a prominent part of their planning process for the future or not. We look if there are takeover risks. We look if there is a restructuring perhaps necessary in the future of the company. We examine the type of securities filings they did at the [SEC] . . . . We look at any SPEs, SPVs, joint ventures that they are using to grow strategically.

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112 See, for example, id, Underwriter #1 at 17–18 (noting that most underwriters' meetings are subject to nondisclosure agreements that provide underwriters with access to nonpublic information). See also Griffith, 154 U Pa L Rev at 1178 (cited in note 6) (emphasizing role of nondisclosure agreements in the underwriting process).

113 There is some information, of course, that prospective insureds will not share even under the terms of a nondisclosure agreement. *D&O Interviews*, Broker #1 at 18 (cited in note 39) ("[T]here is going to be a certain point where . . . the company is not going to be able to release information [to the underwriters].").

114 See, for example, id, Risk Manager #2 at 11 (observing that "there is a very thorough review and research into the guts of the finance [and] the guts of the operation of the company"). Another risk manager noted:

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

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

Then we dive into the corporate governance. We examine who the directors and officers are, their applicable experience. We look at interlocking board relationships. We actually keep a separate database here. Since 1996 we can run our database and tell you if any one director or officer was a defendant in a securities class action or derivative action.

. . .

[W]e record which company they were serving in when they were sued, but what we can then do is go back and look to see if the folks that we are underwriting now were sued in what was a fender bender or if it was a complete corporate meltdown. So we have a driving record in this.

We look at the organization of the corporate governance committees and independence of those committees and how active they are and then we look at insider ownership [and] compensation packages. Then we move into a broader understanding of the entire ownership of the company and . . . what conflicts may or may not may exist within the ownership interest.

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

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

> know, what makes us want to write the account and what makes the necessity of the insurance relevant to the risk of the company and then we price it.[115]

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

B. Financial Analysis

Insurance underwriters think of risk in terms of frequency and severity.[116] What is the likely frequency of an insured loss? And what is the probable magnitude of the loss once incurred? All of the underwriters we interviewed agreed that D&O insurance "is a high severity, low frequency game."[117] And all of them glean an initial estimate of frequency and severity from financial analysis. The reason is simple. Virtually all shareholder litigation stems from investment loss. Thus, a major part of assessing the risk of shareholder litigation is assessing the risk of investment loss.

Underwriters begin the process of risk assessment with an analysis of basic financial information about a company. This financial analysis includes such factors as the prospective insured's industry and maturity,[118] its market capitalization,[119] volatility,[120] and various account-

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115 Id, Underwriter #2 at 3–6. Another leading underwriter listed a similarly broad range of factors and described using them in a way that was somewhat "intuitive." Id, Underwriter #7 at 6 ("[T]he public D&O business is something that to some extent you can only be taught 75 percent. Zero to 25 percent has to be intuitive.").

116 See id, Underwriter #4 at 5 (describing D&O insurance as "low frequency high severity").

117 See, for example, id, Underwriter #1 at 8.

118 Id, Broker #1 at 3–6, Broker #2 at 15 (mentioning industry-related volatility), Underwriter #13 at 14–15 (looking differently at, for instance, pharmaceutical companies and Midwest manufacturers), Underwriter #2 at 3 (listing multitude of factors underwriters consider, beginning with industry and maturity of the company), Actuary #1 at 24–26 (stating that "the industry itself is a factor" in risk assessment), Underwriter #7 at 18 ("We look at the . . . industry [the company] is in."), Underwriter #7 at 29 (noting that "underwriters rarely offer the same kind of limits to a company going public as they would a mature company").

119 One participant explained how market capitalization came to be important to D&O risk rating as follows:

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

Id, Broker #6 at 15–16. See also id, Broker #2 at 14.

ing ratios.[121] Industry and volatility are associated with frequency: some industries are sued more often than others and shareholder litigation tends to coincide with sudden declines in share price (volatility). Market capitalization, meanwhile, is used to predict both frequency and severity: larger firms are sued more often, and larger-capitalization firms have farther to fall in measuring damages. As a result, these financial factors enable underwriters to form an initial estimate of a prospective insured's exposure to shareholder litigation risk.

In this regard, an underwriter's evaluation of these financial factors differs from an equity analyst's. Insurers, unlike investors, do not look favorably upon high-growth companies.[122] Insurers focus more on downside risk because they have a fixed return (the policy premium) that is modest in relation to their exposure to loss (the policy limits), while equity investors have a fixed exposure to loss (their initial investment) and a potentially unlimited upside (their share of the business's growth).[123] This makes a significant difference in risk evaluation performed by an underwriter versus an equity analyst.[124] In the words of an underwriter:

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120 See id, Underwriter #5 at 18 (stating that pricing is initially dependent on easily observed factors including volatility). See also id, Underwriter #4 at 26 (agreeing that volatility is a risk predictor), Broker #1 at 4 ("[S]tock volatility is key.").

121 Participants especially emphasized accounting ratios indicating volatility or stability of cash flows and earnings. See id, Actuary #1 at 24–26 (explaining complex systems in place for tracking volatility, especially of stock price fluctuation, which often "generate[s] a D&O claim"). See also id, Underwriter #7 at 31 (listing cash flow as something affecting premiums), Underwriter #13 at 14–15 (asserting the importance of PE ratios and sustainability of earnings in assessing risk), Broker #1 at 4–5 (describing how a broker evaluates D&O risk), Broker #2 at 14–15 (comparing a broker's analysis to that of a financial analyst for a mutual fund), Broker #5 at 25–26 (pointing to the use of accountants to assess problem areas of companies).

122 One D&O broker described this difference in the following exchange:

> Q: So what are [underwriters] looking for? I mean I understand when I'm buying an equity investment I want the earnings to look like a hockey stick. But that's not what an underwriter cares about, right?
>
> A: Just the opposite. They do not want the hockey stick. The hockey stick, I think, causes them to believe that if there's such a spike, then can a company accommodate that? Can it grow like that without getting to the top of that hockey stick and then dropping like a rock? So they want to make sure that the company is on a platform of sustainable growth, they feel comfortable with the management, understand all of the compliance issues that are in place.

Id, Broker #5 at 26.

123 See generally William A. Klein and John C. Coffee, Jr., *Business Organization and Finance: Legal and Economic Principles* (Foundation 8th ed 2002).

124 In addition to the differences in the risks evaluated by each, the incentive structure of analysts and insurers is different. Analysts typically operate under a fee-for-services model where they derive income from their reputation for accuracy, while D&O underwriters stake their firm's capital on their judgments. Although damage to one's reputation can certainly lead to a loss of income, it is less immediate than, for example, paying out $10–25 million in covered losses as a result of failing to accurately gauge governance risk. As a result, D&O insurers may be more

> [Evaluating D&O risk] is not the same as [evaluating] investment risk .... [T]here are companies that would be terrific companies [to invest in] that would be terrible D&O risks. There are companies that you would never ever put a penny of investment in, but they are great [D&O risks] because they are just not going to have this kind of class action lawsuit.[125]

For a D&O underwriter, growth prospects are largely irrelevant or, worse, a source of volatility that may lead to disappointed shareholder expectations and litigation. In the words of one underwriter, "[I]t is not about picking winners as much as avoiding losers .... If I avoid three or four bad claims a year, we had a great year."[126]

C. Governance Factors

As one participant in our study remarked, there are two "pillars" of D&O underwriting: "Number one is the financial health of the [company]. Number two is how good that company [is] at governing itself."[127] As just described, the financial analysis assesses the potential for a sudden investment loss of any sort. Evaluation of corporate governance assesses the probability that the investment loss will be linked to corporate or securities law violations. Having discussed financial analysis above, in this Part we turn to a discussion of corporate governance. Before beginning, however, we pause to address the problem of definitions.

"Corporate governance" is a broad concept that the legal literature has given a narrow definition. Scholars discuss it most often in the context of specific regulatory reforms[128] or in terms of charter provisions and other easily observable structural characteristics on which regressions can be run.[129] But corporate governance may refer more broadly to any aspect of the system of incentives and constraints operating within a firm. Indeed, the participants in our study tended to

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sensitive to errors and therefore more eager to avoid them. See Griffith, 154 U Pa L Rev at 1179 (cited in note 6) (comparing loss sensitivity of reputational capital and capital reserves).

125 *D&O Interviews*, Underwriter #4 at 3 (cited in note 39).

126 Id, Underwriter #7 at 6.

127 Id, Underwriter #9 at 8.

128 See, for example, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L J 1521, 1560 (2005).

129 See generally Anup Agrawal and Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 48 J L & Econ 371 (2005) (analyzing the relationship between earnings restatements and board and audit committee independence, the financial expertise of directors, auditor conflicts of interest, director blockholding, and the influence of the chief executive officer on the board). See also text accompanying note 239.

give corporate governance this broader definition, referring repeatedly to the importance of "culture" and "character" in D&O underwriting.[130]

Culture and character, we were regularly told, are at least as important as and perhaps more important than other, more readily observable governance factors in assessing D&O risk.[131] In the words of one underwriter:

> I don't view my [underwriters] as financial experts to begin with, but if I am going toe to toe with a CFO of X Corp., am I getting to the bottom of what is going on here? The answer is no. To me, my style in terms of underwriting has been to look for the way people deal with certain issues and how they view their goals and how they are going to achieve them.[132]

Terms such as culture and character, however, need some decoding. As described in greater detail below, we took "culture" to refer to the system of incentives and constraints operating within the organization, including both formal rules and informal norms. "Character" we took to refer to the likelihood that top managers would defect from corporate interests when given an opportunity to do so.

1. Culture: incentives and constraints.

The system of incentives and constraints operating within a firm may be based upon formal rules, informal norms, or, as is most likely, some combination of the two.[133] Participants in our study emphasized each of these aspects of corporate culture. Several underwriters cited executive compensation as a key indicator of intrafirm incentives. An equally large number also emphasized the constraint of internal controls. In their discussion of these incentives and constraints, it was clear that underwriters looked past the formal rules, seeking a sense of how strong the norm of compliance is within the organization or whether, by contrast, there is a norm of defection. As one senior underwriter described:

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130 Culture and character were recurrent themes in our interviews. Typical remarks included: "I believe that really what it comes down to is the culture and the people," *D&O Interviews*, Broker #1 at 14 (cited in note 39); "[U]ltimately the insurance underwriter is really betting on the ethics and confidence of the management of the company," id, Broker #2 at 17; "The only way you are ever going to be able to underwrite this stuff is through people. . . . It is your ability to assess character," id, Underwriter #9, Seminar Tapes 1 & 2 at 26.

131 *D&O Interviews*, Broker #4 at 5 (cited in note 39) ("[T]here's one [underwriting] model that works and it's the best model. It's the people. It's simply the people. Who are you dealing with? Who and how do they act?").

132 Id, Underwriter #15 at 12.

133 Edward B. Rock and Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U Pa L Rev 1619, 1640–47 (2001).

> [N]o company ever just dropped out of the sky. There is a history which is a narrative of how they got in [this business]. Who are the players? Who founded them? What is their culture? You might get to the ethics of the culture of the company, but you [need to] understand how it got put there, into the state it's in now.... Who are they? And where they come from? How did they know each other? In a fraternity? Did they know each other in business? ... I mean, there is a story. They didn't just all land out of the sky, and *you should understand that matters.*[134]

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

> You have a hard time convincing me when a guy makes a fortune and the board signs off on the increases or the other demands or the perks or the airplane flights or the bonus packages, severance packages, or the balloons, or whatever it is. You have a hard time telling me that that board has a real grip on that CEO.[135]

Given recent criticism of corporate compensation practices in both the academic and the mainstream press,[136] it is not surprising that insurers also pay attention to compensation. However, it is worth pointing out that there is not a shareholder cause of action for excessive executive compensation. Shareholders cannot sue simply because the CEO is making too much money but must argue instead that the board was grossly negligent in approving the compensation package[137] or that management misstated earnings in order to maximize the value of their option compensation.[138] Executive compensation itself,

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134 *D&O Interviews*, Underwriter #7 at 29–30 (cited in note 39) (emphasis added).

135 Id, Underwriter #7 at 16.

136 See, for example, Arthur Levitt, Jr., *Corporate Culture and the Problem of Executive Compensation*, 30 J Corp L 749, 749 (2005) ("If there is anything that engages the public today about the business community, it is the issue of compensation."); Lucian Bebchuk and Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* 61–79 (Harvard 2004) (describing how managerial interests taint a variety of common forms of executive compensation); Charles M. Elson, *Corporate Law Symposium: The Duty of Care, Compensation, and Stock Ownership*, 63 U Cin L Rev 649, 649 n 2 (1995) (noting the public outcry over excessive executive compensation).

137 Shareholders may sue under state corporate law for excessive executive compensation, but such claims typically do not get very far in the absence of a clear conflict of interest due to corporate exculpation provisions and application of the business judgment rule. See generally *In re The Walt Disney Co Derivative Litigation*, 907 A2d 693 (Del Ch 2005).

138 See, for example, John Hechinger and Gregory Zuckerman, *Stock-Option Grant Probes Gain Steam As More Firms' Practices Get Scrutiny*, Wall St J C1 (May 23, 2006) (describing investigations of public companies whose option grants appear linked to share price manipulation). See also Charles Forelle, *How Journal Found Options Pattern*, Wall St J A11 (May 22, 2006) (describing statistical methodology used by the newspaper to uncover share price manipulation surrounding option grants).

in other words, does not create liability risk. Rather, the liability risk comes from what the firm's executive compensation practices suggest about the incentives operating within the firm.[139] For similar reasons, our participants cited the stringency of a firm's insider trading policies (and the care with which they are observed) as significant factors in risk assessment.[140]

In addition to the internal incentive structure of the firm, D&O underwriters also review a prospective insured's internal constraints. Indeed, if there was one central corporate governance variable that our respondents sought to emphasize, it was the quality of the prospective insured's internal controls. In the words of a prominent risk manager, "The one word that really captures the heart of [the] process is evidence that there is controllership."[141] Internal controls involve a wide variety of industry-specific practices,[142] but revenue recognition procedures, because they can lead to restatements and thereby to securities claims, were repeatedly emphasized as a core concern.[143] One underwriter gave the example of Harley Davidson:

> Harley Davidson got sued because they were channel stuffing motorcycles.... [T]hat wasn't happening at the board level. That was probably the VP for sales had a monthly sales target that he was desperate about making because his [bonus] compensation

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139 Compare Bebchuk and Fried, *Pay without Performance* at 4 (cited in note 136) ("[D]irectors have been influenced by management, sympathetic to executives, insufficiently motivated to bargain over compensation, or simply ineffectual in overseeing compensation.").

140 See *D&O Interviews*, Broker #6 at 17 (cited in note 39) ("They certainly do put a lot of weight on things like what are your insider trading guidelines. They want them to be fairly stringent."). Unlike executive compensation, insider trading may form the basis of a shareholder claim. See 17 CFR § 240.10b-5. See also 15 USC § 78p (2000 & Supp 2002). But insider trading, especially unusual trading patterns, is perhaps most important as hard evidence of securities fraud. See Marilyn F. Johnson, Ron Kasznik, and Karen K. Nelson, *Shareholder Wealth Effects of the Private Securities Litigation Reform Act of 1995*, 5 Rev Accounting Stud 217, 219 (2000) (discussing the heightened pleading requirements of the Private Securities Litigation Reform Act (PSLRA)); Marilyn F. Johnson, Karen K. Nelson, and A.C. Pritchard, *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, J L, Econ, & Org (forthcoming) (finding "a significantly greater correlation between litigation and both earnings restatements and abnormal insider trading after the PSLRA").

141 *D&O Interviews*, Risk Manager #4 at 5 (cited in note 39).

142 One underwriter elaborated:

> You need to understand some of the accounting issues that were driving claims, particularly revenue recognition procedures at companies.... [E]ach of those industries had different ... revenue recognition issues. You need to be able to drill down, see if the answers were there, and if not, ask the right questions to get them.

Id, Underwriter #5 at 10.

143 See note 140 (emphasizing the importance of earnings management and Rule 10b-5, and the role of a restatement as "hard evidence" of securities fraud).

> was tied to meeting his target, and so they started [channel] stuffing motorcycles.[144]

Because pressures to manipulate results may exist throughout the firm, as this example suggests, the question of internal controls is really the question of whether the organization can constrain these temptations throughout the firm.

The investigation into internal controls does not stop at the board level, nor does it end once underwriters are given a corporation's statement of controllership principles.[145] Instead, our participants noted that underwriters investigate how information flows throughout the firm: "How does 'bad news' flow upward within the organization? Does the corporate culture encourage such news to be brought to the attention of senior management? Are significant developments shared with the board of directors as they become available?"[146]

Underwriters investigate who reports to whom.[147] They inquire into the norms and actual practices underlying formal policies.[148] They

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144 *D&O Interviews*, Underwriter #4 at 32 (cited in note 39). A manufacturer that engages in "channel stuffing" intentionally sends its retailers more products than they are able to sell in order to inflate (temporarily) its sales figures. Unless sales suddenly increase or, in the case of channel stuffing after a downturn, recover, the manufacturer will ultimately have to adjust its accounts receivable, resulting in a loss. One of our participants illustrated the problem with an example:

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

Id, Broker #6 at 34–35 (noting that this scenario "has occurred quite a bit in corporate America").

145 Underwriters take board independence into account as an aspect of controllership. See id, Underwriter #7 at 14–15 (cited in note 39) ("There is a lot of cronyism still.... I mean, you still have entrenched boards, boards that only work for the CEO as opposed to vice versa. It is a fundamental underwriting question we ask people, who works for whom."). The incremental value of more or less independence, however, does not seem to weigh heavily. Compare id, Broker #1 at 8 ("[I]f you had a board that was, you know, one independent and [the rest] inside directors, that is viewed as a negative."). Instead, independence is important only insofar as it indicates the strength of constraints operating within the organization.

146 *Examples of Questions Being Asked by D&O Underwriters* (undated unpublished brokers' document designed to prepare clients for underwriters' meeting) (on file with authors).

147 To an underwriter, good governance involves centralized control and multiple levels of review. As a leading broker described a good D&O risk: "They review everything. Everything is

retain forensic accounting consultants to detect inadequacies in internal controls before they lead to fraud.[149]

The quality of constraints within a corporation may also be indicated indirectly—as a prospective insured's plans for mergers and acquisitions activity was described to us. Of course, M&A itself is a litigation risk,[150] and for this reason insurers inquire, often in both the application and the underwriters' meeting, about the prospective insured's M&A plans.[151] But in our interviews it became clear that D&O insurers are not interested merely in *whether* a prospective insured will engage in M&A activity, but also *how* it will do so.[152] M&A again

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done early.... The CFO knows about a sale that is going on in Europe in real time and has to approve it.... Everything is centralized control." *D&O Interviews*, Broker #6 at 33 (cited in note 39).

148 Id, Risk Manager #4 at 5–6 ("[Not only is there] a process, but how are you exercising the process and what evidence do you have to support your controllership process? ... [A]ll the questions are around that subject.").

149 According to one participant, "a whole cottage industry" has blossomed over the years in the area of forensic accounting. The accounting focuses on business operations and how risks are actually managing their business. See id, Underwriter #9 at 10–16.

150 See Robert B. Thompson and Randall S. Thomas, *The New Look of Shareholder Litigation: Acquistion-Oriented Class Actions*, 57 Vand L Rev 133, 137 (2004) (finding that approximately 80 percent 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 percent of fiduciary duty claims over the same period were derivative suits); Elliot J. Weiss and Lawrence J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions*, 57 Vand L Rev 1797, 1805 (2004) (finding evidence of litigation agency costs in acquisition-oriented class actions).

151 *D&O Interviews*, Risk Manager #3 at 12 (cited in note 39) ("M&A is a bad thing when you are talking D&O insurance. It just opens you up to potential for more claims. I mean, M&A might be a good thing if you are talking to that equity analyst, you know, depending on their views ... so the emphasis is different."), Underwriter #7 at 27 ("Frankly, most D&O claims if you were to look into them, there was a merger."), Underwriter #8 at 20–21 ("[W]e also look at M&A and what is going on in their business from an M&A perspective, whether you are an acquirer or people are acquiring ... your business, because there is a correlation between that and lawsuits."), Broker #6 at 16 ("[We ask h]ave you been in any mergers and acquisitions recently? What is your M&A outlook?").

152 See id, Broker #1 at 5 (emphasizing the prospective insured's "track record ... with respect to such things as mergers and acquisitions or divestitures"). Moreover, insurers limit their exposure to acquisition-related claims in the policy itself. First, with respect to making acquisitions, if the insured acquires a target over a threshold size (often 10–25 percent of the total assets of the insured), the policy terminates within sixty days unless renegotiated. See *AIG Specimen Policy* at § 12(b) (cited in note 22) (providing a 25 percent of assets threshold); *Chubb Specimen Policy* at § 20 (cited in note 22) (providing a 10 percent of assets threshold and sixty day notice period). See also *D&O Interviews*, Risk Manager #4 at 9 (cited in note 39) ("[M]ost contracts have a threshold for additional premium as a result of acquisition, and a typical one might be 10 percent of sales and/or 10 percent of asset value. Either one of those ... could allow the underwriter to assess additional premiums."). The policy remains in effect for acquisitions below the threshold size. Second, with respect to acquisition of the insured, the policy terminates when the transaction closes. See *AIG Specimen Policy* at § 12(a); *Chubb Specimen Policy* at § 21. Claims may still be litigated under the prior policy—if, for example, the claim arises upon announcement of the acquisition but prior to closing, as many such claims do. See Thompson and Thomas, 57 Vand L Rev at 154–55 (cited in note 150) (discussing filing times for acquisition-oriented class actions); Weiss and White, 57 Vand L Rev at 1827–28 (cited in note 150) (same).

comes down to the question of process and controls: "[A]re you just going to go out and buy a company, or do you have a process and what is the process? We actually show them the process."[153] Insurers are interested in whether acquisition activity is value enhancing or rather mere empire building, further evidence of unconstrained management.[154]

In addition, underwriters reported that they take the ownership structure of a prospective insured into account.[155] D&O applications typically require disclosure of insider ownership and significant outside blockholdings.[156] This makes sense because a controlling shareholder may be a substitute for the governance constraints embedded in corporate law or charters, and significant insider share ownership may indicate an alignment of shareholder and management interests.[157] Accordingly, a prospective insured's ownership structure is an important factor in underwriting risk assessment.

Finally, although less often discussed in our interviews than other risk factors, underwriters did note that they take into account such structural governance features as state of incorporation, board independence, committee composition, and separation of the chief executive and board chair roles.[158] Underwriters also described using third-party governance rating services such as the Corporate Library to identify "red flags."[159] In addition, underwriters acknowledged that

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But any future coverage for the combined company must be renegotiated. The merging companies will often purchase a "runoff D&O program" to cover premerger wrongful acts. See *D&O Interviews*, Risk Manager #1 at 16 (cited in note 39). The underwriter thus crafts the policy to respond to two threats—the acquisition itself and a larger than expected insured after the merger. See id, Risk Manager #4 at 10 ("The event of the acquisition is one threat to them if you will, a potential claim, and the management of that new company and the integration of that company creates [another whole] set of probabilities or possibilities.").

153 *D&O Interviews*, Risk Manager #4 at 8 (cited in note 39).

154 Id, Underwriter #2 at 22 (describing "proposed mergers that make no sense" as one indicator of management stupidity).

155 See, for example, id, Underwriter #2 at 5 ("[We seek] a broader understanding of the entire ownership of the company and where that is coming from and what conflicts or not may exist within the ownership interest."), Underwriter #8 at 21 ("We look at the equity of the company very closely. It is obviously a key driver on the rating model that we use. We look at who owns the stock and why.").

156 See, for example, *AIG D&O First Main Application* at § IV (cited in note 102).

157 See Ronald D. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 Harv L Rev 1641, 1662 (2006) (noting that blockholding and diffuse ownership structures "may in some circumstances be functional substitutes; that is, they may have equivalent monitoring capacity").

158 See, for example, *D&O Interviews*, Broker #5 at 28 (cited in note 39) ("They're asking—if the [CEO and chairperson of the board] are the same person—'Why? Have you evaluated whether it should be split and can you help us out as to why you haven't?'").

159 See id, Underwriter #7 at 16. Corporate Library reports governance scores in a report-card format, A through F. Underwriters reported offering credits and debits of up to 15 percent based upon the governance score. See, for example, id, Underwriter #8 at 31–32 (comparing credits for different risk ratings). Others reported that the narrative portion of the Corporate

they consider structural indicia of management entrenchment, such as staggered boards and poison pills, but only in response to our direct questioning.[160] Because entrenchment was never listed independently by an underwriter as an important factor in D&O risk assessment, however, we hesitate to conclude that it is a key underwriting risk factor.

In summary, underwriters investigate corporate culture by uncovering the buried structure of incentives and constraints operating within the firm. They do not confine their investigations to the presence or absence of big-picture structural features, such as an independent board or a formal controllership program. Instead they dig between the formal rules in an effort to unearth the firm's internal culture of compliance or defection.[161] That they expend resources to conduct this investigation when assessing D&O risk suggests that corporate culture affects the risk of shareholder litigation.

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

The other perhaps underappreciated aspect of shareholder litigation risk (at least in mainstream corporate and securities law literature) is an aspect our participants referred to as "character."[162] "Ultimately," as one broker said, "the underwriter is really betting on the ethics and confidence of the management of the company."[163] Character, of course, is an amorphous concept. When we pressed underwriters to define it, they often responded by emphasizing arrogance and excessive risk taking.

Arrogance, our interviews suggested, may indicate individuals who hold themselves above rules and norms.[164] Several underwriters described warning signs, such as "a CFO who has got all the answers, doesn't want to listen. Or a senior management team where all you see is the CEO and no one else.... [J]ust one person out front and no

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Library report is as important in their risk-rating process as the score itself. See, for example, id, Underwriter #1 at 11.

160 Id, Underwriter #5 at 48–50.

161 Compare Kenneth J. Arrow, *The Economics of Moral Hazard: Further Comment*, 58 Am Econ Rev 537, 538 (1968) ("One of the characteristics of a successful economic system is that the relations of trust and confidence between principal and agent are sufficiently strong so that the agent will not cheat even though it may be 'rational economic behavior' to do so.").

162 On the history of character-based underwriting and the contrast between character-based underwriting and the economic understanding of insurance, see generally Tom Baker, *Insuring Morality*, 29 Econ & Soc 559 (2000).

163 *D&O Interviews*, Broker #2 at 17 (cited in note 39). See also id, Actuary #1 at 9 ("[W]hat you're really underwriting when you underwrite D&O is you're underwriting the people, you're underwriting the senior management, the quality of the management team.").

164 See, for example, id, Underwriter #7 at 17 (emphasizing perks such as "country club memberships, airplane travel, [and corporate] homes" as indicia of arrogance or lack of accountability).

one else. You never see them, and it is I, I, I."[165] Others offered anecdotes, including the following:

> I am interviewing . . . a CFO once at a company, and they were a manufacturing company. . . . I said, "Do you have any pollution issues?" He said, "Well . . ." "You know, recent problems?" He said, "What do you mean by problems?" Stuff like that. . . . I said, "Have you ever polluted an aquifer?" And to my surprise he says, "It was a small aquifer." And then he goes on to rationalize . . . how small three parts per billion is, or whatever the number was. He said it was ridiculous. . . . To my way of thinking, this is a bad insured. This is a guy who looks at his problems, [and] he doesn't look at solving the problems or doesn't look at what the law says. He is extemporizing on how he thinks the law ought to be applied. That is very bad. Because when things go wrong, those things will cause you to pay big time.[166]

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

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

> [M]aybe the most important questions you can ask a CEO is how many speeding tickets do you have? What kind of car do you drive? How many times have you been married? How often do you drink? How much do you drink? . . . [D]o you have extramarital affairs? Simply because you're looking for risk takers. *Risk takers above the norm*—those are the people that get in trouble. . . . [I]n a lot of situations, [that kind of information is]

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165 Id, Underwriter #8 at 27 (discussing the importance of meeting personally with company executives).

166 Id, Underwriter #15 at 12–13. Similarly, another described ways in which managers inadvertently reveal their own arrogance:

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

Id, Underwriter #2 at 23.

> more important than how much cash or what their balance sheet looks like, or what new products they have coming out.[167]

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

Pressed on these points, underwriters indicated that they look for evidence that the company is overcommitted to growth because in such situations there will be a strong temptation to misstate results when reality falls behind expectations.[168] Excessive risk taking, in other words, can lead to fraud. An underwriter illustrated this situation as follows:

> [O]ne company ... [said] they were going to grow 20 percent. Some people [said], "I'm not sure how we are going to grow 20 percent, but the CEO said we are going to grow 20 percent." You know, but without that clear articulation of *how* we are going to grow 20 percent, in the absence of really great controls—and maybe they had them, maybe they didn't—you are going to have somebody who [when] the pressure is on [starts thinking], "I had better make my numbers."[169]

Underwriters derive much of this information from their meetings with management. "We talk to people," one underwriter said. "We stare down a lot of people, and if their comfort level is starting to get very solidified with a group of [managers], we will follow them around."[170] In addition to meeting with top management, underwriters also investigate the reputation, skill set, and litigation history of each individual board member.[171] As with the evaluation of corporate culture, this character aspect of risk assessment in D&O underwriting reflects a broader conception of corporate governance that goes well beyond formal provisions such as charter terms and state of incorporation.

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167 Id, Actuary #2 at 23–24 (emphasis added).

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

169 Id, Underwriter #15 at 13–14 (emphasis added).

170 Id, Underwriter #7 at 33. See also id, Underwriter #8 at 24–25 (explaining that underwriting involves "getting a sense of ... trust. [C]an you have confidence in what they filed in their Qs and Ks?").

171 Id, Underwriter #7 at 26, Underwriter #2 at 15–16 (explaining the importance of individual evaluations of management).

3. Again, the cycle.

That underwriters screen for these factors, of course, does not mean that they always identify and act upon the red flags. There are, in fact, a number of reasons to doubt that they do so consistently, including short-term pressure on underwriters to generate premium volume notwithstanding possible long-term losses[172] and the simple likelihood that those who are good at deceiving bosses and markets are likely to be good at deceiving underwriters too.[173] Our answer to such objections is simply to report what underwriters reported to us—they are indeed trying, even if they do not always succeed—and to note that that the rewards for having only one fewer bad risk in an underwriting portfolio, considering typical limits of $10–25 million, are great. The evaluation of culture and character in risk assessment is a revealed preference. Those with the most to lose are paying attention.[174]

A more difficult objection for us to answer points to the cyclical nature of the insurance market: the world as it is now has not always been and may not be for long.[175] Indeed, participants in our study fre-

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172 See, for example, id, Broker #3 at 4. Even without intrafirm pressures to generate underwriting profit, underwriters may fail due to resource constraints—a finite amount of time and attention to devote to all possible D&O risks. See, for example, id, Underwriter #5 at 12 ("[An] analyst is following a dozen or two dozen companies max. Our underwriters are looking at companies. You know, they will look at two dozen companies a month or more. So they won't have the in-depth knowledge."), Broker #2 at 21 ("If an underwriter is under pressure to write a premium, he is going to deal with cognitive dissonance a lot differently than if he isn't under pressure."), 24 ("X is a company that can be very inconsistent depending on what day of the month it is, depending upon whether they are making their [premium] budget or not. If you come to X with a tough account at the end of the month and they haven't made their budget, guess what? You can get a really good deal.").

173 See note 231 and accompanying text (describing the role of self-deception and deception of others in corporate success).

174 It is possible, of course, that the *underwriters'* claim to analyze corporate governance variables may not point to a revealed preference of the D&O *insurer*. An insurance company has several departments, and they may not be perfect agents of the company as a whole. In this context, for example, underwriters may claim to have special expertise in evaluating corporate governance in order to promote and protect their group in the competition for intrafirm resources. Similarly, the underwriting department may resist an indexing approach to risk selection not because it would lead to worse risk selection, but because it would end the underwriters' claimed expertise and lead, inexorably, to the elimination of the department. See notes 95–97 and accompanying text (describing underwriters' rejection of an indexing approach to underwriting). Underwriters, according to this story, emphasize governance not because governance variables lead to better risk selection but because the claim to possess governance expertise enables them to protect their jobs. Our research does not support this hypothesis—none of our participants (neither underwriters, risk managers, brokers, nor counsel) suggested it during the course of our interviews—but neither can our research disprove it.

175 In the words of one underwriter:

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

quently noted that scrutiny of formal governance factors in D&O underwriting is relatively new.[176] Character and culture have been perennial concerns, but scrutiny tends to ebb and flow as markets harden and soften.[177] Since, as noted above, all of our interviews occurred during the sunset of the most recent hard market, we cannot confidently conclude that scrutiny of corporate governance will be a lasting feature of D&O risk assessment. Indeed, one broker suggested that it has already begun to fade:

> A: In essence, [the underwriters] all got caught off guard by the likes of Enron and had never focused really on governance. So the reaction was very extreme.
>
> Q: Has it started to go away?
>
> A: Yes.[178]

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

D. From Risk Assessment to Pricing

All of the factors discussed above, our participants reported, are considered in the risk assessment and ultimately the pricing of a prospective insured. In the words of the underwriter quoted at the beginning of this Part, "[w]e take all that stuff and we rate it for risk. We summarize what makes us want to write the account and what makes the necessity of the insurance relevant to the risk of the company. *And then we price it.*"[179] Our question, of course, was how. How do D&O underwriters derive a price from this extensive list of risk factors?

As we learned, D&O underwriters begin with a simple algorithm, which differs from company to company, and then employ a highly discretionary, largely unobservable (even for the companies' own pricing actuaries[180]) system of credits and debits, the application of which

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D&O Interviews, Underwriter #5 at 13 (cited in note 39).

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

177 See Part II.B.3.

178 *D&O Interviews*, Broker #1 at 12–13 (cited in note 39).

179 Id, Underwriter #2 at 6 (emphasis added).

180 A senior actuary at a leading D&O insurer described the problem as follows:

> The other concern we have is just the validity of the data that is entered into our system, particularly in this area where you have a very small group of experienced underwriters who kind of know, who think they know what to charge for a Fortune 500 company just based on the fact that they do the market every day, and they can probably tell you in a couple minutes, you know, this one should be getting this much and this one over here is

may be constrained by a competitive underwriting market. As described by one of the underwriters in our study, "the market cap and the volatility and some of those easily observed things will get you your first price. [Then the question] is whether ... the risk is 'clean' enough to make the next cut, [where] some of these other more qualitative factors will come into play."[181] The sections that follow explore each of these three components: the algorithm, the system of credits and debits, and the market constraint.

1. The algorithm.

Each of the underwriters and actuaries reported to us that their companies have developed simple algorithms to generate an initial price. One senior executive with a long history in D&O insurance reported that, in the early days, this algorithm was based on the number of directors on the board. Later, the measure of base risk shifted to the value of the assets of the company, and relatively recently shifted again to market capitalization and the other factors that we are about to describe.[182] No underwriter or actuary would provide us with their company's precise algorithm,[183] but they did tell us the factors used in

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worth that much. So what we find is they don't spend a lot of time making sure that the entries into our system are necessarily precisely what they think about a company. You know, they delegate it to an assistant who has to go through this rate process in order to get the account off books, and they don't spend a lot of time making sure that the entries are actually reflective of what they are going to feel about the company. So that is a challenge for us internally, you know, to make this more of a priority so that we have experienced people, you know, making those kinds of decisions about what is going into the data.

Id, Actuary #3 at 19–20.

181 Id, Underwriter #5 at 18.

182 Id, Underwriter #15 at 10 (describing algorithms and adding that previous "rating factors were [the] number of directors and asset size"), Broker #6 at 15 (describing the move from assessing the number of directors to using market capitalization).

183 Some version of the insurer's basic pricing algorithm is disclosed to state insurance commissioners. In a rate schedule filed in the state of California, for example, Chubb disclosed that base rates depend first upon a combination of market capitalization and volatility (beta) with specified increases from the base rate factored in on the basis of limits and industry. The rate schedule then lists a large number of "Rating Modifications"—including "risk relative to industry," "financial trends," "board/management architecture and controls," "individual qualifications," and "overall board/management quality"—most of which require a qualitative (as opposed to quantitative) analysis. See Chubb Group of Insurance Companies, *D&O Elite Directors and Officers Liability Insurance Actuarial Memorandum*, in *Application for Approval of Insurance Rates* exhibit 23 at 1–3 (Cal Dept of Ins File No EO CA0019310C01, filed Dec 22, 2003). After investigation, however, we concluded that the state filings are not a good source of D&O pricing information. The plans include such a broad range of underwriter discretion that they would provide very little guidance even if the companies actually used the plans to generate premiums. See *D&O Interviews*, Actuary #3 at 7 (cited in note 39) ("[T]here is very wide latitude given to underwriters in terms of what is filed with the state regulators."). And, in fact, they do not use the plans to generate their premiums. Not one underwriter that we interviewed described starting the pricing process with the formula in the rating plan. Instead, they described a process in which premiums were

their algorithms: market capitalization (all insurers), industry sector (most insurers), stock price volatility (many insurers), accounting ratios (many insurers), and age/maturity of the applicant corporation (some insurers).[184]

2. Credits and debits.

All underwriters reported using some form of debit and credit system to arrive at an ultimate price, which, as a result, can vary widely from the output of the basic pricing algorithm. As described by one of our participants: "[A]ctuaries set the overall rates for an insurance company, but then within that rating system, an underwriter has a lot of leeway. I mean, they probably have judgments that are plus or minus 40 percent."[185] The influence of actuarial science thus declines once underwriters begin to issue credits and debits.

Insurers differ widely on how they determine their system of credits and debits. A small number of insurers use quantitative guidelines based upon the presence or absence of specific governance features.[186] An underwriter from an insurance company with a highly quantitative model described the process as follows: "So, for example, if you are in a certain industry class, you are going to get debited between 5–10 percent or credited between 5–10 percent. If you have got a very poor board score, you are going to pay anywhere from 10–20 percent more."[187]

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

184 A senior reinsurance underwriter described the evolution of the pricing algorithm as moving toward "a merging of ... corporate finance concepts and actuarial pricing concepts" and pointed out that "writing a D&O insurance liability policy [is] very[,] very similar to a put option for stock." *D&O Interviews*, Underwriter #9 at 21–22 (cited in note 39). In this view, the financial analysis underlying the pricing algorithm may address the likelihood of sudden investment loss of any kind, while the debit and credit process described next attempts to determine the likelihood that the loss will be linked to corporate or securities law violations. For excess layers, some participants reported that they simply apply a discount factor to the premium quoted by the primary carrier, while others reported that their company does a ground-up pricing exercise.

185 Id, Broker #2 at 18–19.

186 Id, Underwriter #8 at 20 ("We have a clear set of guidelines around pricing plus or minus on certain items.").

187 Id. Note that the "board score" refers to the score on the company report prepared by the Corporate Library. See note 107 and accompanying text.

Even for this insurer, however, the range of credits and debits grants underwriters significant discretion.[188] Most insurers allocate even more discretion to individual underwriters in setting premiums,[189] although additional layers of monitoring—committee oversight or peer consultation—apply as account sizes increase.[190] The goal of all such processes is to adjust premiums so that higher-risk firms pay more while better-governed firms "instead of getting debits . . . get credits."[191]

How much influence, then, do specific corporate governance factors have in D&O pricing? We cannot say with any precision, first, because our participants would only describe pricing in general terms, and second, because the system is so highly discretionary that insurance companies and even individual underwriters may make inconsistent choices. In particular, the actuaries we interviewed doubted that underwriters have a consistent system of evaluation that applies the same factors in the same way over time.[192] In spite of the potential for

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

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

D&O Interviews, Underwriter #10 at 20–21 (cited in note 39).

189 See id, Underwriter #9 at 19 (noting that "[a]n underwriter ultimately [either] consciously or unconsciously formulates an opinion about a risk, and that opinion leads him to make a certain decision" about the price).

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

191 Id, Broker #6 at 33–34.

192 Id, Actuary #1 at 28, Actuary # 3 at 3–4 (discussing the "pure crap shoot" aspect of insuring Marilyn Monroe's leg). See also William M. Grove and Paul E. Meehl, *Comparative Efficiency of Informal (Subjective, Impressionistic) and Formal (Mechanical, Algorithmic) Prediction Procedures: The Clinical-Statistical Controversy*, 2 Psych Pub Policy & L 293, 315 (1996) ("Humans simply cannot assign optimal weights to variables and they are not consistent in applying their own weights."). One innovative suggestion for improving underwriters' risk assessments comes from the literature on prediction markets. Prediction markets are formed by sponsors who create tradable contracts providing for payments on specified future contingencies. Traders then buy and sell the contracts on the basis of their estimates of the likelihood of the given contingency. These markets have been used, for example, to forecast elections and to assist in inter-

inconsistent application and the evolving nature of the underwriting process, our participants reported that "there is no question ... whatsoever" that corporate governance information "works its way into pricing."[193] The degree of influence and precision of the measuring system, however, is much more debatable.[194] If the data were available, this would be an excellent area for econometric research.[195]

3. The market constraint.

Underwriters want to sell insurance and generate large premiums. Their ability to do so, however, depends on the premiums charged by their competitors.[196] An underwriter that charges significantly more than its competitors for the same risk will find that it has relatively few underwriting opportunities. As a result, the market for D&O insurance operates as a constraint on the ability of underwriters to factor risk into price. If a D&O underwriter attaches a very high-risk premium to a particular account, it may not have the opportunity to underwrite that account.

As they go through the debit and credit process, underwriters are highly aware of the price the competition has quoted or is likely to quote for the risk in question. They know historical premiums paid by a prospective insured and are finely attuned to prevailing market con-

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nal corporate decisions and have often been shown to be more accurate than individual decisionmakers. See generally Michael Abramowicz and M. Todd Henderson, *Prediction Markets for Corporate Governance* (University of Chicago Law School Law and Economics Olin Working Paper No 307, Sept 2006), online at http://ssrn.com/abstract=928896 (visited Apr 12, 2007) (summarizing existing literature on prediction markets and arguing that markets could be formed to predict corporate governance risk); Michael Abramowicz, *Information Markets, Administrative Decisionmaking, and Predictive Cost-Benefit Analysis*, 71 U Chi L Rev 933 (2004) (describing the use of prediction markets in the context of agency decisionmaking).

193 *D&O Interviews*, Risk Manager #2 at 20 (cited in note 39). See also id, Risk Manager #4 at 12 (noting that "underwriters finally woke up that they needed to underwrite the program and not just offer the coverage," and as a result corporate governance and internal controls are now central considerations in pricing).

194 Id, Risk Manager #3 at 14–15 (noting that the issue was in fact debated within his firm).

195 See, for example, John E. Core, *The Directors' and Officers' Insurance Premium: An Outside Assessment of the Quality of Corporate Governance*, 16 J L, Econ, & Org 449, 456–62 (2000) (using Canadian data); Zhiyan Cao and Ganapathi Narayanamoorthy, *Accounting and Litigation Risk* 24–26, 29–30 (Yale School of Management Working Paper No 47, Nov 2005), online at http://ssrn.com/abstract=853024 (visited Apr 12, 2007) (matching Tillinghast data with publicly available information to test the influence of corporate governance risk on D&O insurance premiums on U.S. firms); George D. Kaltchev, *The Demand for Directors' and Officers' Liability Insurance by US Public Companies* 34–52 (working paper, July 2004), online at http://ssrn.com/abstract=565183 (visited Apr 12, 2007) (using privately obtained panel data). See also Griffith, 154 U Pa L Rev at 1150 (cited in note 6) (advocating disclosure of this information).

196 Although two large insurers underwrite more than half of all primary policy limits, the D&O market is a generally fluid market with low barriers to entry. See note 21 and accompanying text.

ditions.[197] They can draw on their personal networks for information, and in some cases will simply be told by the broker what other carriers are quoting, both on the particular risk and on similar risks in the market. Moreover, the primary insurer's quotation is disclosed to all excess carriers before they provide their final quote, putting them in an even better position to predict the prices charged by their competitors. As a result, underwriters may adjust their pricing on the basis of factors not strictly relevant to the assessment of the risk.

This dynamic may contribute to the herd behavior of the D&O market and, in conjunction with intrafirm pressures to generate underwriting premiums, explain the winner's curse scenario frequently lamented by participants in our study.[198] Here, however, we wish only to note that these pricing dynamics, like the cycle itself, complicate the insurer's ability to match premiums to risks.

IV. CORPORATE AND SECURITIES LAW APPLICATIONS

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

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197 As we witnessed at the industry conferences we attended, D&O brokers and underwriters talk constantly about the market.

198 See note 172 and accompanying text (noting that pressures within insurance companies to generate premium volume may lead them to underwrite policies even when the premium does not fully compensate the insurer for the risk undertaken). See generally Richard Thaler, *Anomalies: The Winner's Curse*, 2 J Econ Perspectives 191 (1988) (explaining the winner's curse, a tendency for the winning bidder in an auction to overpay). See also Scott E. Harrington and Patricia M. Danzon, *Price Cutting in Liability Insurance Markets*, 67 J Bus 511, 520–21 (1994) (introducing the concept of the winner's curse into analysis of the insurance underwriting cycle). When considering the importance of the winner's curse, it is worth noting the following:

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

Baker, 54 DePaul L Rev at 421 n 97 (cited in note 84).

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

Because virtually all corporations purchase D&O insurance to cover the risk of shareholder litigation, and because virtually all shareholder litigation settles within the D&O insurance limits,[199] the D&O insurance premium represents the insurer's best guess of the insured's expected liability costs.[200] The D&O premium, in other words, represents an insured's expected corporate and securities law liability charged as an annual fee. One of our first research questions was whether this transformation of the liability rules of corporate and securities law into an annual fee alters the deterrent effect of the law. Does this annual fee increase the deterrence of fraud? Does it stimulate the improvement of corporate governance?[201]

Our research supports the proposition that D&O insurers seek to price policies according to the risk posed by each corporate insured, which, if successful, would fulfill a basic requirement of deterrence theory—that the burden of liability fall more heavily on bad actors.[202] As described in detail above, we find that insurers actively seek to distinguish good companies from bad ones. They gather information through detailed applications and personal meetings with top-level management. They analyze a variety of factors, focusing on the accounting risk and governance practices of the prospective insured. Underwriters report that all of these factors influence D&O pricing, at least since the most recent hard market cycle. Ideally, then, we can expect worse-governed firms to pay more for an equivalent amount of D&O insurance than their better-governed peers.[203] They will have systematically higher operating costs than peer firms, making it more difficult for them to compete in product and capital markets, potentially driving bad firms to seek to reduce the annual D&O fee by im-

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199 See notes 2–3 and accompanying text.

200 Premium amounts also include a loading fee reflecting the expenses and profits of the insurance company. Griffith, 154 U Pa L Rev at 1168 (cited in note 6).

201 We address other approaches to managing the moral hazard of D&O insurance in Baker and Griffith, 95 Georgetown L J (forthcoming 2007) (cited in note 8).

202 See generally Steven Shavell, *On the Social Function and the Regulation of Liability Insurance* (Geneva Papers on Risk and Insurance Theory, March 2000), online at http://ssrn.com/abstract=224945 (visited Apr 12, 2007).

203 Shareholder litigation and corporate governance are substitutes. We would therefore expect firms with stronger ex ante corporate governance to experience less ex post shareholder litigation. See Eric Talley and Gundrun Johnsen, *Corporate Governance, Executive Compensation and Securities Litigation* 15 (University of Southern California Law School, Olin Research Paper No 04-7, May 2004), online at http://ssrn.com/abstract=536963 (visited Apr 12, 2007) ("[C]orporate governance and litigation are policy substitutes: the less invasive a firm's corporate governance regime, the greater the likelihood that the firm will face securities litigation as a form of ex post discipline.").

proving the quality of their corporate governance.[204] In this way, the annual cost of liability insurance would carry forward the deterrence function of corporate and securities law.

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

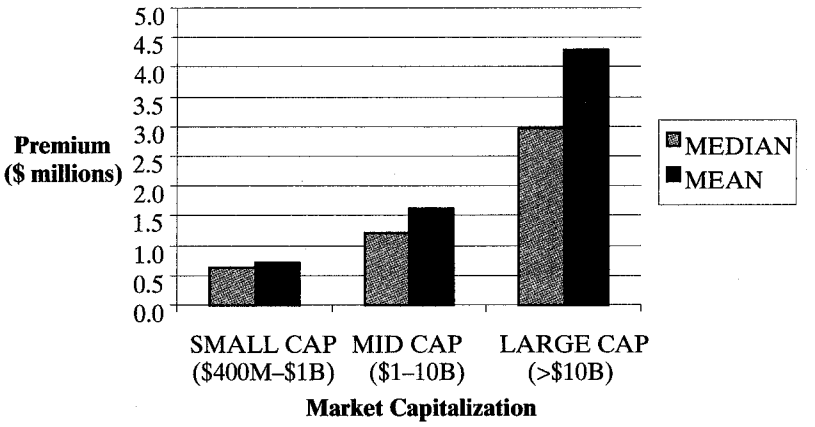
First, D&O insurance expenses might be so small, given a corporation's overall costs and cash flows, that companies fail to take them into account as a significant source of cost savings. Without firm-specific information, we cannot comment on whether D&O insurance costs are large enough, relative to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

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

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

FIGURE 3: ANNUAL PREMIUMS BY MARKET CAPITALIZATION CATEGORY



Source: Tillinghast, *2005 Survey* at 72 table 61C (cited in note 2). We derived the "Mid Cap" category as a weighted average of three market capitalization classes reported by Tillinghast. See note 74.

Interestingly, liability insurers may play a part in the failings of the liability system by keeping the costs of shareholder litigation artificially *low*. If this seems counterintuitive, recall that securities claims almost always settle within the limits of available insurance.[205] This, alone, is unsurprising since plaintiffs' lawyers typically prefer to be paid by an insurance company that is contractually obliged to pay them rather than to expend extra effort seeking recovery from individuals who will do everything they can do to protect their personal assets.[206] Now consider what happens if the real cost of securities litigation grows at a faster rate than insurance limits, which, by some accounts at least, seems to have occurred in the 1990s when market capitalizations grew exponentially but D&O limits remained relatively stable.[207] Because plaintiffs' lawyers would prefer to settle for insurance proceeds only, settlements will not reflect the real cost of liability but rather a lower amount—the growth rate of insurance limits.[208] In

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205 See note 3.

206 See Baker, 12 Conn Ins L J at 6–7 (cited in note 10); Baker, 35 L & Socy Rev at 289–93 (cited in note 16).

207 See Miller, Foster, and Buckberg, *Recent Trends* at 7 (cited in note 25) (providing data that shows expected settlements have risen more slowly than investor losses).

208 See James D. Cox and Randall S. Thomas, *Letting Billions Slip through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 Stan L Rev 411, 450 (2005) ("[W]e suspect that settlements are fixed . . . by the amount of available insurance or cash from the issuer.").

this situation, bad actors will pay significantly less in liability costs than the harm they cause. They will, in other words, be underdeterred. As importantly, damages will be effectively capped at typical policy limits.[209] And this compression of damages may lead to an inadequate spread between the liability costs of good and bad actors. When these liability costs are converted into an ex ante insurance premium, they will be similarly compressed, leading to further cross-subsidization of bad firms by good firms and therefore less deterrence.

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

As one of us has argued at length elsewhere, a corporation's D&O premium, if disclosed, would reveal valuable information about the corporation's governance quality to capital market participants.[210] Because underwriters seek to assess the risks posed by insureds and to charge an appropriate premium for different degrees of risk, the price of a firm's D&O policy represents the insurer's assessment of the governance quality of the insured,[211] taking into account, of course, the deductibles, limits, and other terms of the policy (which also would have to be disclosed).[212] Armed with this signal of governance quality, capital market participants may adjust their reservation values, discounting the share price of firms whose D&O premiums reveal low-

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209 As reported earlier, there are a small number of highly visible settlements in excess of the policy limits. See note 3. See also Baker, 12 Conn Ins L J at 6–7 & n 13 (cited in note 10) (using the Texas Department of Insurance commercial liability claims database to report "that there was a payment in excess of policy limits in only 31 out of 9723 [commercial] liability insurance paid claims in 2002 and that the total amount paid above the limits in those cases was $9 million, as compared to $1.8 billion in total [commercial] liability payments in Texas in 2002"); Zeiler, et al, *Physicians' Insurance Limits* at 3 (cited in note 16) (using the Texas Department of Insurance medical liability claims data to report an even smaller ratio of above-limit payments and that medical malpractice insurance settlements cluster at the policy limits).

210 See Griffith, 154 U Pa L Rev at 1150 (cited in note 6).

211 Because of D&O pricing competition in cyclical insurance markets, the signal of the D&O premium should not be taken as an absolute measure of governance quality but rather as a relative measure. Firms' D&O premiums should not be compared to each other across markets but, because insurers face similar underwriting pressures in a given market, only within that market. In other words, comparisons should be made only among firms whose policies were underwritten at approximately the same time. Id.

212 In order for the premium to have this signaling effect, market analysts would have to control for the financial and industry factors that predict the likelihood of investment loss generally. These adjustments would control for each of the factors in the base price algorithm, leaving only the governance variables. See note 183.

quality corporate governance, thereby reintroducing the deterrence function of corporate and securities law.[213]

B. Do the Merits Matter in Securities Litigation?

Corporate and securities law scholars have extensively debated the question of whether outcomes in shareholder litigation are related to the underlying merits of claims or whether such claims are, in fact, largely frivolous.[214] The principal argument is that shareholder litigation is driven by plaintiffs' lawyers whose incentives are so weakly correlated with shareholder interests that claims are both brought too often and settled too cheaply.[215] Supporting this argument, scholars have shown that shareholder claims have settled for relatively small amounts, often for attorneys' fees alone.[216] Others have sought to show that settlements tend to cluster around nonmeritorious factors, such as a "going rate" demanded by plaintiffs' lawyers to settle such claims.[217] These arguments were influential in the passage of the PSLRA in 1995.[218] Since then, research has shown that settlements have corre-

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213 It is worth pointing out again that what equity analysts are looking for (predictors of future performance) is not exactly the same as what D&O underwriters are screening for (predictors of future litigation). See note 124. However, litigation activity has a significant negative effect on shareholder returns. See Sanjai Bhagat, John Bizjak, and Jeffrey L. Coles, *The Shareholder Wealth Implications of Corporate Lawsuits*, 27 Fin Mgmt 5, 6 (1998) (finding that corporate defendants lose nearly 1 percent of their value on the day a lawsuit is filed and almost 3 percent when the lawsuit alleges securities fraud). Equity analysts and other capital market participants therefore have strong incentives to take into account the information revealed by the D&O premium.

214 See generally Johnson, Nelson, and Pritchard, J L, Econ, & Org (forthcoming) (cited in note 140); Steven J. Choi, *Do the Merits Matter Less after the Private Securities Litigation Reform Act?* (NYU Law and Economics Research Paper No 03-04, Feb 2005), online at http://ssrn.com/abstract=558285 (visited Apr 12, 2007).

215 See John C. Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 L & Contemp Probs 5, 8 (1985). See also Kraakman, Park, and Shavell, 82 Geo L J at 1736–37 (cited in note 5) ("[I]nitiators of shareholder litigation ... are ... likely to be attorneys ... in search of legal fees.").

216 See Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J L, Econ, & Org 55, 61 (1991) (finding that although only half of the settlements in her sample resulted in any recovery to shareholders, 90 percent awarded attorneys' fees).

217 See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements of Securities Class Actions*, 43 Stan L Rev 497, 500 (1991) (concluding that the merits do not matter). But see Cox, 39 Ariz L Rev at 503–04 (cited in note 3) (disputing Alexander's conclusion by, inter alia, pointing out her failure to control for market events that may have explained some of her results); Elliott J. Weiss and John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L J 2053, 2084 (1995) (recalculating settlement amounts as a function of potential damages and finding that Alexander's 25 percent "going rate" can no longer be supported).

218 See, for example, Private Litigation Under the Federal Securities Laws, Hearings before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 103d Cong, 1st Sess 302–08 (1993) (statements of Ralph V. Whitworth, President of the United Shareholders Association, and A.A. Sommer, Jr., Chairman, Public Oversight Board of

lated more closely with evidence of fraud, such as accounting restatements and abnormal insider trading.[219] The merits, in other words, seem to matter more than they once did.[220] But the extent to which the merits matter in shareholder litigation remains an open question.

Our research supports the proposition that the merits *somewhat* matter. We found that D&O insurers do indeed inquire into a host of governance factors that are likely to be related to the merits of shareholder litigation.[221] We have been careful to emphasize that these are not the only factors that they examine, nor can we evaluate whether D&O insurers correctly weigh these factors in their risk assessment. Nevertheless, D&O underwriters do report that they take merits-related factors into consideration. Because this is a revealed preference of D&O insurers—the party with the most to lose in the event that its risk assessments are incorrect—our findings provide evidence that these factors do affect the risk of shareholder litigation.

C. What Matters in Corporate Governance?

Similarly, corporate and securities law scholars have also long sought to determine which corporate governance variables are most important either in terms of firm performance or litigation risk. Numerous studies examine factors such as board independence,[222] committee

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the SEC Practice Section of the AICPA) (discussing the problems of frivolous lawsuits and opportunistic attorney practices in D&O litigation); William S. Lerach, *Securities Class Action Litigation under the Private Securities Litigation Reform Act's Brave New World*, 76 Wash U L Q 597, 598–601 (1998) (stating that Congress "relied heavily upon Professor Janet Cooper Alexander's article" in enacting the PSLRA). On the PSLRA in general, see note 140.

219 See Johnson, Nelson, and Pritchard, J L, Econ, & Org (forthcoming) (cited in note 140).

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

221 We are not seeking here to furnish a theory of what should count as "merit" in shareholder litigation. Because corporate governance and shareholder litigation are substitutes and well-governed firms ought therefore to be sued less often than poorly governed firms, the conventional approach in the literature is to treat corporate governance variables as proxies for merit. See id at 1489–91. That corporate governance variables weigh in the underwriters' assessment of D&O risk, therefore, provides indirect support for the proposition that the merits do matter.

222 See Bernard S. Black and Sanjai Bhagat, *The Non-Correlation between Board Independence and Long-Term Firm Performance*, 27 J Corp L 231, 231 (2002) (finding that firms with more independent boards do not perform better than other firms); Eric Helland and Michael Sykuta, *Who's Monitoring the Monitor? Do Outside Directors Protect Shareholders' Interests?*, 40 Fin Rev 155, 171 (2005) (finding that, from 1988 to 2000, firms with more independent boards were less likely to be sued by their shareholders). But see Johnson, Nelson, and Pritchard, J L, Econ, & Org (forthcoming) (cited in note 140) (finding no greater ability to predict securities litigation on the basis of a handful of governance factors including average board tenure, average number of additional directorships held by outside directors, percentage of outside directors, number of audit committee meetings, percentage of independent members of the audit commit-

composition,[223] executive compensation,[224] and management entrenchment[225] for their effects on firm performance or litigation risk. Scholars have also constructed various governance indices to test correlation of corporate governance variables and firm performance. Using their "Governance Index," Paul A. Gompers, Joy L. Ishii, and Andrew Metrick found that firms with more promanagement governance terms perform significantly worse than firms with more proshareholder governance terms.[226] Seeking to discard noise variables, Lucian A. Bebchuk, Alma Cohen, and Allen Ferrell narrowed the Governance Index to a six-factor "Entrenchment Index" and found these six factors in fact drove the results of the Governance Index.[227] Meanwhile, Lawrence D. Brown and Marcus L. Caylor broadened the number of factors under consideration and found that a number of variables not included on other indices—including management compensation practices, meeting attendance, board independence, and committee composition—were significantly correlated with performance.[228]

Our findings suggest that these easily observable factors may be overemphasized in the corporate and securities law literature. We found, instead, that D&O underwriters base a large amount of their risk assessment on the deep governance of a prospective insured,

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tee, separation of the chief executive and board chair functions, whether the CEO was a firm founder, and whether the firm had a 5 percent or greater blockholder).

223 See Agrawal and Chadha, 48 J L & Econ at 371 (cited in note 129) (finding that the probability of a restatement is lower for companies whose boards or audit committees have an independent director with financial expertise and higher for companies in which the chief executive officer belongs to the founding family).

224 See Talley and Johnsen, *Corporate Governance* at 4 (cited in note 203) (finding a close relationship between incentive compensation and securities litigation and estimating that "each 1% increase in the fraction of a CEO's contract devoted to medium- to long-term incentives . . . predicts a 0.3% increase in expected litigation and a $3.4 million dollar increase in expected settlement costs") (emphasis omitted).

225 See, for example, K.J. Martijn Cremers and Vinay B. Nair, *Governance Mechanisms and Equity Prices*, 60 J Fin 2859, 2870 (2005) (treating the Gompers, Ishii, and Metrick index, discussed in note 226 and accompanying text, as an entrenchment index to compare the interaction of internal versus external governance constraints).

226 See Paul A. Gompers, Joy L. Ishii, and Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q J Econ 107, 107 (2003) (using the twenty-four corporate governance variables tracked by IRRC, most of which related to takeover preparedness, to develop a governance rating system and comparing the performance of the most highly rated firms against the lowest scoring firms throughout the 1990s).

227 See Lucian A. Bebchuk, Alma Cohen, and Allen Ferrell, *What Matters in Corporate Governance?* 2–4 (Harvard Law School John M. Olin Center Discussion Paper No 491, Mar 2005), online at http://ssrn.com/abstract_id=593423 (visited Apr 12, 2007). The six entrenchment factors were: (1) staggered boards, (2) limitations on shareholders' ability to modify bylaws, (3) limitations on shareholders' ability to modify the charter, (4) supermajority voting provisions, (5) golden parachutes, and (6) poison pills. Id at 2.

228 See Lawrence D. Brown and Marcus L. Caylor, *Corporate Governance and Firm Performance* 21–22 (unpublished draft, Dec 2004), online at http://ssrn.com/abstract=586423 (visited Apr 12, 2007).

weighing both the culture of the firm (the system of incentives and constraints embedded within the firm) and the character of its management (its ability to rationalize its way around rules and whether it is likely to be made up of "risk-takers above the norm").[229]

Culture and character do not make sense within a theory where the primary corporate governance concern is board entrenchment—a factor in which D&O underwriters are relatively uninterested.[230] They do, however, comport with a broader theory of corporate governance that recognizes aspects of organizational behavior. In recent years, several scholars have sought to erect this new framework of corporate governance.

For example, Donald C. Langevoort has argued that in order to survive the tournament-style promotion structure within firms, executives must cultivate traits such as "over-optimism, an inflated sense of self-efficacy and a deep capacity for ethical self-deception."[231] Yet these very traits that enable executives to succeed also put the firms they manage at greater risk of fraud and failure, a dynamic exemplified by Enron itself:

> Enron was filled with people who [were] optimistic, aggressive, and focused. The culture quickly identified itself as special and uniquely competent, believing that special skill rather than luck (or just being first) was responsible for the early victories. That self-definition then set a standard for how up-and-coming people acted out their roles: Enron was a place for winners. With this—and the stock market's positive feedback—the company's aspiration level rose.
>
> This aspiration level required a high level of risk-taking by the firm .... [T]he compensation and promotion structure at Enron ... harshly penalized the laggards at the firm, which, on average, tends to lead to herding behavior (risk *aversion*). To counteract this, the company had to magnify the reward structure con-

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229 See Parts III.C.1–2.

230 Underwriters acknowledged takeover protections as a relevant risk assessment factor only when asked directly and, even then, they did not emphasize them or discuss them at length. See note 160 and accompanying text.

231 Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals about Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 Geo L J 285, 288 (2004). Langevoort elaborates, noting that "the luckier risk-takers will outperform more risk-averse realists on average, and the positive feedback will enhance their self-efficacy." Id at 299.

> siderably for those who ended up as stellar performers—a winner-take-all kind of tournament.[232]

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

This hypercompetitive culture breeds a certain kind of character—one with a tendency to equate what is self-serving with what is right, what Langevoort refers to as "ethical plasticity."[233] In his words:

> The person who most likely strikes the right competitive balance in a high-stakes promotion tournament is the one who best conceals from others the inclination to defect when necessary—extremely difficult in a corporate setting where one is being closely observed by subordinates, peers and superiors—yet does so nimbly. People who best deceive others are usually those who have deceived themselves, for they can operate in a cognitively unconflicted way. The Machiavellian with the best survival prospects in the corporate tournament is especially adept at rationalization: convincing himself as well as others that what is self-serving is also right.[234]

Executives with this type of character in this kind of culture are among the most likely to lead their organizations into a spiral of ever greater risk taking and, when their luck finally sours, to convert risk taking into fraud.[235]

Other scholars make similar arguments. In seeking to predict which firms are most likely to restate their earnings, Stanford's William H. Beaver identified the following set of factors: (1) a company has experienced unusually high growth, (2) management attributes this growth to skill rather than luck, (3) management has made continued

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232 Donald C. Langevoort, *The Organizational Psychology of Hyper-Competition: Corporate Irresponsibility and the Lessons of Enron*, 70 Geo Wash L Rev 968, 973–74 (2002).

233 Langevoort, 93 Geo L J at 299 (cited in note 231). A reinsurance underwriter similarly observed:

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

D&O Interviews, Underwriter #10 at 55 (cited in note 39).

234 Langevoort, 93 Geo L J at 303 (cited in note 231).

235 Langevoort, 70 Geo Wash L Rev at 974 (cited in note 232) (summarizing this cycle by noting that "overconfidence commits them to a high-risk strategy; once committed to it, they are trapped").

growth an integral part of corporate strategy, (4) management is arrogant or naïve about their prospects for sustaining such growth, and (5) management perceives the financial reporting and internal controls as a nuisance or subservient to entrepreneurial goals.[236] Similarly, Howard M. Schilit, a leading expert in forensic accounting, calls special attention to firms with weak internal controls, intense competition, and managers with questionable ethical judgment, sounding a particular alarm on high-growth companies whose growth is beginning to slow (Enron) and companies that are struggling to survive (WorldCom).[237] Finally, David Skeel has found evidence of this same pattern of destructive risk in a series of major corporate scandals going back over a century.[238]

D&O underwriters, it would seem, are screening for precisely these traits. Their unease with "risk takers above the norm"[239] and managers who are "not sure how we are going to grow 20 percent, but ... we are going to grow 20 percent"[240] is based on suspicion of over-optimistic promises and over-committed managers. Similarly, disquiet concerning executives who rationalize their pollution issues by noting that "[i]t was a small aquifer"[241] is consistent with Langevoort's de-

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236 See William H. Beaver, *What Have We Learned from the Recent Corporate Scandals that We Did Not Already Know?*, 8 Stan J L, Bus & Fin 155, 163 (2002) (further noting that "based upon the information disseminated in the financial press, the [corporate scandals] appear to fit these conditions quite well"). See also Nassim Nicholas Taleb, *Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets* 161 (West 2d ed 2005) (discussing the tendency to mistake luck for skill).

237 See Howard M. Schilit, *Financial Shenanigans: How to Detect Accounting Gimmicks and Fraud in Financial Reports* 32 (McGraw-Hill 2d ed 2002). Management teams in this situation face a kind of final period problem, in which fraudulent risk taking and possible success may appear preferable to truthful disclosure and certain failure, whether failure means termination of employment, takeover, or bankruptcy. See generally Jennifer H. Arlen and William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U Ill L Rev 691 (1992). In the words of Arlen and Carney:

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

Id at 702–03.

238 See David Skeel, *Icarus in the Boardroom: The Fundamental Flaws in Corporate America and Where They Came From* 16 (Oxford 2005). See also generally Sean J. Griffith, *Daedalean Tinkering*, 104 U Mich L Rev 1247 (2006) (reviewing Skeel).

239 See note 167 and accompanying text.

240 See note 169 and accompanying text.

241 See note 166 and accompanying text.

scription of ethical plasticity and Beaver's concern for those who view compliance with rules as subservient to entrepreneurial goals.

That underwriters screen for deep governance, again, is a revealed preference. We cannot say how important deep governance variables are in comparison with other aspects of corporate governance, nor can we evaluate whether underwriters are adept at measuring these variables.[242] But we can say that underwriters report that deep governance variables are an important part of assessing D&O risk. That these variables are largely missing from mainstream scholarship on corporate governance is, thus, a bit of a puzzle.[243] Our study thus suggests an important area of further research—specification and econometric testing of deep governance variables.

CONCLUSION

Insurance companies transmit, via D&O premiums, the liability content of corporate and securities law to American corporations. This Article has described how D&O insurers evaluate risk in order to arrive at that premium number. We found that, in addition to performing a basic financial analysis of the company, underwriters focus a large part of their efforts on understanding the corporate governance of the prospective insured, especially nonstructural "deep governance" variables such as culture and character.

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

Finally, we contribute to the economic analysis of law by providing an insurance market case study that is both theoretically informed and thoroughly grounded. Such theoretically informed qualitative research should serve to advance the economic understanding of how

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242 Underwriters do, however, have special access to information—direct access to top managers at the underwriters' meeting—that might enhance their ability to make such determinations. See notes 111–113 and accompanying text.

243 One explanation may be, to borrow from Archilochus, that economists are hedgehogs and the large dataset regression is their one big trick. See Anne Pippin Burnett, *Three Archaic Poets: Archilochus, Alcaeus, Sappho* 60 (Harvard 1983) ("The fox knows many tricks, the hedgehog just one—but his is a good one.").

law works.[244] It provides a reality check on the model-building and quantitative research methods on which law and economics scholars increasingly rely. Law, after all, is a social field, and a considerable amount of explanatory power may be lost in abstractions that fail to reflect how the world in fact works. Our alternative is to test the insights of economic research in its social context, to provide a thick description of the actors in a social field and their understanding of what they do and how and why they do it. Such research ought to play a large role in the design of economic models as well as their critique and ultimate improvement. In addition, qualitative methods allow researchers to explore questions for which there are no quantitative data available and to investigate fields that are not yet sufficiently understood to model. Our ultimate goal is thus not to replace economic modeling or quantitative research methods but rather to suggest a means of improving them.

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[244] Our approach to qualitative research, of course, is not without precursors. In this regard we follow in some large footsteps. See sources cited in note 13. See also generally Gideon Parchomovsky and Peter Siegelman, *Selling Mayberry: Communities and Individuals in Law and Economics*, 92 Cal L Rev 75 (2004) (describing American Electric's buyout of Cheshire, Ohio, as a case study for nuisance disputes and the resulting holdouts, bargaining, and community dynamics); Eric A. Feldman, *The Tuna Court: Law and Norms in the World's Premier Fish Market*, 94 Cal L Rev 313 (2006) (describing Japanese tuna merchants' use of a specialized court for conflict resolution and evaluating its efficacy through qualitative metrics).