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

*Sean J. Griffith**

ABSTRACT

This Essay explores the connection between corporate governance and D&O insurance. It argues that D&O insurers act as gatekeepers and guarantors of corporate governance, screening and pricing corporate governance risks to maintain the profitability of their risk pools. As a result, D&O insurance premiums provide the insurer's assessment of a firm's governance quality. Most basically, firms with relatively worse corporate governance pay higher D&O premiums. This simple relationship could signal important information to investors and other capital market participants. Unfortunately, the signal is not being sent. Corporations lack the incentive to produce this disclosure themselves, and U.S. securities regulators do not require registrants to provide this information. This Essay therefore advocates a change to U.S. securities regulation, making disclosure of D&O policy details—specifically premiums, limits and retentions under each type of insurance, as well as the identity of the insurer—mandatory.

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I. GATEKEEPING

Much of the blame passed around after the recent spate of corporate governance scandals has fallen ultimately on the gatekeepers. Soon after the fall of Enron and WorldCom, Professor Coffee wrote that “Enron is more about gatekeeper failure than board failure.”¹ Moreover, although gatekeepers can include a variety of third-party intermediaries—including outside auditing firms, debt rating agencies, equity analysts, investment bankers, and lawyers²—most of the post-Enron attention has been focused on the role of the outside auditor.³ In his prescription for fixing the gatekeeping crisis, Professor Coffee ultimately joined others in advocating a regime of strict liability for outside auditors, essentially converting the auditor into an insurer of the company’s financial statements.⁴

¹ John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 BUS. LAW. 1403, 1419 (2002).

² Professor Coffee defines gatekeepers as “reputational intermediaries who provide verification and certification services to investors.” *Id.* at 1405. *See also* Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third Party Enforcement Strategy*, 2 J. L. ECON. & ORG. 57, 57 (1986) (defining gatekeepers as “private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers”).

³ Most, not all. *See, e.g.*, Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 7245 (2002) (adopting standards to increase the gatekeeping role of outside counsel); Claire A. Hill, *Rating Agencies Behaving Badly*, 35 CONN. L. REV. 1145 (describing failure of debt ratings agencies to act as gatekeepers); Susan P. Koniak, *Corporate Fraud: See, Lawyers*, 26 HARV. J.L. & PUB. POL’Y 195 (2003) (arguing that a “lion-sized portion of blame” for Enron and other corporate governance crises rests with lawyers).

⁴ *See* John C. Coffee, Jr., *Gatekeeper Failure And Reform: The Challenge Of Fashioning Relevant Reforms*, 84 B.U.L. REV. 301 (2004) (suggesting a form of strict liability for auditors that would limit their exposure to a multiple of the highest annual revenues the gatekeepers had recently received from the defrauding client). Professor Coffee’s ultimate proposal is similar to a proposal previously made by Professor Partnoy. *See* Frank Partnoy, *Barbarians At The Gatekeepers?: A Proposal For A Modified Strict Liability Regime*, 79 WASH. U. L. Q. 491 (2001); Frank Partnoy, *Strict Liability For Gatekeepers: A Reply To Professor Coffee*, 84 B.U.L. REV. 365 (2004). Comparing his proposal to Professor Coffee’s, Professor Partnoy has written:

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

Partnoy, 84 B.U.L. REV. at 375. Rather than converting the auditor into an insurer, others have instead advanced a more direct insurance-market solution—Financial Statement Insurance—and argued that companies ought to be able to choose between financial statement auditing and financial statement insurance. *See* Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement*

Yet for all of the focus on the gatekeeping role of the outside auditor, another potential gatekeeper has escaped notice. This is the directors' and officers' ("D&O") liability insurer. Although their primary role is to spread the risk of loss from shareholder litigation, not necessarily to provide the verification and certification services expected of third-party gatekeepers, the D&O insurer has all the right incentives to act as a corporate governance gatekeeper. Because a firm's risk of shareholder litigation corresponds to the firm's corporate governance, D&O insurers have every reason to become experts at assessing corporate governance in order to evaluate and ultimately charge for the risks they assume.⁵ The D&O insurer thus serves as an accidental gatekeeper, guarding the entrance of its risk pool by evaluating the governance quality of prospective insureds and charging an appropriate premium to firms it agrees to insure.

The D&O insurer's incentive to serve as a corporate governance gatekeeper produces a simple but powerful hypothesis concerning the relationship of D&O insurance to corporate governance: *firms with worse corporate governance pay higher D&O premiums than firms with better corporate governance*. A firm's D&O coverage should thus convey an important signal about the firm. Specifically, by examining the firm's premium, limits and retentions under each type of coverage, as well as the identity of the primary insurer, investors and other capital market participants should be able to learn the insurer's assessment of the quality of the firm's corporate governance.⁶

This Essay develops the governance-insurance hypothesis and explores its implications and limitations. After this Introduction, Part II evaluates the link between corporate governance and shareholder litigation, arguing that even if shareholder litigation does not necessarily lead to better corporate governance, better corporate governance ought to lead to less shareholder litigation, which provides D&O insurers with an adequate reason to concern

Insurance Alternative to Auditor Liability, 52 UCLA L. REV. 413 (2005); Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited*, 8 STAN. J. L. BUS. & FIN. 39 (2002).

⁵ Such expertise would be a product of competition against other D&O insurers since those that are less able to predict the nature of the risks they underwrite face adverse selection in their risk pools and, ultimately, claims costs significantly higher than their more skilled competitors. George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970) (providing the classic account of adverse selection from the example of a used car market).

⁶ A policy's "limit" is the total amount of coverage—that is, the maximum amount the insurer could be made to pay. The "retention," also referred to as the "deductible" is the portion of the claim that the insured must pay even if the policy's limits are not exhausted.

themselves with corporate governance. Part III reviews the role and function of D&O insurance in corporations, describing how D&O insurance works and why corporations buy D&O insurance. Part IV then examines the relationship between corporate governance and D&O insurance, arguing that D&O insurers *should* and in fact *do* take corporate governance into account when writing (and pricing) D&O policies. As a result, Part IV concludes that a firm's D&O coverage should convey an important signal to investors and other capital market participants. Unfortunately, as discussed in Part V, this signal is not reaching the market. Corporations typically do not disclose the details of their D&O policies and, in the United States unlike other countries, no court or regulator makes them.

They should. Because basic D&O policy details could signal important information to investors and thereby improve the efficiency of the capital markets, this Essay argues that U.S. securities regulations should be changed to require the disclosure of this information. The SEC has sufficient authority to make this change which, as described in Part V, would be technically simple and unlikely to incur principled opposition. Moreover, the benefits of this change are potentially large, effectively unleashing a new gatekeeper in American corporate governance and triggering a flood of useful information into the market. The Essay then closes, in Part VI, with a brief summary and conclusion.

II. SHAREHOLDER LITIGATION AND CORPORATE GOVERNANCE

The hypothesis that D&O insurers function as corporate governance gatekeepers, signaling firm value through the D&O premium depends, first, on the relationship between shareholder litigation and corporation governance. As used in this Essay, "shareholder litigation" refers to all claims covered under a D&O policy, whether brought by a regulatory agency, a holder, purchaser, or seller of a firm's securities.⁷ The Essay gives a similarly expansive definition to "corporate governance," defining it broadly to refer to any policies or structural mechanisms effecting management of the firm.⁸ If there were no relationship between shareholder litigation and

⁷ See *infra* note 50 (defining "Claims" under a typical D&O policy).

⁸ This understanding of corporate governance does not limit it to specific governance terms, typically found in charter or bylaw provisions, which have generally been found to have an ambiguous effect on firm value. See, e.g., Lucian Arye Bebchuk, Alma Cohen, and Allen Ferrell, *What Matters in Corporate Governance?* Harvard Law & Economics Discussion Paper No. 491, available online at <http://ssrn.com/abstract=593423> (2004); Lawrence D. Brown & Marcus L.

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

Shareholder litigation, notwithstanding the breadth of the definition I have given it, typically involves three types of claims: shareholder derivative actions, shareholder direct actions, and securities fraud claims. Derivative suits—actions brought by shareholders on the corporation's behalf to recover for a manager's breach of duty—were once thought to exert an important constraint on managerial agency costs.⁹ Now, however, a wide variety of procedural obstacles enables boards to terminate such claims early and at relatively low cost.¹⁰ In addition to the derivative suit, state corporate law also allows shareholders to sue individually or as a class when they can allege an injury that is not derivative of an injury to the corporation.¹¹ These claims, typically brought as class actions

Caylor, *Corporate Governance and Firm Performance* (2004); K.J.M. Cremers & V.B. Nair, *Governance Mechanisms And Equity Prices*, Yale Working Paper (2003); Gompers, Ishii, and Metrick, *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107 (2003). The correlation of D&O insurance pricing to specific governance terms is outside of the scope of this paper and is the subject of an empirical project that I am currently undertaking with my colleague Tom Baker.

⁹ See, e.g., *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949) (stating that the derivative action “born of stockholder helplessness, was long the chief regulator of corporate management” and noting the argument that “without it there would be little practical check on such abuses”). This Article will refer to the divergence in interests between management and shareholder interests as “agency costs.” See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (identifying the divergence in interests between principal and agent as a central feature of the separation of ownership and control).

¹⁰ These include the requirement that the plaintiffs make demand and, in some states, post a bond for corporate defense costs. More broadly, procedural hurdles include the business judgment rule and the ability of a special litigation committee to wrest control of the litigation from the plaintiff. See generally N.Y. Bus. Corp. Law §627 (requiring posting of a bond); *Grimes v. Donald*, 673 A.2d 1207 (Del. Supr. 1996) (discussing the demand requirement); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. Supr. 1981) (special committee); *Auerbach v. Bennett*, 419 N.Y.S. 2d 920 (1979) (special committee). These procedural obstacles reflect the widely-held view that derivative litigation is a corporate nuisance, of value only to plaintiffs' attorneys, leading some to argue that the derivative action should be abolished. See, e.g., STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 404-405 (2002).

¹¹ See *Grimes v. Donald*, 673 A.2d at 1213 (discussing distinction between derivative and direct claims).

challenging board conduct in the context of takeovers or acquisition transactions, have come to dominate state corporate law filings.¹² They are not as easily terminated as derivative claims and, according to some commentators, target precisely those transactions in which agency costs are potentially highest.¹³ Finally, securities litigation may be brought in many of the same situations that give rise to state corporate law claims.¹⁴ Although these claims must be framed around misrepresentations or inadequacies in corporate disclosure,¹⁵ the basic concern—that company managers have misused their positions to the disadvantage of their shareholders—is the same whether the complaint is framed under corporate or securities law.¹⁶ The biggest difference, it seems, is the potential for damages, with securities litigation presenting by far the greatest liability threat to corporations and their managers.¹⁷

¹² See Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 137 (2004) (finding that approximately 80% of all fiduciary duty claims filed in Delaware Chancery Court in 1999 and 2000 were class actions challenging board conduct in an acquisition and that only 14% of fiduciary duty claims over the same period were derivative suits).

¹³ See *id.*, at 139 (arguing that “shareholder acquisition litigation polices those management transactions with the highest potential for self-dealing”). Agency costs may be high in both hostile and friendly acquisitions. See generally Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 975, 977-81 (arguing that boards should not be permitted to block hostile takeover offers); Sean J. Griffith, *Deal Protections in the Last Period of Play*, 71 FORDHAM L. REV. 1899, 1946 (2003) (arguing that the management team’s last period presents agency costs and therefore the possibility of diversions from shareholder welfare even in the context of negotiated acquisitions). But see Elliot J. Weiss & Lawrence J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions*, __ VAND. L. REV. __ (forthcoming 2004) (finding that indications of litigation agency costs are also present in acquisition-oriented class actions).

¹⁴ See Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 861 (2003) (arguing that outside of the context of self-dealing and acquisitions “corporate governance ... has passed to federal law and in particular to shareholder litigation under Rule 10b-5”).

¹⁵ See *Basic, Inc. v. Levinson*, 485 U.S. 224, 241-47 (1988) (allowing a 10b-5 claim to survive dismissal on the basis of an allegation that shareholders sold at a price reflecting the company’s false or misleading statements, thereby replacing traditional notions of fraud with the “fraud-on-the-market” theory).

¹⁶ Thompson & Sale, *supra* note 14, at 903 (citing the concern “that management has misused its position with respect to corporate assets”).

¹⁷ See, e.g., Elaine Buckberg, et. al., *Recent Trends in Class Action Litigation: Bear Market Cases Bring Big Settlements* (NERA Economic Consulting 2005) (reporting that the mean securities settlement increased by 33% in 2004 to \$27.1 million and stating that, although the median settlement fell slightly from \$5.5 million to \$5.3 million, the “increase in mean settlements cannot be explained by a handful of extraordinary settlements”); Laura E. Simmons & Ellen M. Ryan, *Post-Reform Act*

A long list of actions may give rise to one or more of these forms of shareholder litigation. Knepper and Bailey, for example, provide a 170 item checklist of potential bases for liability with category headings including “Governance, Management, and Business,” “Informed Business Judgment,” “Unauthorized or Ultra Vires Actions,” “Self-Dealing and Conflicts of Interest,” “Change of Control Situations,” and “Disclosures.”¹⁸ The common theme underlying all of these liability threats, however, is a corporate structure that enables managers to act contrary to the best interests of their shareholders. Whether shareholders bring a derivative claim alleging a wealth transfer from shareholders to management, a direct action claiming that an entrenched board has not acted to maximize shareholder wealth in the context of a takeover, or a securities claim alleging that managers misstated earnings in order to protect their incentive compensation packages, the underlying cause is the failure of the corporation to design a structure to constrain its managers from acting to benefit themselves at the expense of their shareholders.¹⁹

Good governance ought to lead to less litigation. Corporate governance constraints may prevent managers from deviating from shareholder interests and thus triggering shareholder claims. Alternately, even if it cannot prevent managerial opportunism, corporate governance mechanisms may enable its detection and eradication, thereby limiting the total loss to shareholders and, ultimately, the cost of litigation.²⁰ In other words, insofar as defective corporate governance underlies all forms of shareholder litigation, better governance ought to translate into less litigation or, at least, less costly claims.

The assertion that better governance leads to less litigation is not the same as the assertion that that litigation will lead to better governance. Indeed, there is considerable doubt concerning the latter proposition. In an influential study of derivative litigation, for example, Professor Romano concluded that “shareholder litigation is

Securities Lawsuits: Settlements Reported Through December 2003, at 4 (Cornerstone Research 2004) (reporting that average securities claims costs have tripled since 1997). The higher recoveries in securities litigation may reflect the fact that there are fewer procedural hurdles in the way of securities plaintiffs in comparison to corporate law plaintiffs. *See supra* note 10.

¹⁸ WILLIAM E. KNEPPER & DAN A. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS*, 7th ed., at §17.02.

¹⁹ The same harm may thus give rise to a claim under corporate law, whether derivative or direct, and securities law. *See* Thompson & Sale, *supra* note 14 (noting this overlap).

²⁰ *See generally* OLIVER E. WILLIAMSON, *THE MECHANISMS OF GOVERNANCE* 47-48 (1996) (discussing costs of opportunism).

a weak, if not ineffective, instrument of corporate governance.”²¹ Relatedly, in a famous study of securities class action settlements, Professor Alexander concluded that the merits do not matter in the settlement of securities claims.²² The core concern driving both analyses can be characterized as “litigation agency costs”—that is, the divergence between the interests of the plaintiffs’ attorney controlling the litigation and the shareholder plaintiffs that the attorney supposedly represents.²³ This disconnect leads plaintiffs’ lawyers both to file claims that shareholders would prefer not to press,²⁴ and to settle claims that shareholders would prefer to pursue.²⁵ Litigation agency costs thus distort the ability of shareholder litigation to check managerial agency costs.²⁶

²¹ Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L. ECON. & ORG. 55, 84 (1991).

²² Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements of Securities Class Actions*, 43 STAN. L. REV. 497 (1991).

²³ See Alexander, *supra* note 22, at 500 (citing “the economic incentives of litigation decisionmakers” as a core cause of the failure of settlements to follow the merits of the claim); Romano, *supra* note 21, at 57 (“attorneys’ incentives are the key factor in shareholder litigation”). Accord John C. Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 L. & CONTEMP. PROB. 5 (1985).

²⁴ See, e.g., Elliot Weiss & John Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L. J. 2053, 2060-64 (1995) (describing the plaintiffs’ lawyers practice of rushing to the courthouse any time a dip in stock price can be tied to a piece of bad news).

²⁵ See Romano, *supra* note 21, at 61 (supporting hypothesis that plaintiffs’ attorneys are willing to settle for attorneys’ fees but recovery to shareholders by finding that although only half of the settlements in her sample resulted in any recovery to shareholders, 90% awarded attorneys’ fees). On the question of when, according to shareholders’ best interests, shareholder litigation should be pursued, see Reinier Kraakman, Hyun Park & Steven Shavell, *When Are Shareholder Suits in Shareholder Interests*, 82 GEO. L. J. 1733 (1994).

²⁶ See generally Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487 (1996); Randy J. Kozel & David Rosenberg, *Solving the Nuisance-Value Settlement Problem: Mandatory Summary Judgment*, 90 VA. L. REV. 1849 (2004); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs’ Attorney’s Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 3 (1991); Adam J. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925 (1999); See also authors cited at *supra* note 23. The problem of litigation agency costs also shaped the reforms adopted in the Private Securities Litigation Reform Act of 1995. See Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C. 77-78). D&O insurance arguably exacerbates these distortions by effectively releasing directors and officers from the threat of personal liability. See James D. Cox, *Private Litigation and the Deterrence of Corporate Misconduct*, 60 LAW & CONTEMP. PROB. 1, 21-37 (1997) (weighing arguments that insurance undercuts the deterrence effects of shareholder litigation).

Skepticism that shareholder litigation operates as an effective governance constraint should not, however, be taken as reason to doubt that effective corporate governance will lead to less shareholder litigation.²⁷ Litigation agency costs disrupt the causal connection between litigation and governance, but not necessarily the link between governance and litigation. The distortion of litigation agency costs arises only *after* conduct giving rise to a potential claim has taken place, at which point plaintiffs' lawyers may pursue nuisance suits and settle valid claims so that the ultimate result bears little relation to the socially optimal sanction for the conduct.²⁸ Corporate governance mechanisms, by contrast, operate *before* the harmful conduct has occurred. Because corporate governance operates at a level prior to the introduction of litigation agency costs and may prevent the harm from ever taking place, corporate governance has a more direct impact on shareholder litigation than shareholder litigation does on corporate governance.²⁹ Stated most concisely, better corporate governance should lead to less shareholder litigation regardless of whether shareholder litigation leads to better corporate governance.

In order to advance the insurance-as-gatekeeper hypothesis, this Essay need only claim that better governance leads to less litigation, not that litigation leads to better governance. Scholarship focusing on the problem of litigation agency costs has drawn the latter conclusion into doubt, but not the former. Insurers therefore retain strong incentives to inquire into the strength of a firm's corporate governance in underwriting its D&O policy.

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

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

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

III. THE ROLE AND FUNCTION OF DIRECTORS' & OFFICERS' LIABILITY INSURANCE

Directors' and Officers' Liability Insurance arose in the 1950s and 1960s as a species of the general liability policies that insurers had long marketed.³⁰ The first D&O policies were not well adapted to the special context of corporate litigation, leaving gaps in coverage and, because they seemed to clash with public policy objectives, raising issues of enforceability.³¹ The troubling public policy question was whether a corporation could insure its managers against losses for which it could not legally indemnify them.³² Although commentators had argued that insurance payments should not be allowed in any circumstance where indemnification was illegal,³³

³⁰ See Joseph F. Johnston, Jr., *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993 (1978) ("Although [D&O] policies have been marketed since the 1950s, the coverage had little attention until the mid-1960s."). Accord Joseph W. Bishop, Jr., *New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability*, 22 BUS. LAW. 92, 103 (1966) (noting that the author had written four years earlier that directors and officers "do not commonly insure themselves against the expenses of litigation arising out of their corporate status" but that since that time insurers had found a highly receptive market for D&O insurance, representing "a violent new twist" on the older problem of the propriety of indemnification payments).

³¹ Professor Bishop quipped:

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

22 BUS. LAW. 92, at 103.

³² See *id.*, at 106.

³³ See *id.*, at 107 (arguing that "where the applicable statute flatly prohibits indemnification inconsistent with its terms, it seems to me plainly illegal for the corporation to pay for insurance against expenses, such as payments to the corporation to compensate it for a breach of duty to it") and 109-110 (arguing that because "courts would never allow a corporation to indemnify an insider against amounts paid the corporation in settlement or satisfaction of judgment" of a claim for breach of fiduciary duty, the same criteria should be applied "to the corporation's payment for insurance which may operate to relieve the insider of such liability"). See also Joseph W. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L. J. 1078, 1087 (1967) (arguing that "an insurance policy paid for by the corporation whose effect was to free corporate managers from the fear of civil liability for breach of their duty to show good faith in their dealings with the corporation" would violate public policy); Note, *Indemnification of Directors: The Problems Posed by Federal Securities and Antitrust Legislation*, 76 HARV. L. REV. 1403, 1428 (1963) (arguing that "insurance in its present form should be voided as contrary to public policy wherever it would free the director from a burden from which he could not be freed by indemnification"); Note, *Public Policy and Directors' Liability*

state legislators ultimately mooted the argument by passing statutes that expressly allowed corporations to purchase and maintain D&O insurance even against those losses that the corporation could not itself indemnify.³⁴

D&O insurance thus operates as a contractual mechanism to spread the risk of shareholder litigation.³⁵ It moves the risk from individual directors and officers to the corporation they manage and then to a third-party insurer, with the ultimate result that individual managers are almost never saddled with personal liability for causing corporate losses.³⁶ If the shareholders sue, the corporation or its insurer pays. This Part offers a close examination of this insurance arrangement.

Insurance, 67 COLUM. L. REV. 716, 719 (1967) (arguing that insurance against breach of the duty of loyalty is contrary to public policy even if paid by the director himself).

³⁴ For example, Delaware General Corporate Law §145(g) provides:

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

DEL. CODE ANN. TIT. 8, 145(g) (2004). *See also* JOSEPH WARREN BISHOP, JR., THE LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE §8.01 (revised edition, 1998) (“All states authorize the corporation to purchase and maintain insurance on behalf of directors and officers against liabilities incurred in such capacities, whether or not the corporation would have the power to indemnify against such liabilities.”).

³⁵ Although employment litigation plays a large role in D&O coverage for smaller companies, it does not for larger firms. *See* Tillinghast 2003 Directors and Officers Liability Survey: Executive Summary of U.S. and Canadian Results, at 7 (2004) (reporting that “91% of the claims against nonprofit [companies] were brought by employees, while only 24% of claims against for-profit companies with greater than 500 shareholders were brought by employees”). Because the focus of this Article is on publicly traded companies, it focuses on shareholder litigation and not employment litigation as the primary source of litigation risk for D&O insurance.

³⁶ *See* Bernard S. Black, Brian R. Cheffins & Michael Klausner, *Outside Director Liability*, Stanford Law and Economics Olin Working Paper No. 250 (2003). Recent settlements involving WorldCom and Enron compel the “almost” qualification. *See* Gretchen Morgenson, *Ex-Directors at WorldCom Settle Anew*, N.Y. TIMES (Mar. 19, 2005) (describing agreement according to which former WorldCom directors will personally contribute to settlement amount). On the difficulties of reaching personal assets rather than insurance assets in the ordinary tort context, *see* Tom Baker, *Blood Money, New Money and the Moral Economy of Tort Law in Action*, 35 LAW & SOC'Y REV. 275, 277 (2001).

A. How D&O Insurance Works

The general label “D&O insurance” is often applied to three distinct insurance arrangements. First, there is coverage to protect individual managers from the risk of shareholder litigation. Second, there is coverage to reimburse the corporation for its indemnification obligations. And third, there is coverage to protect the corporation from the risk of shareholder litigation to which the corporate entity itself is a party. The first two aspects of D&O coverage trace to the original Lloyd’s of London D&O form.³⁷ The third form of coverage is a newer development. A D&O insurance package may consist of these forms of coverage in any proportion.

The only form of D&O insurance that actually insures individual directors and officers is referred to within the industry as “Side A coverage.”³⁸ Side A coverage essentially provides that the insurer will pay covered losses on behalf of managers when the corporation itself does not indemnify its managers.³⁹ Covered losses include compensatory damages, settlement amounts, and legal fees incurred by the individual in connection with her service as a director or officer of the corporation.⁴⁰

³⁷ The original Lloyd’s form contained two policies, “ALS(D4)” and “ALS(D5),” one for individual coverage and one for corporate coverage. See Joseph Hinsey, *et al.*, *What Existing D&O Policies Cover*, 27 BUS. LAW. 147, 150 (1972) (“In a documentary sense there are indeed two policies, designated ... as ALS(D4) and ALS(D5) and bearing different policy numbers as issued.”).

³⁸ The types of coverage are named in reference to the insurance documents listing the respective rights and obligations. Side A coverage relates to “Insuring Agreement A,” Side B coverage to “Insuring Agreement B,” and so on.

³⁹ Typical policy language provides:

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

The Hartford, Directors, Officers and Company Liability Policy, Specimen DO 00 R292 00 0696, § I.A. [hereinafter, *Hartford Specimen Policy*]. The effect of the carve out for losses paid pursuant to Insuring Agreement B is to prevent the managers from being paid twice for the same loss.

⁴⁰ *Id.* at §IV.J. (including compensatory damages, settlement amounts, and legal fees). 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. *Id.*, at §IV.A. 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. *Id.* at § IV.O.

The second form of D&O coverage, “Side B coverage,” does not protect individual managers at all but rather reimburses the corporation for indemnifying its directors and officers.⁴¹ Payments under Side B coverage are thus triggered when the corporation incurs an obligation to indemnify its managers, which most policies deem to be required in every case where a corporation is legally permitted to do so.⁴² Together, Side A and B coverage allocate the risk of loss from shareholder litigation as follows. First, when a company is legally permitted to indemnify its managers for their liabilities, as it generally is, it must do so.⁴³ Second, when a company does indemnify its managers, the insurer will reimburse the company

⁴¹ Typical policy language provides:

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

Id. at §I.B.

⁴² *Id.* 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). When a corporation that is legally able to indemnify its directors and officers refuses to do so, the insurer would remain obligated under the policy’s Side A coverage, but the obligation would be subject to the (higher) Side B retention as well as a coinsurance percentage). *Id.* This presumptive indemnification aspect of the D&O policy is aimed at preventing the possibility of opportunism, where a corporation refuses to indemnify solely to cause the payment obligation to fall on the insurer.

⁴³ Although most state corporate law codes broadly permit indemnification, many states, including Delaware, do not allow indemnification for settlements (or judgments) in derivative litigation on the theory that such awards benefit the company and are paid, minus the chunk awarded to the plaintiffs’ attorneys, into the corporate treasury. *See* DGCL §145(a) (permitting indemnification for expenses, judgments, and settlements for actions except those “by or in right of the corporation”). Because derivative litigation is asserted by shareholders in the corporation’s name, it is an action “by or in right of the corporation.” To allow indemnification in such situations would be circular: the director paying the settlement to the corporation only to be given back the same amount by the corporation as indemnification. *See generally* Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance*, 51 BUS. LAW. 573, 580 (1996) (“The theory is that the corporation would be indemnifying the director or officer for a settlement ultimately paid to the corporation itself as plaintiff. Certain state legislatures, including Delaware’s, have determined that such circularity of payment is unacceptable.”) (citation omitted). Delaware does, however, permit corporations to indemnify directors for defense costs incurred by directors and officers in reaching settlement or judgment. DGCL §145(b). Finally, 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 indemnified. *See, e.g.,* Raychem Corp. v. Federal Ins. Co., 853 F. Supp. 1170 (N.D. Cal. 1994).

pursuant to the terms of its Side B coverage.⁴⁴ Third, when a company is not legally permitted to indemnify its directors and officers, as in the settlement of derivative actions, the insurer will pay pursuant to the company's Side A coverage.⁴⁵

The result of all of this is that an insurer's Side A coverage obligations are triggered principally when liabilities arise from the settlement of derivative litigation or when the company is insolvent. Otherwise, and in the vast majority of cases, the liability falls on the corporation in the form of an indemnification obligation to its managers.⁴⁶ Side B coverage then shifts this liability, albeit at a higher retention, to the third-party insurer.⁴⁷ The basis for both forms of coverage, it is important to note, is the appearance of a claim against the company's managers. Neither Side A nor Side B coverage is available to cover liabilities that the corporation itself may have to a party in any given action.

Side C coverage emerged to fill this void. Evolving first as a solution to the disputes between insurance companies and corporate defendants over what portion of a securities settlement ought to be allocated to the managers (and therefore reimbursed by the insurer under the corporation's Side B coverage) versus to the corporation (and therefore uncovered and paid directly by the corporation),⁴⁸ Side

⁴⁴ Side B coverage has higher retentions than Side A coverage, which may have no retention at all. See Hartford Specimen Policy, §VI.F. and Declarations Items D (retentions).

⁴⁵ A slight wrinkle arises when a corporation's legal ability to indemnify diverges from its financial capacity to do so. Most policies resolve this issue by creating a "financial insolvency" exception to the presumptive indemnification provision which requires the insurer to reimburse individual managers under Side A of the policy when the corporation is financially unable to indemnify them. See *Hartford Specimen Policy* §VI.F. (providing Financial Insolvency exception); §IV.G. (defining financial insolvency as the status resulting from the appointment of a receiver, liquidator, or trustee to supervise or liquidate the company or the company becoming a debtor in possession). These provisions allow managers of insolvent firms to collect insurance proceeds without becoming subject to the higher retention amounts and coinsurance payments required when a corporation otherwise refuses to indemnify.

⁴⁶ Don A. Bailey, *Side-A Only Coverage*, Feb. 11, 2004 (unpublished manuscript on file with author) (reporting that "the vast majority of Claims covered under a D&O Policy are indemnified by the Company").

⁴⁷ See *supra* note 44.

⁴⁸ See, e.g., *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424 (9th Cir. 1995) (recognizing the insurer's right to allocation unless insurer has improperly refused to defend the insured or has made no claim to separate the portion of the settlement for which it was liable); *Safeway Stores, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh*, 64 F.3d 1282 (9th Cir. 1995) (applying "larger settlement rule," entitling corporation to reimbursement of all settlement costs where corporation's liability is purely derivative of liability of insured officers and directors) ; *First Fidelity*

C coverage moots the allocation issue by insuring the corporation itself against direct claims.⁴⁹ 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...⁵⁰

To ensure that the company retains some “skin in the game” at settlement, insurers may insist on a higher retention amount for Side C claims as well as a significant co-insurance percentage.⁵¹ Still, Side C coverage is the final step in the process of shifting the cost of shareholder litigation to a third party insurer.

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

Bancorp v. Nat’l Union, 1994 U.S. Dist. LEXIS3977, at *12 (E.D. Pa. Mar. 30, 1994) (“[B]oth the directors and officers as well as the corporate entity faced liability in the underlying litigation. The mere fact that liability arises exclusively from the conduct of the insured... does not provide a basis for the insurer to be responsible for the liability of those who are uninsured.”); PepsiCo, Inc. v. Cont’l Cas. Co., 640 F. Supp. 656, 662 (S.D.N.Y. 1986) (addressing the issue of allocation between covered and non-covered parties and holding that the insurer bore the burden of proving that the ultimate allocation was reasonable in light of the “relative exposures” of the parties). *See also* Monteleone, Bailey & McCarrick, *Allocation of Defense Costs and Settlements Under D&O Policies*, INSIGHTS, Vol. 5, No. 11 (Nov. 1991).

⁴⁹ *See* Monteleone & Conca, *supra* note 43, at 618-20 (noting the various responses of insurers to the problem of allocation disputes, including predetermined allocation agreements and entity coverage).

⁵⁰ *Hartford Specimen Policy*, §I.C. A securities claim is defined in the policy to include claims by securities holders alleging a violation of the Securities Act of 1933 or the Securities Exchange Act of 1934 or rules and regulations promulgated pursuant to either act as well as similar state laws and includes claims “arising from the purchase or sale of, or offer to purchase or sell, any Security issued by the company” regardless of whether the transaction is with the company or over the open market. *Id.* at §IV.M. If the company purchases Side C coverage, the definitions of “claim,” “loss,” and “wrongful act” expand to include the company and not just the directors and officers.

⁵¹ *See Hartford Specimen Policy*, Declarations Page, Item D (providing for separate retention amount for A, B, and C coverage) and E (providing for coinsurance percentages for securities claims).

protecting the company from direct liability from securities litigation. What all of these goals have in common, however, is the shifting of risk from shareholder litigation, in whole or in part, to a third party insurer.

B. Why Corporations Buy D&O Insurance

The vast majority of American public companies—a proportion consistently reported at well over 90%—buy D&O insurance.⁵² This presents a puzzle. Insurance, after all, is not free. Insurance premiums reflect not only the policy's risk—an actuarially determined probability of loss—but also a loading fee reflecting the insurer's costs and profits.⁵³ This means that it always costs more to buy insurance for a risk than to bear it oneself.⁵⁴ Moreover, unlike individuals, for whom third-party insurance may be the only available means of spreading risk, corporations are themselves sophisticated risk-shifting mechanisms, ultimately allocating the risk of business failure to shareholders whose losses, thanks to limited liability, cannot exceed the extent of their investment. Furthermore, because shareholders can spread this risk costlessly (or nearly so) by holding a diversified portfolio of stocks, it is a puzzle why corporations buy insurance at all. Why would corporations pay extra for something that their shareholders can get for free in the capital markets?

For basic property and casualty insurance, economists have largely answered this question.⁵⁵ First, features of the tax code,

⁵² Tillinghast 2003 Directors and Officers Liability Survey, *supra* note 35, at fig. 3 (showing that since 1997 90% or more of U.S. respondents have purchased D&O insurance, with 97% of U.S. respondents purchasing coverage in 2003).

⁵³ KARL BORCH, *ECONOMICS OF INSURANCE* 13-15, 163 (1990) (describing the insurance premium as the sum of the expected claim payment under the insurance contract, the administrative expenses of the insurance company and the reward to the insurer for bearing the risk, later referring to the difference between expected claims payments and the insurance premium as the “loading” of the contract).

⁵⁴ As a result, it is thought to be rational for individuals to purchase insurance only for very large potential losses that, if incurred, would significantly diminish their quality of life and irrational to insure against small losses—by buying extended consumer warranties, for example—that one could easily bear oneself. [CITATION PENDING]

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

including the availability of deductions for insurance premiums but not for internal reserves,⁵⁶ create incentives for corporations to purchase insurance rather than to self-insure.⁵⁷ In addition, because transaction costs in bankruptcy are high,⁵⁸ creditors and shareholders alike may prefer that the corporation purchase insurance against large potential losses in order to keep the firm out of bankruptcy.⁵⁹ Creditors may also insist that corporations insure major assets in order to protect the security of their loans.⁶⁰ Some forms of property and casualty coverage may thus add value to the corporation.

These explanations, however, do not apply to the purchase of D&O insurance. Although there may still be some tax advantage to buying insurance over reserving, such advantages shrink with the size of coverage. Because D&O policies and premiums are smaller than property and casualty coverages, the relevant tax deductions as well as the costs associated with creating self-insurance reserves are also smaller.⁶¹ Similarly, because likely D&O losses are a fraction of potential losses under a general property and casualty policy, they pose less of a bankruptcy threat.⁶² Finally, there is no evidence that creditors insist on D&O insurance as a condition for making corporate loans. All of which suggests that the corporate benefits from the purchase of D&O insurance are considerably smaller than the corporate benefits from the purchase of basic property and casualty insurance. The costs, however, remain the same.⁶³ The predominance of D&O insurance therefore is all the more puzzling.⁶⁴

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

⁵⁶ [CITE IRC. CONFIRM ACCURACY.]

⁵⁷ See Mayers & Smith, *Demand*, *supra* note 55, at 289-91, 294-95 (describing and modeling tax incentives for corporate insurance purchases); MacMinn & Garven, *Corporate Insurance*, *supra* note 55, at 557-60 (same).

⁵⁸ See J. B. Warner, *Bankruptcy Costs: Some Evidence*, 32 J. FIN. 337 (1977).

⁵⁹ See Mayers & Smith, *Demand*, *supra* note 55, at 284-85; MacMinn & Garven, *Corporate Insurance*, *supra* note 55, at 548-50.

⁶⁰ See Mayers & Smith, *Demand*, *supra* note 55, at 287 (noting that “[b]ond indentures frequently contain covenants requiring the firm to maintain certain types of insurance coverage”); MacMinn & Garven, *Corporate Insurance*, *supra* note 55, at 550-57 (modeling corporate insurance as a means to mitigate agency problems between corporate managers and bondholders).

⁶¹ [CITATION COMPARING SIZES OF GENERAL CORPORATE POLICIES V. D&O POLICIES]

⁶² [NOTE SAYING WHY AND PROVIDING STATISTICS TO SUPPORT]

⁶³ The cost of coverage includes a loading fee that is proportional to the total amount of coverage. See *supra* note 53 and accompanying text.

⁶⁴ See *supra* note 52 and accompanying text (noting that over 95% of American corporations purchase D&O insurance).

benefiting the corporation itself. Because Side A coverage protects individuals, it can be justified on the basis of individual risk aversion.⁶⁵ Corporate managers insist on D&O insurance to protect their personal wealth from the risk of shareholder litigation, making such coverage necessary to attract qualified persons to board service and executive-level employment.⁶⁶ Side A coverage is thus explained as an aspect of the individual's compensation package, a cost that the labor market has allocated to the employer.⁶⁷ However, this is not a complete explanation for D&O insurance. It does not explain why corporations also purchase coverage, under Side B and C of the policy, for the corporation itself.

Indeed, entity-level coverage for the risk of shareholder litigation is particularly puzzling since the corporation controls the governance processes that create litigation risk. Because corporations can mitigate this litigation risk by improving their governance structure and shareholders can eliminate the risk of business failure by holding a diversified portfolio, the party in the best position to bear the risk of shareholder litigation would seem to be the corporation itself.⁶⁸ Moreover, once the loading fees associated with D&O insurance are taken into account, the costs of entity-level coverage appear to outweigh the benefits. Entity-level D&O insurance, in other words, appears to be a negative net present value investment. Why, then, do corporations buy it?

⁶⁵ See generally PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS*, 207-209 (17th ed. 2001) (describing risk-aversion and its relationship to the diminishing marginal utility of income).

⁶⁶ Participants in the insurance market cite this as the basic explanation for D&O insurance. See, e.g., Randy Parr, *Directors and Officers Insurance*, in *D&O LIABILITY INSURANCE 2004: DIRECTORS & OFFICERS UNDER FIRE 13* (PLI 2004) (reporting that "it is difficult for corporations to attract and keep outside directors").

⁶⁷ Coverage for individual directors and officers was recognized as an aspect of compensation early in the evolution of D&O insurance. See, e.g., Johnston, *supra* note 30, at 2013 (stating that the fact that the corporation paid D&O premiums "was nothing more than another form of compensation for the executives and another way of attracting capable managers"). Interestingly, the first D&O policies allocated a portion of the premium, usually 10%, to the individual insured. See Wallace, *More on Sitting Ducks: (Officers and Directors, That Is)*, *INSURANCE*, April 16, 1966, 32, 36 (describing then-typical "ration of 90% of the premium to the corporation and 10% to the officers and directors"). This aspect of the policy has been discontinued, presumably because individual directors and officers asked for and received corporate payment of the full premium.

⁶⁸ Although D&O insurance may guarantee a recovery *ex post* for shareholders who sue a bankrupt or insolvent firm, *ex ante* shareholders could more efficiently manage the risk of corporate bankruptcy by holding a diversified portfolio of shares. The diversification point similarly moots arguments regarding the insurer's efficiencies in claims administration.

If the purchase of entity-level D&O insurance is not a sensible investment for the firm, it may nevertheless serve the interests of the firm's managers. Managers who, unlike diversified shareholders, have a significant personal stake in the firm they manage, have a greater personal incentive to avoid corporate-level losses.⁶⁹ Even if losses are unlikely to lead to insolvency (and manager unemployment), they may still impact corporate assets and earnings, drawing unwelcome scrutiny from the capital markets including, perhaps, a challenge to the management of the firm.⁷⁰ More directly, losses resulting in a reduction in the firm's earnings are likely to have an impact on the managers' compensation. The probable losses from shareholder litigation are in precisely this category—too small to jeopardize the solvency of the firm, but large enough to put management's paycheck at risk. This may go a long way towards explaining the purchase of entity-level D&O insurance.

Managers may purchase entity-level D&O coverage because their compensation packages are based on accounting measures of performance, especially earnings, and because shareholder litigation is likely to have a direct adverse impact on corporate earnings.⁷¹ Entity-level D&O insurance allows managers to avoid these shocks to earnings.⁷² By buying D&O insurance, managers essentially trade

⁶⁹ As a general matter, this incentive arrangement is good for shareholders since managers that seeks to avoid losses obviously benefits shareholders' portfolios overall. In this one instance, however, because using D&O insurance to avoid corporate level losses is a negative net present value investment, shareholder and manager interests are not aligned.

⁷⁰ The challenge may be in the form of a proxy fight or an unwanted takeover bid. See generally Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1164 (1981); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 6 (1983). Significant reductions in earnings or assets may also result in a credit downgrade. See, e.g., Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 79 (2004) (describing how credit ratings work and what they signal to the market).

⁷¹ See generally LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004) (detailing defects in the design of executive compensation packages that lead to similarly distorted incentives).

⁷² In addition, a positive externality (from the managers' point of view) of this system may be that shareholder litigation becomes a less noteworthy event since it is handled almost exclusively by the third party insurer and rarely threatens the corporation itself. This may not be the case if corporations had to handle this litigation by itself. Because the corporation's risk of loss from any claim would thus be substantially higher, shareholder attention might be more focused on the company each time a shareholder claim arose.

large but infrequent expected losses for smaller annual costs in order to smooth earnings volatility.⁷³ Entity-level coverage, in other words, is a form of earnings management. Managers buy it to protect their compensation in spite of the fact that it is a negative net present value investment for the corporation. In this way, entity level D&O coverage is a paradigmatic example of agency costs—the dislocation between shareholder and manager incentives.⁷⁴

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

IV. D&O INSURANCE AND CORPORATE GOVERNANCE

Once corporations purchase D&O insurance, regardless ultimately of why they buy it, the risk of shareholder litigation is shifted, in whole or in part, to a third party insurer. Given the relationship between corporate governance and shareholder litigation,⁷⁵ the insurer subjects its capital reserves to risks largely determined by the insured's corporate governance. The implications of this relationship between D&O insurance and governance risk are explored in this Part.

⁷³ See Buckberg, et. al., *supra* note 17 (reporting that the mean securities settlement in 2004 was \$27.1 million, while the median settlement was \$5.3 million).

⁷⁴ Accord John M.R. Chalmers, et al., *Managerial Opportunism? Evidence from Directors' and Officers' Insurance Purchases*, 57 J. FIN. 609, 610-11 (2002) (investigating the hypothesis that managers are willing to buy large amounts of D&O coverage at high premiums because they receive all of the benefits of the coverage but bear the costs only in proportion to their fractional ownership of the firm's equity and finding, in a sample of IPO-stage firms, that "managers choos[e] abnormally high D&O insurance coverage based on their belief that their shares are priced too high"); John E. Core, *On the Corporate Demand for Directors' and Officers' Insurance*, 64 J. RISK & INS. 63, 81 (1997) (investigating the hypothesis that more entrenched managers are more likely to purchase D&O insurance and finding, in a sample of Canadian firms, that the "firms with higher excess director pay... are more likely to carry D&O insurance coverage and purchase higher limits," suggesting that managers bundle compensation and insurance because they do not internalize the cost of either).

⁷⁵ See *supra* Part II.

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

Insurance companies are experts at assessing risk. Because the success of an insurer's business depends upon taking in more capital than it pays out, the insurer must develop an ability to assess the probable payout obligations of each exposure and then charge an appropriate premium for the risk. Just as providers of auto insurance must assess the likelihood that a particular driver will cause an accident, a D&O underwriter must determine the likelihood that a particular management team will incur shareholder litigation. D&O underwriters therefore ought to develop categories of high risk corporate governance and low risk corporate governance just as car insurance underwriters develop categories of high and low risk drivers.⁷⁶

Insurers may assess a prospective insured's governance risk at the time the D&O policy is first underwritten and then, on an ongoing basis, at each annual renewal. Each year, the underwriter has the option of refusing to renew a policy or of increasing a premium in response to new information about a firm's governance risk. Similarly,⁷⁷ because D&O policies are bought and sold in competitive markets, prospective insureds have an opportunity to shop for the most comprehensive and least expensive coverage. Each party to the insurance arrangement is thus constrained by competition. A company with very poor corporate governance may be unable to find a willing underwriter, and an underwriter that prices its coverage very high may be unable to find clients.

⁷⁶ Governance risk may not be the only significant pricing point for the policy, but other factors should wash out when compared across industries or across different markets. If a particular industry, for example, is a likely target of shareholder litigation, firms in that industry may pay relatively high premiums compared to companies in other industries, but when compared to each other, pricing differences should be expected largely to track governance risk. Industry newsletters generally confirm this view. See, e.g., Lynna Goch, *Falling Markets, Rising Risks*, BEST'S REVIEW, May 2001, at 56 (stating that: "D&O underwriters price policies based on market capitalization of public companies.... Market conditions, type of risk, industry and terms of the policy also affect the pricing."); Lisa S. Howard, *European D&O Carriers Swearing Off 'Drive-By' Underwriting*, NAT'L UNDERWRITER, Dec. 2, 2002, at 20 (reporting that underwriters are once again "digging deep to really analyze a company, its board structure, who the people are and what their history is, what business they're in, and how they conduct their business.").

⁷⁷ Chubb and AIG are the leading primary underwriters in the U.S. market, with Chubb, The Hartford, and XL Specialty leading in the excess limits market. See Tillinghast 2003 Directors and Officers Liability Survey, *supra* note 35, at 7.

The policy application is the first step in the underwriting process and the insurer's most basic tool to collect information concerning a prospective insured.⁷⁸ Application forms are required of both new and renewal applicants, but the questions asked of each differ. New applicants are asked whether they or any subsidiary corporation has previously held a D&O policy and, if so, are asked for further details concerning the identity of the previous insurer, the previous policy's limit and deductible, and the policy premium.⁷⁹ This information may allow the underwriter to make an initial assessment of the prospective insured, using the reputation of the previous insurer to judge the overall acceptability of the risk profile and the prior policy's limits, deductible, and premium as a proxy for the prior underwriter's ultimate assessment of the risk presented by the prospective insured. The application form also asks new applicants about any prior claims experience and whether any covered person has knowledge of acts or omissions that may give rise to a claim.⁸⁰ Both new and renewal applicants are asked about recent or planned corporate restructurings, including mergers & acquisitions activity, reorganizations, and sales or distributions of businesses as well as plans to register an offering of securities.⁸¹ New and renewal applicants are also asked to attach to the application a list identifying all directors and officers, the company's most recent annual report, proxy notices, and recent securities law filings as well as the company's most recent interim financial statements.⁸² The apparent purpose of these documents is to enable the underwriter to perform due diligence on the insured, but perhaps as importantly, these documents become incorporated into the application which becomes the basis of the policy and, if they contain a material misstatement or omission, a possible grounds for rescission of the insurance policy.⁸³ This feature of the application bonds a

⁷⁸ See E-Mail from Joseph P. Monteleone, Vice President, Hartford Financial Products, dated Feb. 16, 2005 ("completion of the application typically begins the process and precedes any meetings between the prospective insured and the underwriters") [hereinafter *Monteleone E-mail*].

⁷⁹ The Hartford, Proposal for Directors, Officers, and Company Liability Insurance, Form DO 00 R288 05 1103, at item 4a [hereinafter, *Hartford Specimen Application*].

⁸⁰ *Id.*, at item 5.

⁸¹ *Id.*, at item 3.

⁸² *Id.*, at item 7.

⁸³ The Hartford Specimen Application provides in its boilerplate that "ALL WRITTEN STATEMENTS AND MATERIALS FURNISHED TO THE INSURER IN CONJUNCTION WITH THIS PROPOSAL FORM ARE HEREBY INCORPORATED BY REFERENCE INTO THIS PROPOSAL AND MADE A PART HEREOF" and also that "THIS PROPOSAL SHALL BE THE BASIS OF THE CONTRACT SHOULD A POLICY BE ISSUED." *Id.* This language in the application is immediately followed by state-specific fraud warnings.

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

In many cases, the information supplied in the policy application is supplemented by meetings during which prospective insured makes presentations, described by participants as similar to an IPO road-show,⁸⁴ to prospective underwriters.⁸⁵ These presentations showcase, among other things, the prospective insured's corporate governance. Insurance brokers counsel clients to highlight positive governance terms. One document I obtained from a broker advises prospective insureds to discuss which outside auditing firm they use and to disclose whether they also purchase non-audit services from the same firm, essentially flagging a key corporate governance issue that arose in the wake of the Enron collapse.⁸⁶ The same document urges corporations to emphasize any steps taken to improve its governance, including "[p]articipating or completing any Corporate Governance workshops," and lists as other items to accentuate: the directors' equity interest in the company, how directors are screened and chosen, and whether the corporation has separated the roles of board chair and chief executive officer, all items that have repeatedly arisen in recent discussions of corporate governance.⁸⁷

⁸⁴ D&O Interview, Oct. 12, 2004 (transcript on file with author). These meetings are organized by the company's insurance broker and involve key company officials, typically the CFO and occasionally the CEO, and one or more insurance underwriters.

⁸⁵ See *Monteleone E-mail*, *supra* note 78 ("In the case of a very large (e.g. Fortune 1000) risk with multiple layers of coverage being sought, there may be an in-person meeting with the primary [insurer] and participation of excess insurers by teleconference.").

⁸⁶ See "Company Facts" (unpublished industry document on file with author). An introductory passage counsels:

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

Id. See also Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1237-39 (2002) (discussing problems arising from accounting firms that sell both auditing and advisory or consulting services).

⁸⁷ *Id.* On the role of importance of these specific governance provisions, see generally authors cited at *supra* note 8.

Another document prepared by a D&O broker to help clients prepare for these meetings advises on “Examples of Questions Being Asked by D&O Underwriters” and counsels clients to prepare for specific questions involving related party transactions,⁸⁸ earnings management,⁸⁹ and takeover planning.⁹⁰ In this document, the company is asked to consider how it responds to pressures to hit earnings targets and to address any company practices that might be criticized as earnings management.⁹¹ The questions also highlight general corporate governance issues including:

How does ‘bad news’ flow upward within the organization? Does the corporate culture encourage such news to be brought to the attention of senior management? Are significant developments shared with the Board of Directors as they become available? How does the company select a new member of the Board? How does the search process take place?⁹²

All of these questions go directly to the quality a firm’s corporate governance. Earnings management and related-party transactions may trigger either or both of securities litigation and derivative lawsuits.⁹³ Similarly, a board’s takeover planning may indicate entrenchment and whether shareholder suits are likely to be brought in connection with acquisition activity.⁹⁴ Perhaps most significant, however, is the question of intra-corporate information flows.

⁸⁸ Unpublished industry document on file with author. Listed questions include: “Does the Parent Company or any Subsidiary utilize any off balance sheet entities for financial transactions? Does any member of the Board of Directors have any outside affiliation or any common business interest with any major shareholder (10% or more)? Within the past three years, did the Parent Company or any Subsidiary engage in any related party transactions?”

⁸⁹ *Id.* These questions include: “Has the Parent Company changed auditors or restated its financials in the past three years? Please discuss the extent of the experience of the Audit Committee Members. How often do they meet? Does the Internal Audit Function have a direct report to the Audit Committee/Board of Directors? Has your external auditor approved revenue recognition practices? What is the length and scope of the company’s relationship with its outside auditors? What percentage of fees has the company paid for auditing vs. consultant fees? Are there any planned changes to this mix going forward? How does management cope with pressure to meet ‘street’ expectations? Where might the company be subject to criticism, if at all, for ‘earnings management’? How strong are internal controls over the financial reporting process?”

⁹⁰ *See id.*, (asking: “How does the company review potential mergers and acquisitions?”).

⁹¹ *See id.*

⁹² *Id.*

⁹³ *See* Thompson & Sale, *supra* note 14.

⁹⁴ *See* Thompson & Thomas, *supra* note 12.

Although not tied to a specific shareholder claim, answers to this question may indicate how potential problems are handled within the organization and perhaps handled before they give rise to shareholder litigation. In this way, the underwriter appears to be looking for clues to the health of the organization that go beyond issues tied to specific governance terms or types of litigation.

The insurer's ability to interact with corporate officials, whether when the policy is first underwritten or later, on an ongoing basis, allows its assessment of corporate governance to be based on a broader set of factors than would be revealed by charter terms or public documents.⁹⁵ When asked what governance factors seem to matter most, one broker remarked to me:

Let me tell you something. I've seen over 50 models of all different underwriters, and there's one model that works and it's the best model: It's the people. It's simply the people. Who are you dealing with? Who are they, and how do they act? Are they in it for themselves or are they in it for their shareholders?⁹⁶

The ability to take such intangible measures of governance quality into account may provide the D&O insurer with a better perspective on governance quality than outsiders with little or no access to company officials. Underwriters have the ability to ask questions and force prospective insureds to make representations and revelations regarding their corporate governance that are not always available to outsiders. Moreover, because these representations can be incorporated into the policy and, if false, form the basis of a rescission action, they can be expected to have a level of credibility and candor that most statements made by corporate officials do not.⁹⁷ D&O insurers thus form their estimate of an insured's governance quality on the basis of credible private information, unavailable to other market participants.

In addition to this unique access to information, insurers have the right incentives to perform a careful analysis of the prospective insured's governance risk. First, unlike other third party assessments of corporate governance, including equity analysts, Institutional Shareholder Services, and debt ratings agencies such as Moody's and Standard & Poor's, insurers lose capital when they evaluate a company incorrectly. Although it is possible to argue that other third-party corporate governance ratings also suffer when they are incorrect, because these tend to operate on a fee-for-services model,

⁹⁵ See *supra* note 8 and accompanying text.

⁹⁶ D&O Interview, morning, Nov. 12, 2004, (transcript on file with author).

⁹⁷ See *supra* note 83 and accompanying text (discussing the incorporation of the application into the policy, making it a basis for a rescission action).

which would incur losses only if repeated inaccuracies threatened their reputation, the sensitivity of these services to the cost of wrong guesses is considerably less direct than an insurer's.⁹⁸ Second, unlike mutual and pension funds and other diversified equity investors, insurance companies cannot eliminate the non-systematic risk of firm-specific governance. To be sure, insurers build portfolios of insureds, but insurance underwriting takes place in a competitive market and not every insurer receives a portion of every risk. As a result, each insurer's portfolio of insureds is different, with insurers that are skilled at distinguishing good and bad risks predictably building better overall portfolios than those who are not.⁹⁹ Because diversified equity investors can eliminate these kinds of non-systematic risk, there is less incentive for institutional investors to develop expertise in actively distinguishing good and bad risks. Third, unlike bond holders, who can control their downside risk through a combination of contract, security, and priority, insurers have no security interest and no system of priority to protect their rights if their risk assessments are ultimately wrong.

Given the structure of their incentives and their unique access to information, one can expect insurers to develop expertise in distinguishing good and bad governance risks and to build these assessments into their models for pricing D&O insurance. Simply stated, how much a firm pays for a specific amount of D&O insurance should provide a reliable outside assessment of its corporate governance.

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

⁹⁸ Moreover, because their success is not tied directly to the ratings they generate, but to the organizations that hire and pay them, ratings agencies' evaluations can be captured by other kinds of agendas—e.g., either pro- or anti- regulatory—that do not necessarily correspond to accurate evaluations of governance risk.

⁹⁹ Again, this is the problem of adverse selection. See Akerloff, *supra* note 5.

B. Incentive Effects

Businesses can improve their earnings in two ways: they can increase revenues or cut costs. Insurance expenses, including D&O premiums, are a source of cost. It follows, then, that corporations could improve their earnings by cutting them and, in order to create a competitive advantage, have ample incentive to do so. One way to cut insurance costs, of course, is not to buy coverage. As discussed above, however, corporations tend to purchase coverage even if it is on the whole a negative net present value investment.¹⁰⁰ Another way that corporations might try to manage insurance cost is to eliminate those governance features that lead to higher D&O premiums.

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

One problem with this incentives story is that while D&O insurance premiums are by no means small—the average premium for U.S. for-profit companies was \$1,237,000 in 2003¹⁰¹—they may not be large enough to spur large changes in corporate governance policies. If, as seems to be the case, the D&O insurance premium has a relatively small overall effect on a corporation's revenue stream, the marginal costs of regularly reviewing and revising internal governance policies—involving expensive legal and financial advisors as well as the time and attention of the general counsel and top level management—may easily outweigh the marginal benefits of savings in policy premiums.

Also, insofar as the corporation's reason for purchasing entity-level coverage is based upon agency costs within the firm,¹⁰² it is rather quixotic to expect corporations to cut D&O expenses in order to increase earnings. It is always true that managers could make their corporations run better by trimming agency costs. Managers could improve the bottom line by cutting their salaries, giving back their benefits packages, and firing their cronies. But it is also always true that they will be generally disinclined to do so. In this way, just as it

¹⁰⁰ See *supra* Part III.B.

¹⁰¹ Tillinghast 2003 Directors and Officers Liability Survey, *supra* note 35, at fig. 1 (reporting the median premium for these companies as \$562,000).

¹⁰² See *supra* Part III.B.

would not be surprising for D&O premiums to be higher for companies with bad managers, it would not be surprising for bad managers to refuse to be good in order to reduce an expense that is ultimately borne by the shareholders. Any reduction in agency costs would be better for shareholders, but if bad managers are not willing to fix these problems generally, it is unlikely that the additional corporate expense of marginally higher D&O premiums would spur them to do so.

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

C. Signaling Effects

Even if the cost of D&O insurance does not provide a sufficiently strong incentive to spur a corporation to optimize its corporate governance, it may nevertheless signal important information to market participants. First, the type of insurance package purchased by a particular firm may signal information concerning the firm's likely motives in purchasing it and, by extension, some gauge of the extent of agency costs within the organization. Second, following the hypothesis that insurers develop expertise in separating good governance risks in order to charge an appropriate premium, the price of a firm's D&O policy represents the insurer's assessment of the quality of the firm's corporate governance. Equipped with the information revealed by these signals, investors and other capital market participants may react by discounting the shares of firms revealed to have high agency costs or low-quality corporate governance, ultimately creating another incentive (avoiding this discount) for firms to improve their corporate governance.

The type of D&O coverage that a corporation purchases could convey an important signal to the market. As discussed in Part III above, D&O insurance may be intended to benefit either or both of the corporation's individual managers and the corporate entity itself. Insofar as the insurance is intended to benefit individuals, it may be a necessary feature of the benefits package required to attract top-level talent to the firm. Entity-level coverage, however, may trace to agency costs.

Because it is simple to distinguish whether D&O coverage was purchased to benefit individual managers, on the one hand, or the corporate entity, on the other, a company's D&O package can serve as a simple proxy for agency costs. Side A coverage only benefits individuals while Side B and Side C coverages only benefit the corporate entity.¹⁰³ A corporation purchasing only Side A coverage may suffer less from agency costs than a firm that has bought a large amount of Side B and Side C coverage as well.¹⁰⁴ Market participants could learn this information simply by reviewing the types of coverage purchased by a particular insured.

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

Finally, and perhaps most importantly, the price the corporation pays for its coverage conveys important information concerning the corporation's governance quality. If firms do not continually optimize their corporate governance and firms with worse corporate governance pay more for D&O insurance than firms with better corporate governance, market participants could use D&O insurance pricing as a proxy to evaluate a firm's corporate governance. The most obvious place to look for this information is the firm's D&O premium.

A company's insurance premium could be converted into a proxy for governance quality with a few relatively simple adjustments. First, because insurance premiums depend in part on the coverage

¹⁰³ See *supra* Part III.A.

¹⁰⁴ My conversations with insurance industry participants revealed that some firms do in fact purchase "Side A only coverage." As one executive with a major D&O underwriter described it to me:

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

D&O Interview, November 12, 2004, afternoon (transcript on file with author). *Accord* Bailey, *supra* note 46.

limits and the firm's retention, premium data must be adjusted to effective coverage amounts. This, however, would be a relatively easy adjustment to make, given a broad data-set including insurance premiums, limits, and retentions for many companies. Second, in addition to these features of the insurance policy itself, insurance premiums may correlate to other features of the corporation or its business. Firms within a particular industry—an industry that has attracted the attention of Eliot Spitzer, for example—may be subject to systematically higher D&O rates than firms in other lines of business with less industry-wide risk of shareholder litigation.¹⁰⁵ However, this distortion too could be corrected by comparing D&O insurance pricing across a set of firms within a specific industry in order to identify norms and outliers. Finally, insurance premiums may correlate to market capitalizations,¹⁰⁶ whether because larger firms attract more attention in shareholder litigation (perhaps because they appear more often on the front page of the *Wall Street Journal*) or because firms with high share prices have farther to fall in measuring damages.¹⁰⁷ Nevertheless, the influence of market capitalization in insurance pricing also can be removed by comparing firms with similar market capitalizations.

Thus, in spite of this noise in insurance prices, on the whole, a firm's premium for D&O insurance should convey important information concerning the firm's corporate governance. Most basically, the more a firm pays, the worse its governance. Moreover, because the insurer risks its own capital in making this assessment, the D&O premium functions as a revealed preference and is therefore likely to be a reliable indication of the insurer's best assessment of the insured's governance quality. Understanding this, fund managers, arbitrageurs, and other professional investors can be expected to build these signals into their models of firm value. D&O insurance data could thus provide another data point for analysts to crunch as they seek to value firms. If D&O insurance policies reveal negative

¹⁰⁵ Accord Howard, *supra* note 76, at 22 (quoting a managing director at Chubb as stating that “if you happen to be in an industry group that insurers perceive as extremely high risk at the moment, and you also happen to have your shares listed [in the United States], then you're going to be paying a hell of a lot more premium than you did last year”).

¹⁰⁶ See Goch, *supra* note 76. John Core and George Kaltchev have both found a strong correlation between premium and market capitalization. See *infra* Part V.B.

¹⁰⁷ This is true whether the theory of damages is the traditional “out of pocket” measure—*i.e.*, the difference between what the plaintiff received and what she would have received had there been no fraudulent conduct—or “recessionary” damages. See, *e.g.*, *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972) (out of pocket damages in securities fraud context); *Randall v. Loftsgaarden*, 478 U.S. 647, 659 (1986) (recessionary damages in securities fraud context).

information—for example, high premiums or a high degree of entity-level coverage—the corresponding negative impact in the equity and credit markets may provide yet another incentive for firms to optimize their corporate governance.

V. DISCLOSING D&O INSURANCE

In spite of the fact that the D&O insurer performs an essential gatekeeping function in underwriting governance risks, signaling the firm's governance quality in the insurance premium, this signal is not, in fact, reaching the market. Current U.S. law does not require the disclosure of D&O policy details although other countries, notably Canada, do. This Part explores the approach of each country's securities regulators to D&O policy details and argues ultimately that the U.S. Securities and Exchange Commission should require registrants to disclose details concerning their D&O policies on an annual basis.

A. D&O Disclosure Obligations in the United States

U.S. law does not require disclosure of D&O policy details, and most U.S. companies do not in fact disclose the details of their D&O policies. SEC rule-making is particularly interesting on this point because the SEC's public policy pronouncements regarding indemnification are inconsistent with its position on insurance in spite of the fact that indemnification and insurance raise many of the same issues.

Congress has not addressed the issues raised by management indemnification and insurance, but the SEC, following Congress's stated intent of inducing compliance with the securities laws, has taken a firm position against the indemnification of officers and directors for securities law violations.¹⁰⁸ The SEC requires that all registrants under the Securities Act of 1933 include the following language in their registration statements:

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

¹⁰⁸ H.R. Rep. No. 85, 73d Cong., 1st Sess. 3, 5, 9 (1933); S. Rep. No. 47, 73d Cong., 1st Sess. 5 (1933) (stating an intent "to impose a duty of competence as well as innocence" in the Securities Act of 1933). See generally James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959) (providing a personal and anecdotal account of the passage of the Securities Act).

advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable.¹⁰⁹

The SEC's position on indemnification is rooted in the view that spreading the cost of legal sanction renders managers less likely to comply with the law.¹¹⁰ Because insuring directors and officers against these costs would seem to implicate precisely the same policy concerns as indemnifying them, it would be reasonable to suppose that the SEC similarly opposes D&O insurance. This supposition, however, appears to be incorrect.

The SEC takes a milder position on D&O insurance than it takes on indemnification. The SEC has not declared insurance against securities law liabilities to be a violation of public policy. In fact, the SEC has arguably endorsed the corporate purchase of D&O insurance, stating that the maintenance of a D&O policy, even when paid for by the company, will not bar acceleration of a registration statement.¹¹¹ Moreover, unlike the harsh language imposed on

¹⁰⁹ Regulation S-K, item 510, 17 C.F.R. §229.510 (requiring that this statement be included in the registration statements of registrants not requesting acceleration of effectiveness). For registrants requesting acceleration of the effective date, the same statement is required as well as the following additional language:

In the event that a claim for indemnification against such liabilities (other than the payment by the registrant of expenses incurred or paid by a director, officer or controlling person of the registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

Regulation S-K, item 512(h), 17 C.F.R. §229.512(h). These line-item disclosures are triggered in each of the major forms governing the registration of securities. See, e.g., Forms S-1, S-2, S-3, S-4, S-8 and S-11.

¹¹⁰ See LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATIONS, 3d § 2.C.2. (2004) (stating basis of avoiding frustration of the *in terrorem* effect of the Securities Act). See also *Globus v. Law Res. Serv. Inc.*, 418 F.2d 1276, 1288-89 (2d Cir. 1969), (concurring with SEC position and denying indemnification on the view that liability “was designed not so much to compensate the defrauded purchaser as to ... deter negligence”) cert. denied, 397 U.S. 913 (1970). Similarly, public policy has been held to prevent indemnification under other federal statutes. See, e.g., *Sequa Corp. v. Gelmin*, 851 F. Supp. 106 (S.D.N.Y., 1993) (indemnification for RICO liability against public policy).

¹¹¹ 17 C.F.R. 230.461(c) (“Insurance against liabilities arising under the Act, whether the cost of insurance is borne by the registrant, the insured or some other person, will not be considered a bar to acceleration....”). The Commission does, however, consider registered investment companies a special case, requiring greater scrutiny of insurance arrangements. *Id.*; see also Investment Companies and Advisers Act, 15 U.S.C. § 80a-17(h) (prohibiting “any provision which protects ...

registrants adopting indemnification provisions, the SEC requires only that the existence and “general effect” of D&O insurance policies be disclosed.¹¹² Considering that insurance and indemnification raise the same policy concerns,¹¹³ the maintenance of distinct positions seems inconsistent, and in any event, has never been explained by the SEC.¹¹⁴

The regulation that requires registrants to disclose the existence of D&O insurance does not require the disclosure of any policy details. Item 702 of Regulation S-K requires that registrants:

[s]tate the general effect of any statute, charter provisions, by-laws, contract or other arrangements under which any controlling persons, director or officer of the registrant is insured or indemnified in any manner against liability which he may incur in his capacity as such.¹¹⁵

Although the “general effect” of D&O insurance may be read to require some discussion of policy details, registrants generally provide nothing more than an opaque statement that coverage will be

any director or officers of [a registered investment company] against ... willful misfeasance, bad faith, gross negligence or reckless disregard of ... duties”).

¹¹² See Regulation S-K, item 702, 17 CFR §229.702. This disclosure is triggered, like the disclosures required by items 510 and 512(h), by each of the major forms governing the registration of securities. See, e.g., Forms S-1, S-2, S-3, S-4, S-8 and S-11.

¹¹³ Interestingly, the Commission originally treated insurance and indemnification together in item 510 of Regulation S-K, requiring disclosure of insurance arrangements in sub-section of the provision mandating inclusion of the policy statement on indemnification. See SEC Release 33-6383, 1982 WL 90370, at *14, *19, *100-101, and *115 (splitting what was then S-K 510(a) and (b) into what is now S-K 510 and 702, respectively).

¹¹⁴ See LOSS & SELIGMAN, *supra* note 110, at § 2.C.2., n.83 (“The Commission policy on indemnification is hardly a jewel of consistency. It applies solely to indemnification by registrants and not to indemnification by insurers or by other third parties.”); Milton P. Kroll, *Some Reflections on Indemnification Provisions and S.E.C. Liability Insurance In Light of BarChris and Globus*, 24 BUS. LAW. 681, 687-92 (1969) (reviewing SEC policies on indemnification and insurance). The inconsistencies in the SEC’s position are several. On its face, it applies only to violations of the Securities Act, not the Securities Exchange Act, and therefore captures disclosure violations in connection with securities issuance but not to securities fraud under section 10b-5, a distinction for which the basis is unclear. Furthermore, the bar on indemnification of securities law liabilities has been interpreted by courts not to apply to defense costs or settlement. See, e.g., *Raychem Corp. v. Fed. Ins. Co.*, 853 F. Supp. 1170 (N.D. Cal. 1994) (holding that indemnification of settlement is not against public policy); *Goldstein v Alodex Corp.*, 409 F. Supp. 1201 (E.D. Pa. 1976) (ruling that indemnification of defense costs is not against public policy). Since most securities claims are settled, these exceptions seem to swallow the rule.

¹¹⁵ 17 CFR §229.702.

available, subject to unstated limits, to cover certain liabilities arising from the directors' or officers' conduct as such.¹¹⁶ By granting effectiveness to these registration statements, the SEC effectively accepts such non-descriptive language in fulfillment of the required disclosure.

The SEC could require much more detail. The SEC could, for example, treat D&O insurance as a "material contract" and require that policies be filed as an exhibit to the registration statement.¹¹⁷ It could also treat D&O insurance as an aspect of executive compensation, triggering a fulsome description of policy features including the cost and value of the policy, as it does in the case of life insurance.¹¹⁸ However, the SEC has made neither of these choices, instead treating D&O insurance as a matter distinct from executive compensation and thereby minimizing the required disclosure of policy details.¹¹⁹

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

¹¹⁶ For example, in its registration statement, Yankee Candle made the following statement:

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

Amended Registration Statement on Form S-3 of Yankee Candle Co., Inc., (Apr. 22, 2002) at II-1.

¹¹⁷ See Regulation S-K item 601(b)(10), 17 C.F.R. §229.601 (requiring that certain "Material Contracts" be filed as exhibits to the registrants public filings).

¹¹⁸ See, e.g., Regulation S-K item 402(b)(2)(iv)(E), 17 C.F.R. §402 (requiring disclosure of dollar value of life insurance provided by the corporation to its executives and the premiums paid by the corporation).

¹¹⁹ The SEC has expressly stated that it will not treat D&O insurance as a form of executive compensation.

Premiums paid for liability insurance for officers and directors and benefits paid under such insurance plans are not forms of remuneration to the extent that the insurance plan is intended to relieve officers and directors of liability relating to their job performance.

1978 SEC LEXIS 2277 (1978) (release regarding "Disclosure of Management Remuneration"). In taking this position, the SEC essentially follows the IRS, which also does not treat D&O insurance as executive compensation. See KNEPPER & BAILEY, *supra* note 18, at §22.22.

that Canadian securities regulators require disclosure of precisely these items.

B. A Canadian Comparison

Unlike their counterparts in the United States, Canadian securities regulators do require disclosure of D&O insurance details. Public companies in Canada must disclose basic information concerning their D&O insurance policies, including coverage limits and premiums, in their proxy filings and registration statements.¹²⁰ This provides the opportunity to conduct a natural experiment. Can the information disclosed in these Canadian filings be used to establish a link between corporate governance and D&O insurance? A handful of economists have tested this data, but legal differences between the two countries make it difficult to import conclusions from Canada or any foreign jurisdiction to American corporate governance.¹²¹

Professor Core has preformed the leading study examining Canadian data to determine whether D&O premiums can be related to corporate governance variables.¹²² Hypothesizing that D&O premiums would be a function both of business-specific risk factors and governance-related risk factors, Core separated proxy variables relating to each.¹²³ Grouping measures of ownership structure, board

¹²⁰ See Ontario Securities Commission, Form 30. This information is publicly available on the Ontario Securities Commission's online database of public filings. See System for Electronic Document Analysis and Retrieval ("SEDAR"), available online at <http://www.sedar.com>. Canadian corporations are given express permission to purchase D&O insurance under the Canadian Business Corporations Act, R.S.C., ch. C-44, § 124(6) (2004) ("A corporation may purchase and maintain insurance for the benefit of an[officer or director] against any liability incurred by the individual ... in the individual's capacity as a director or officer of the corporation...").

¹²¹ Although the legal systems of the U.S. and Canada are broadly similar, Canada is a considerably less favorable environment for entrepreneurial plaintiffs lawyers. Canada retains the English "loser pays" system, increasing the risk borne by the plaintiffs' lawyers. As a result, contingent fees are used less often and, when they are used, are subject to a reasonableness standard. Class actions and derivative suits are filed less often, perhaps because punitive damages are rarely awarded. See, e.g., Ronald J. Daniels & Susan M. Hutton, *The Capricious Cushion: The Implications of the Directors' and Officers' Liability Insurance Crisis on Canadian Corporate Governance*, 22 CANADIAN BUS. LAW J. 182 (1993).

¹²² See John E. Core, *The Directors' and Officers' Insurance Premium: An Outside Assessment of the Quality of Corporate Governance*, 16 J. L. ECON. & ORG. 449 (2000).

¹²³ *Id.*, at 454 ("a firm's D&O premium is hypothesized to be a function of both the quality of its corporate governance and its business risk").

size, and management entrenchment together as indicators of “governance quality” and firm size, financial performance, and U.S. exchange listing as proxies for “business risk.”¹²⁴ Core regressed each variable against D&O premiums, finding approximately half of the governance quality variables to be statistically significant, while each of the business risk variables was statistically significant.¹²⁵ Significant governance quality variables—including insider stock ownership and voting control, director independence, and executive employment contracts¹²⁶—enabled Core ultimately to conclude that Canadian data supports an association between D&O premiums and governance quality.¹²⁷

One of the variables Core found to be most significant, however, underscores the study’s inherent limitations. If a Canadian firm is also listed on a U.S. exchange, exposing it to U.S. securities litigation, the firm has significantly higher D&O premiums. This emphasizes the difference between U.S. and Canadian liability risks. At least with regard to shareholder litigation, and perhaps representative litigation generally, the legal systems between the two countries are different enough to make cross-country comparisons somewhat tenuous. Thus, although Core’s study supports the link between corporate governance and D&O insurance predicted by this Essay, without U.S. data it cannot support a firm conclusion.

In a recent working paper, Professor Kaltchev attempts to develop his own U.S. data set from proprietary and confidential information supplied by two insurance brokerage firms.¹²⁸ Kaltchev’s data set includes information on insurance limits and retentions—that is, data on the *amount* of D&O insurance purchased—for almost 300

¹²⁴ *Id.*, at 457-462.

¹²⁵ These proxies included management experience (the longer the manager has been on the board, the lower the firm’s litigation risk), financial performance (the worse the firm’s return on equity, the worse its litigation risk), size (greater total assets, greater risk), prior litigation (firms with a history of litigation are worse litigation risks), and U.S. operations or U.S. listing (both of which increased litigation risk).

¹²⁶ *Id.*, at 463-466. Core notes that all governance variables have the predicted sign and that they add explanatory power to the model as a group, even if only four of nine are individually significant. *Id.*, at 468.

¹²⁷ *See id.*, at 451 (“The results indicate that D&O premiums are significantly higher when inside control of share votes is greater, when inside ownership is lower, when the board is comprised of fewer outside directors, when the CEO has appointed more of the outside directors, and when insider officers have employment contracts.”)

¹²⁸ George D. Kaltchev, *The Demand For Directors’ and Officers’ Liability Insurance By US Companies*, 34 (July 2004) (describing the unique data set consisting of approximately 300 U.S. companies spanning the period 1997-2003).

companies, which he has used to test hypotheses for why companies purchase D&O insurance.¹²⁹ Perhaps unsurprisingly, Kaltchev finds the best predictor of D&O limits is the insured company's market capitalization.¹³⁰ After size, the leading indicators of insurance amounts seem to be returns, with larger returns on assets tending to produce lower insurance limits.¹³¹ This could be taken to suggest that better managers are less likely to insist on high levels of D&O insurance or, relatedly, that companies that perform better are less likely to be sued. Alternately, an inverse relationship between returns and coverage limits may simply indicate that firms with high cash flows can more easily self-insure against litigation risk. Kaltchev's findings also support a significant relationship between indicators of financial health, as indicated by leverage and volatility, and D&O coverage limits: the higher a company's leverage and volatility, the more insurance it buys. Of the corporate governance variables tested, it is worth noting that companies that have not split the chief executive and chairperson of the board functions tend to buy more D&O insurance and that director and officer ownership of firm stock correlates to lower policy limits.¹³²

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

¹²⁹ *Id.*

¹³⁰ *Id.*, at 52 (noting that “[the market value of firm equity] appears to be directly related to limits, as a measure of the potential size of loss”). This is as one would expect since the larger the market capitalization, the greater the potential damages in shareholder litigation.

¹³¹ *Id.*

¹³² *Id.*, at 36 (arguing that this confirms “the hypothesis that higher managerial ownership aligns the interests of shareholders and managers and that insurance and ownership are ... substitutes”). *But see* Core, *supra* note 122, at tbl. 2 (finding, in Canadian data set, that separation between chief executive and chairperson roles does not seem to affect premiums).

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

The law should be changed to require disclosure of greater detail concerning a company's D&O policies. In addition to disclosing the existence of a policy, companies should be required to disclose the identity of the insurer, the limits and retention under each side type of coverage (Side A, B, and C), and perhaps most importantly, the D&O premium. These disclosures should be required on an annual basis. Each of these additional disclosures could provide valuable information that is currently unavailable to capital market participants.

This Essay has argued that a firm's D&O insurance premium is related to its governance quality and should therefore convey an important signal concerning the value of the firm's corporate governance. Requiring disclosure of the firm's D&O insurance premium on an annual basis would thus provide investors with valuable information, alerting them to changes in the governance risk of the firm. If, for example, a firm's D&O insurance significantly increased in a year in which similarly situated firms in the same industry experience no change in their premiums, investors would be put on notice that something significant had changed at the firm. Moreover, because the governance assessment implicit on the insurance premium is based on private information provided to the D&O insurer—information that the insurer, unlike equity analysts operating under Regulation FD, is under no obligation to share with other market participants—the signal offered by a change in insurance premiums may alert investors to a piece of information that, because it is not public, is otherwise unavailable to them.¹³³

Details on the *amount* of D&O insurance purchased—that is, the company's policy limits and retentions—would provide several vital pieces of information. First, without information on the amount of insurance purchased, data on premiums would be too noisy to be meaningful. Information on limits and retentions is necessary to specify precisely what the company is paying for and to enable comparisons across different firms buying similar amounts of coverage. Moreover, requiring information about the amount of coverage under each *type* of coverage—that is, Side A, B, and C—would provide additional signals to the market. As described above, Side A coverage is the only form of coverage that benefits officers and directors individually. The amount of Side A coverage purchased by a firm could thus convey an important signal about the confidence

¹³³ 17 C.F.R. 243 (2001) (preventing selective disclosure of material nonpublic information).

of its managers regarding the liability risks they expect to face. Sanguine managers may require their firms to purchase less coverage. As a result, other things being equal, a firm purchasing lower amounts of Side A insurance may tend to pose less risk of shareholder litigation. Unlike Side A coverage, Side B and Side C coverages benefit the company only and, as described above, may be rooted in managerial agency costs. As a result, a company purchasing large amounts of coverage under Sides B and C sends a signal not only that its managers believe the firm presents a relatively large risk of shareholder litigation but also that it has the kind of managers who would rather waste corporate assets in a negative net present value investment than put their personal compensation packages at risk by allowing the firm to self-insure against shareholder litigation.

Finally, the identity of the D&O insurer would provide valuable information about the reputation of the gatekeeper. Investors may draw different conclusions if, for example, a company's primary D&O insurer is a market leader in D&O insurance versus an unknown, cut-rate insurer. The cut-rate insurer may have an incentive to lower premiums irrespective of governance risk in order to capture greater market share. Although this will be a losing strategy in the long run, upstart firms may try it in the short run to establish a set of clients, hoping to make up the increased risk with higher premiums in the future. More directly, some insurers may develop a reputation for developing better risk pools than others with the result that the companies they underwrite will be viewed by investors as better governance risks.

Given the potential value of this new information to market participants, the SEC should change the relevant regulations to cause corporations to provide it. This would be a technically simple matter. The Commission could amend Regulation S-K item 702 to mandate, instead of a weak statement of the "general effect" of insurance arrangements, explicit disclosure of the registrant's D&O premium, its limits and retentions under each type of coverage, and the identity of the registrant's primary D&O insurance carrier. Then, in order to make this disclosure annual, the Commission could add a cross reference in Form 10-K to item 702, thereby requiring registrants to disclose detailed information on D&O insurance when they file their annual reports.

Although such modifications would be technically simple, the Commission may encounter political resistance to this change, both from registrants and insurers. Their most likely argument is that mandating disclosure of D&O insurance details will encourage the filing of non-meritorious lawsuits by plaintiffs' lawyers eager to reach insurance assets. It is unlikely, however, that plaintiffs' lawyers will learn much from these additional disclosures that they did not already

know or suspect. After all, it is no secret that over 95% of U.S. companies carry D&O insurance and that average limits for companies with assets in excess of \$100 million are in the tens of millions of dollars.¹³⁴ Plaintiffs' lawyers know this and, because they make a living out of it, can be expected to estimate a company's likely coverage within a fairly accurate range. Moreover, once a claim arises, plaintiffs' lawyers can be expected to hone their estimate of a defendant company's D&O coverage to such a degree that requiring disclosure of this information on an annual basis is unlikely to alter the dynamics of either filing or settlement.

There may, however, be some subtext to this and other objections of both registrants and the insurance industry. Registrants may resist the disclosure of D&O insurance data because, as described above, it threatens to reveal new information about the level of agency costs at the firm. Yet this is precisely why the SEC should require it. Moreover, not every company will suffer from these disclosures. There are likely to be companies, for example, that pay relatively little in D&O premiums or that purchase only Side A coverage, both of which signal good governance and low agency costs. Unmasking this information would provide positive information about these firms and, potentially, result in a positive adjustment in their share value. In addition, disclosure of the amount that all registrants pay for D&O coverage may make the market for D&O insurance more competitive. If, when renewing its policy, a company is able to cite the lower premiums paid by several of its competitors, the company may be in a position to bargain for a lower premium itself. This improved transparency would thus benefit all companies in that market.¹³⁵

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

¹³⁴ Tillinghast 2003 Directors and Officers Liability Survey, *supra* note 35, at fig. 3 and 5.

¹³⁵ It would not benefit insurance brokers, however, who as intermediaries in these transactions purport to add value through their special knowledge and expertise of the marketplace. If this information was made publicly available, the need for intermediaries would be reduced. Although the brokers may object, it is not clear that this is not in fact another benefit of disclosure.

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

VI. SUMMARY AND CONCLUSION

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