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The Shocking Impact of Corporate Scandal on Directors' and Officers' Liability

Nancy R. Mansfield

Joan T.A. Gabel

Kathleen A. McCullough

Stephen G. Fier

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THE SHOCKING IMPACT OF CORPORATE SCANDAL ON DIRECTORS' AND OFFICERS' LIABILITY

Nancy R. Mansfield★
Georgia State University

Joan T. A. Gabel★★
University of Missouri

Kathleen A. McCullough★★★
Florida State University

Stephen G. Fier★★★★
The University of Mississippi

ABSTRACT

Directors and officers liability (hereinafter D&O) serves as a deterrent to corporate wrongdoing. Recent cycles of corporate scandal have impacted the tools used to manage the risk that D&O liability creates. The impact of these scandals is a “shock,” which is a sudden event that alters the market profoundly. Market alteration has counter intuitively resulted in increased availability of D&O insurance at a lower price, despite an increase in D&O liability. With increased D&O coverage offerings at lower costs, the market has become soft, making coverage readily available. Carriers are competing for insureds and there is now a risk of undermining the deterrent effect that D&O liability provides. This paper explores whether D&O liability’s deterrent effect has been jeopardized in this soft D&O insurance market.

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NANCY R. MANSFIELD, JOAN T. A. GABEL, KATHLEEN A.
MCCULLOUGH, STEPHEN G. FIER

"Truth makes many appeals, not the least of which is its
power to shock." – Jules Renard¹

INTRODUCTION

Directors and officers liability (hereinafter D&O) serves as a deterrent to corporate wrongdoing² and D&O insurance emerged to manage the risk of this liability.³ Recent cycles of corporate scandal, however, have impacted the liability and insurance tools used to manage the risk that D&O liability creates. This impact, within the Risk Management literature, is considered a "shock"⁴ that alters the normal market for D&O

* Professor of Legal Studies, Georgia State University; J.D., 1978, University of Georgia; B.A., 1975 University of North Carolina at Chapel Hill.

** Robert J. Trulaske, Sr. Dean and Professor of Management, University of Missouri; J.D., 1993, University of Georgia; B.A., 1988, Haverford College.

*** Associate Professor and State Farm Professor in Risk Management and Insurance, Florida State University; Ph.D., 2000, University of Georgia; BBA, 1995, St. Mary's University.

**** Assistant Professor and Liberto-King Professor of Insurance, University of Mississippi; Ph.D., 2011, Florida State University; B.S., 2003, Florida State University.

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¹ EVAN ESAR, 20,000 QUIPS & QUOTES: A TREASURY OF WITTY REMARKS, COMIC PROVERBS, WISECRACKS, AND EPIGRAMS (Barnes & Noble Books 1995) (1968).

² Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 488-89 (2007) ("The primary goal of liability rules in corporate and securities law, it is often said, is to deter corporate officers and directors from engaging in conduct harmful to their shareholders. Yet it is typically a third-party insurer that satisfies these liabilities under the terms of the corporation's D&O policy. The deterrence goals of corporate and securities liability are thus achieved indirectly, through an insurance intermediary, if indeed they are achieved at all." (citations omitted)).

³ See *id.* at 487.

⁴ Shock is defined as "[a] profound and sudden disturbance of the physical or mental senses; a sudden and violent physical or mental impression depressing the body's vital forces, as by a sudden injury or medical procedure." Black's Law Dictionary 1504 (9th ed. 2009).

insurance profoundly and unexpectedly.⁵ One might expect a shock to reduce the supply of coverage (as it had in the early 2000s), but this market alteration has counterintuitively resulted in increased availability of D&O insurance coverage at a lower price following the passage of the Sarbanes-Oxley Act (hereinafter “SOX”), even with the increased uncertainty in the late 2000s associated with corporate governance. With increased D&O coverage offerings at lower costs, the market has become “soft,”⁶ making coverage readily available. Carriers now are competing for insureds and offering high coverage at a low price to such an extent that there is now a risk of undermining the deterrent effect that D&O liability provides.⁷

This paper explores whether D&O liability’s deterrent effect has been jeopardized by this soft D&O insurance market. In Part I, we describe the parameters of D&O liability and its deterrent effect.⁸ In Part II, we evaluate the risk management tools, namely D&O insurance, that have emerged in response to D&O liability and explore how those tools have evolved to support the goal of deterrence. In Part III, we discuss how recent scandals have “shocked” the market for D&O liability risk management options. In Part IV, we conclude by analyzing whether the impact of these shocks and the resulting soft market has undermined the deterrent effect of D&O liability.

I. D&O LIABILITY AND ITS DETERRENT EFFECT

“[T]he primary goal of liability rules in corporate and securities law . . . is to deter corporate officers and directors from engaging in conduct harmful to shareholders.”⁹ D&O liability is an offshoot of

⁵ See Stephen Fier, Kathleen McCullough, Nancy R. Mansfield & Joan, T. A. Gabel, *The Directors and Officers Insurance Marketplace: An Empirical Examination of Supply and Demand in Uncertain Times* (Dec. 15, 2009) (unpublished manuscript) (on file with authors), available at <http://ssrn.com/abstract=1524063> (examining the impacts of the “loss shocks” created by the corporate scandals of the early 2000’s and the implementation of the Sarbanes-Oxley Act to evaluate “probability updating theory,” which holds that after such “loss shocks” decision makers’ perceptions of future losses shift, resulting in a change in price or the availability of coverage). See also discussion *infra* note 76.

⁶ In a soft market, insurers loosen underwriting standards and profits typically decline. Baker & Griffith, *supra* note 2, at 507. Further, D&O insurers are typically less selective when determining whether to issue a D&O liability policy and often give discounts. *Id.* at 508.

⁷ See Tower Perrin, *Directors and Officers Liability: 2008 Survey of Insurance Purchasing Trends* 42 (TowersWatson 2009), <http://www.towerswatson.com/assets/pdf/2791/2791.pdf> (last visited May 14, 2012); see also discussion *infra* pp. 25–30.

⁸ See discussion *infra* Part I.

⁹ Baker & Griffith, *supra* note 2, at 487 n.2; Reinier Kraakman, Hyun Park & Steven Shavell,

common law agency theory that holds “a principal is subject to a duty to indemnify an agent for damages the agent is required to pay to a third person”¹⁰ D&O liability leverages this agency principle in two contexts: (1) claims by shareholders that directors and officers have breached their duties to the corporation and (2) federal securities law claims via shareholder derivative suits.¹¹ Shareholder derivative suits serve as the primary deterrent mechanism to prevent wrongful conduct and ensure directors and officers uphold their fiduciary duties.¹² In either case, directors and officers bear personal liability.¹³ By placing personal liability on directors and officers for their actions (or inactions), the burden of corporate loss shifts, from shareholders to the decision makers.¹⁴ Thus, liability “raise(s) the expected cost of the undesirable behavior” by the directors and officers and the potential for personal liability for their

When Are Shareholder Suits in Shareholder Interests?, 82 GEO. L.J. 1733, 1738 (1994).

¹⁰ Joseph F. Johnston, Jr., *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993, 1994 (1978).

¹¹ Joshua Dobiac, *I Came, I Saw, I Underwrote: D&O Liability Insurance's Past Underwriting Practices and Potential Future Directions*, 14 CONN. INS. L.J. 487, 490 (2008). D&O liability may arise in other circumstances. For example, directors and officers may also be liable for corporate debts under the doctrine of piercing the corporate veil. The following is a non-exclusive list of potential devices used to pierce the corporate veil: the alter ego theory, a claim of breach of fiduciary duty, tort claims, criminal charges, actions taken after dissolution, director liability under the Business Corporation Act of 1983, evidence of kickbacks and bribes, failure to pay wages, failure to pay taxes, refusal to allow shareholders to review corporate records, and violation of other statutes such as the Franchise Disclosure Act. David M. Madden, *The Limits of Limited Liability for Corporate Officers, Directors, and Shareholders: Eleven Things You Need to Know*, DCBA BRIEF Jan. 2009, <http://www.dcbabrief.org/vol210109art1.html>.

¹² See Kraakman et al., *supra* note 9, at 1738; see also Baker & Griffith, *supra* note 2, at 488. As a result of these derivative suits, directors and officers may be liable for civil penalties, face criminal sanctions, and personal financial liability to the shareholders. See Jeff Gerrish, *What is Your Real Liability as a Director or Officer?*, A.B.A. BANKING L.J. (March 15, 2010), available at http://www.ababj.com/index2.php?option=com_content&do_pdf=1&id=1118&Itemid=140; see also Madden, *supra* note 11. These liabilities can serve as substantial deterrents to directors and officers contemplating breaching their fiduciary duties, failing to pay taxes, committing securities fraud, or any other action for which they could be held liable. Madden, *supra* note 11.

¹³ Directors can be sued for acts such as shaping policies that hurt the corporation, engaging in “needlessly expensive financing,” investing without outside consultation, and failing to investigate charges. JOSEPH WARREN BISHOP II ET AL., *LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE* § 3:9 (Thompson Reuters 2011). However, directors are not personally liable for others’ acts unless they have personal knowledge of the wrongdoing or should have known of the wrongdoing. See EDWARD BRODSKY & M. PATRICIA ADAMSKI, *LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES AND LIABILITIES* § 2:18 (Thomson Reuters 2011).

¹⁴ R. Link Newcomb, Note, *The Limitation of Directors’ Liability: A Proposal for Legislative Reform*, 66 TEX. L. REV. 411, 434 (1987).

actions serves as a deterrent.¹⁵ Liability may arise through both shareholder derivative suits and securities lawsuits.

A. D&O Liability in Derivative Suits for Breach of Corporate Duties

Directors and officers of a corporation are bound by certain duties and when a duty is breached, shareholders may seek to hold them liable and recover the value lost through a derivative lawsuit—suing the directors and officers on behalf of the corporation.¹⁶

In a lawsuit charging a breach of duty to the corporation, the directors and officers are presumed to have acted in good faith and in the best interests of the corporation.¹⁷ In the absence of bad faith or gross abuse of discretion, the court-developed doctrine of the Business Judgment Rule attaches and the courts will not interfere so long as the decision “may be attributable to any rational business purpose.”¹⁸ Thus, in bringing a derivative suit, the Business Judgment Rule plays a major role.¹⁹ The

¹⁵ Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Projects*, 35 STAN. L. REV. 927, 941 (1983). See also Newcomb, *supra* note 14, at 434–35. Often the prospect of a derivative lawsuit is enough to deter misconduct. Kraakman et al., *supra* note 9, at 1738.

¹⁶ Directors and officers must use care and diligence in their management and administration of the affairs of the corporation. J. F. Rydstrom, *Liability of Corporate Directors for Negligence in Permitting Mismanagement or Defalcations by Officers or Employees*, 25 A.L.R.3D 941, at § 2[a] (1969); see also discussion *infra* Part I.A. (expanding on the duties of care, loyalty, and good faith); Baker & Griffith, *supra* note 2, at 494 (discussing shareholder derivative suits resulting from actions of directors and officers).

¹⁷ *Warshaw v. Calhoun*, 221 A.2d 487, 493 (Del. 1966) (defining the Business Judgment Rule as incorporating good faith and best interests). The business judgment rule is generally defined as “a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” Robert Roy, *Duty of Corporate Directors to Exercise “Informed” Judgment in Recommending Responses to Merger or Tender Offers*, 46 A.L.R.4TH 887, at §3 (1986). But see *Moran v. Household Intern, Inc.*, 490 A.2d 1059, 1076 (Del. Ch. 1985) (describing the rule as a “tool of judicial review and only indirectly a standard of conduct for corporate management”).

¹⁸ *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971) (explaining that the Business Judgment Rule does not apply when directors act in bad faith or grossly abuse their discretion); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (setting forth the “rational business purpose” test); see also *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) (upholding immense severance package despite little evidence of an informed decision-making process).

¹⁹ The business judgment rule is reflected in several aspects throughout the process, most notably the concept of demand. A shareholder must either make a demand on the board to take action and assert the claim or allege that demand was excused. *Grimes v. Donald*, 673 A.2d 1207, 1215 (Del. 1996) (“The demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of the corporation.”) (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). In states where demand is excused due to futility, one reason could be that the “underlying transaction

protection afforded to directors under the rule is notoriously difficult for plaintiffs to overcome,²⁰ but because there are situations where shareholders are able to recover against directors and officers for a breach of the duties of care, loyalty, or good faith, directors and officers are presumed to temper their behavior accordingly.

1. Duty of Care

Directors satisfy their duty of care—a gross negligence standard—if they “inform[] themselves[,] ‘prior to making a business decision, of all material information reasonably available to them.’”²¹ Thus, courts

is not the product of a valid exercise of business judgment.” *Id.* at 1216 (citing *Aronson*, 473 A.2d at 814). Courts will normally apply the business judgment rule presumption in these situations looking at various factors such as the interest and independence of the board, procedures followed when the board was acting, and whether it was an egregious violation of business judgment. *Marx v. Akers*, 666 N.E.2d 1034, 1041 (N.Y. 1996) (holding demand is excused where the “challenged transaction is so egregious such as a violation of a duty “that it could not have been the product of sound business judgment”).

²⁰ See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996) (“[Overcoming the Business Judgment Rule] is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (requiring “a showing of gross and palpable overreaching” to overcome the Business Judgment Rule once it attaches); *Auerbach v. Bennett*, 393 N.E.2d 994, 1001-03 (N.Y. 1979) (describing that when a special litigation committee (SLC) is appointed to inquire into a shareholders’ allegations, the actions of the SLC in addition to the initial actions alleged are also subject to the business judgment rule). However, in Delaware specifically, shareholders have a slightly easier time as the burden of proof is on the SLC or the corporation to show that it is subject to business judgment protection. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788-89 (Del. 1981) (demonstrating that the court looks at the interest, independence, and procedures the SLC used and then applies its own business judgment as to whether the case should be dismissed). See also *Citizens United v. Fed. Election Comm’n*, 130 S.Ct. 876, 978 (2010) (Stevens, J., concurring and dissenting in part) (“[B]y ‘corporate democracy,’ presumably the Court means the rights of shareholders to vote and to bring derivative suits for breach of fiduciary duty. In practice, however, many corporate lawyers will tell you that ‘these rights are so limited as to be almost nonexistent,’ given the internal authority wielded by boards and managers and the expansive protections afforded by the business judgment rule.”). The plaintiff may rebut the presumption in favor of the directors, resulting in a greater degree of judicial scrutiny, by proving that the director breached its duty of care, loyalty, or good faith. If the plaintiff rebuts the presumption, the Business Judgment Rule will not apply, and the directors must satisfy the formidable “entire fairness” test. See discussion *infra* Parts I.A.

²¹ *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). The duty of care generally requires that a director exercise reasonable care in regards to all relevant information prior to making a decision, and in the performance of his general responsibilities. *Aronson*, 473 A.2d at 812. See also *In re Lear Corp. S’holder Litig.*, 967 A.2d 640, 651-52 (Del. Ch. 2008) (discussing that a gross negligence standard should be used in relation to the business judgment rule so directors are not unduly hampered and can have leeway in decisions without constant worry about judicial oversight).

determine whether the decision-making *process*, as opposed to the *substance* of the ultimate decision, was adequate.²² Once a court finds that the process was inadequate (e.g. that the board was unreasonably informed), the board cannot defend itself by reference to the substantive benefits of their action or the legitimate purposes behind the decision.²³ In addition, the duty of care is an affirmative duty; that is, directors must be active and inquire about the decision.²⁴ Mere passive acquiescence is insufficient to satisfy the duty of care.²⁵

The outer limits of the duty of care were explored in *Smith v. Van Gorkom* and *Brehm v. Eisner*.²⁶ In *Van Gorkom*, the board's decision to sell the company was not protected by the Business Judgment Rule because the decision was made during a two-hour meeting, after hearing a short and inaccurate presentation by the CEO, and without having read the contract for sale.²⁷ Yet, in *Eisner*, the court may have partially retreated from *Van Gorkom* in favor of greater judicial deference.²⁸ In *Eisner*, the board approved an immense severance package, complete with options that automatically vested upon a no-fault termination.²⁹ Despite the fact that an executive compensation expert, hired by the board to review the severance package, did not even read the contract, and only one paragraph

²² See, e.g., *Cinerama, Inc. v. Technicolor, Inc.*, Civ. A. No. 8358, 1991 WL 111134, at *8 (Del. Ch. June 24, 1991) (stating the due care element of the Business Judgment Rule as "an objective review of the process by which [the board] reached the decision under review") (emphasis added).

²³ See generally *Van Gorkom*, 488 A.2d at 858 (ignoring directors' claims that the merger would benefit the company by converting otherwise unrealizable tax credits to realizable tax credits).

²⁴ See, e.g., *In re Caremark*, 698 A.2d at 967 (suggesting in dicta that directors may be personally liable for failing to affirmatively inquire to ensure that an adequate internal control system exists); *Francis v. United Jersey Bank*, 432 A.2d 814, 826-30 (N.J. 1981) (finding elderly director of a family business liable for failing to prevent misappropriation of funds by related officers because the director did not take any affirmative action, such as reading the financial statements). The duty of care also incorporates good faith, and decision-making that does not lead to the waste of corporate assets or other abuses of discretion. *Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988).

²⁵ See *Francis*, 432 A.2d at 823; *Aronson*, 473 A.2d at 813 (stating that the Business Judgment Rule does not afford protection "where directors have either abdicated their functions, or absent a conscious decision, failed to act"); *Harman v. Willbern*, 374 F.Supp. 1149, 1161 (D. Kan. 1974) (stating that directors are responsible for knowing all facts that they reasonably should have known or discovered).

²⁶ *Van Gorkom*, 488 A.2d 858; *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

²⁷ *Van Gorkom*, 488 A.2d at 875; see *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003) (finding Business Judgment Rule did not cover the conduct of the directors where the CEO of Disney unilaterally decided to hire someone and board did not inquire into the decision or the employment agreement).

²⁸ *Eisner*, 746 A.2d 244.

²⁹ *Id.* at 250.

in the board minutes addressed the package, the court found inadequate evidence that the directors failed to reasonably inform themselves.³⁰ Although the Business Judgment Rule defers to decisions made by corporate directors, it is still within the court's discretion to find for a plaintiff when directors breach the duty of care.

2. *Duty of Loyalty*

A plaintiff may also rebut the presumption in favor of directors by proving a breach of the duty of loyalty.³¹ Directors breach the duty of loyalty by using their "position of trust and confidence to further their private interests."³² Thus, they may not "do anything that would work injury to the corporation," including the usurpation of a corporate opportunity.³³ For example, a person may breach this duty by serving as director of corporations on both sides of a transaction or by receiving some material benefit from the transaction not received by the shareholders.³⁴ However, if the defendant director can prove that all material facts surrounding the conflict of interest were disclosed and that a majority of the disinterested directors or shareholders ratified the decision, the burden shifts back to the plaintiffs and the Business Judgment Rule applies.³⁵

³⁰ *Id.* at 259.

³¹ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 358 (Del. 1993).

³² *Id.* at 361. A breach of the duty of loyalty can include situations where there are competing interests, usurpation of a corporate opportunity, or deleting a restricting covenant in an employment contract. See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788 (Del. 1981); *Egnell, Inc. v. Weniger*, 94 Ill. App. 3d 325, 329 (1981). However, seeking indemnity against claims arising out of a merger and approving separate sales of assets to third parties are situations where the duty is not breached. See *In re Sea-Land Corp. S'holders Litig.*, 642 A.2d 792, 805 (Del. Ch. 1993).

³³ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d at 361 (stating that directors must not "deprive [the corporation] of profit or advantage which [their] skill and ability might properly bring to it").

³⁴ *Id.* at 362; see also *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1167 (Del. 1995) (holding that any personal benefit received must be "material" to overcome the business judgment presumption). *BISHOP II ET AL.*, *supra* note 13 ("The vast majority of reported decisions holding directors liable for breach of fiduciary duty rest on self-dealing or conflict of interest, not negligence.").

³⁵ See *In re Wheelabrator Tech., Inc.*, 663 A.2d 1194, 1203 (Del. Ch. 1995) (shifting burden back to plaintiffs because a fully informed shareholder vote approved the disputed merger). *BISHOP II ET AL.*, *supra* note 13 ("A transaction involving interested directors will not be set aside if the transaction was fair, was approved by independent directors upon disclosure of all material factors, or was approved by the shareholders upon disclosure of all material facts." (citations omitted)).

3. *Duty of Good Faith*

Plaintiffs also can rebut the presumption by proving that the directors acted in bad faith or with a dishonest purpose.³⁶ In these cases, the plaintiff must make “factual assertions of specific wrongdoing” as opposed to “conclusory allegations.”³⁷ The duty of faith is not as clearly defined as the other duties owed.³⁸ If successful in a shareholder derivative suit, the directors and officers can be held liable to the corporation for the losses that resulted from the breach of their fiduciary duties.

Cumulatively, the remedies available for breach of these duties of care provide a multi-layered deterrent. In addition to the duties of care, securities lawsuits provide yet another layer of deterrence. Unlike shareholder derivative suits which typically result in unwanted publicity and changes to corporate governance, securities lawsuits provide deterrence because of the sheer magnitude of potential personal liability.

B. *D&O Liability in Securities Law Suits*

Shareholder derivative suits include both breach of duty claims as described above and securities law claims under the Securities Act of 1933 and Securities Exchange Act of 1934.³⁹ Securities law claims generally

³⁶ *Kamin v. Am. Express Co.*, 383 N.Y.S.2d 807, 815 (Sup. Ct. 1976).

³⁷ *Id.*

³⁸ “The duty to act in good faith is, up to this point relatively uncharted. Because of the increased recognition of the importance of good faith, some conceptual guidance to the corporate community may be helpful. In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 64 (Del. 2006).” It encompasses subjective bad faith (conduct motivated by an actual intent to do harm) and gross negligence without more is not a showing of bad faith. *Id.* Therefore, the duty of good faith is at the other end of the spectrum from the duty of care. *Id.* But see *Stone v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006) (clarifying that the duty of good faith is part of the duty of loyalty, not a separate basis for liability); See generally *In re Caremark Int’l Inc. Derivative Litig.*, 906 A.2d 959 (expressing only duties of care and loyalty).

³⁹ Securities Act of 1933, 15 U.S.C. § 77a (2009); Securities Exchange Act of 1934, 15 U.S.C. § 78a (2009). The most common securities law claims arise under Rule 10b-5 in § 10(b) of the Exchange Act of 1934. See 15 U.S.C. § 77l (2000); 17 C.F.R. § 240.10b-5 (2006). Rule 10b-5 claims may be brought for any misrepresentation made “in connection with the purchase or sale of any security.” Baker & Griffith, *supra* note 2, at 497 n.43 (internal citations omitted); Hyeesoo Hyun Chung & Jinyoung Park Wynn, *Managerial Legal Liability Coverage and Earnings Conservatism*, 46 J. ACCT. & ECON. 135, 138 (2008). The second most common securities law claims, involving false registration statements made in connection with the sale of securities, arise under Section 11 the Securities Act of 1933. See 15 U.S.C. § 77k (2009). The third most common securities law claims arise under 12(2) of the Securities Act of 1933. See 15 U.S.C. § 77l(a)(2) (2009) (stating that Section 12(2) claims may be brought against anyone who “offers or sells” a security by use of a prospectus or

focus on fraud or false or misleading representations made by the corporation in connection with a disclosure required by federal securities law.⁴⁰ In addition to indirect liability through a shareholder derivative suit, directors and officers may also be sued directly by the Securities and Exchange Commission (SEC) for violations of the federal securities laws.⁴¹

Shareholder derivative suits for breach of the corporate duties as well as the SEC mechanisms for suing directors and officers shift the burden of errors in judgment (as well as blatantly inappropriate conduct) by directors and officers from the shareholder to the directors and officers. New shareholder derivative suits and securities class action suits are filed each year and remind directors and officers that the threat of liability is bona fide.⁴² In fact, between January 1, 1996 and June 30, 2010, Cornerstone Research identified 3,120 federal securities class action filings.⁴³ In 2009, the average securities class action settlement rose more than thirty percent to \$37.2 million making the magnitude of liability increasingly daunting.⁴⁴ This liability—both professional and personal—of the directors and officers serves as a deterrent effect against errant and inappropriate conduct and has resulted in risk management mechanisms

oral communication which contains an omission or false or misleading statement of a material fact).

⁴⁰ Baker & Griffith, *supra* note 2, at 497.

⁴¹ Dobiac, *supra* note 11, at 491.

⁴² Cornerstone Research, *Securities Class Action Filings: 2009: A Year in Review 12* (2009), http://securities.stanford.edu/clearinghouse_research/2009_YIR/Cornerstone_Research_Filings_2009_YIR.pdf (explaining 9.2 percent of all S&P 500 Companies faced new filings in 2008 and 4.6 percent faced new filings in 2009).

⁴³ Cornerstone Research, *Securities Class Action Filings: 2010 Mid-Year Assessment 2* (2010), http://www.cornerstone.com/files/Publication/a4e3e805-e0c7-4c6f-9f1c-3cee924a6b19/Presentation/PublicationAttachment/28990788-04f9-4ffd-938f-419be91146b6/Cornerstone_Research_Filings_2010_Mid_Year_Assessment.pdf (stating 3,120 as the total number and 195 as the average number of federal securities class action filings between January 1, 1996 and June 30, 2010).

⁴⁴ Cornerstone Research, *Securities Class Action Settlements: 2009 Review and Analysis 2* (2009), http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&ved=0CFEQFjAB&url=http%3A%2F%2Fwww.cornerstone.com%2Ffiles%2FPublication%2F1ab95c24-3653-41ca-909f-e996035c1c48%2FPresentation%2FPublicationAttachment%2Fadb055f-1e09-4a16-9a0f-ebb0cc432145%2FCornerstone_Research_Settlements_2009_Analysis.pdf&ei=FlbrT4C0G6f50gGe1mCBQ&usq=AFQjCNFqQ8c5kaU50dy4lQeh5r8tZetF9A&sig2=qV3fGVqXuPB8kRHbZ3gMw (stating “the average settlement rose from \$28.4 million in 2008 to \$37.2 million in 2009”).

II. D&O INSURANCE AND ITS ALIGNMENT WITH D&O LIABILITY'S DETERRENT EFFECT

A. Background on D&O Insurance

D&O insurance initially emerged from Lloyd's of London in the 1930's as a response to the Securities Act of 1933 and the Securities Exchange Act of 1934.⁴⁵ Few corporations purchased D&O insurance in the early days because indemnifying directors and officers was contrary to public policy.⁴⁶ Over the next few decades, however, corporations advocated that "a key ingredient to effective corporate management was the protection of corporate officials from personal liability."⁴⁷ By early to mid-1960, many states adopted new statutes explicitly permitting D&O insurance⁴⁸ and in the 1970s⁴⁹ state legislatures permitted the indemnification of corporate directors and officers.⁵⁰ For D&O insurance, the 1970's presented a time of continued growth and relatively low costs.⁵¹ Today, almost all publicly held corporations carry D&O insurance policies allowing some management of personal and corporate liability.⁵² Although D&O insurance is no longer considered by the courts and legislature as contrary to public policy,⁵³ the insurers have placed limitations on who they will cover and for what.⁵⁴

⁴⁵ See Dobiac, *supra* note 11, at 487 n.6; Joseph P. Monteleone, *Directors and Officers Liability Insurance: The Sarbanes-Oxley Act of 2002 and other Topical Issues*, SHO77 A.L.I.-A.B.A. 313 (2002).

⁴⁶ Dobiac, *supra* note 11, at 488; Joseph P. Monteleone & Nicholas J. Conta, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 BUS. LAW. 573, 574 (1996).

⁴⁷ Monteleone & Conta, *supra* note 46, at 574.

⁴⁸ See Johnston, Jr., *supra* note 10, at 1995-2005.

⁴⁹ See Dobiac, *supra* note 11, at 488; Monteleone & Conta, *supra* note 46, at 574.

⁵⁰ Michael D. Sousa, *Making Sense of the Bramble-Filled Thicket: The "Insured vs. Insured" Exclusion in the Bankruptcy Context*, 23 EMORY BANKR. DEV. J. 365, 372 (2007) (noting that "[I]n 1965, approximately less than 10% of corporations carried directors and officers liability insurance; by 1971, however, approximately 70% to 80% of all major corporations had purchased liability insurance for their directors and officers."). See also Monteleone & Conta, *supra* note 46, at 574.

⁵¹ See Dobiac, *supra* note 11, at 488.

⁵² See Baker & Griffith, *supra* note 2, at 487 n.2; Dobiac, *supra* note 11, at 488; TOWERS PERRIN, *DIRECTORS AND OFFICERS LIABILITY SURVEY: 2006 SURVEY OF INSURANCE PURCHASING AND CLAIMS TRENDS* (2006) available at http://www.towersperrin.com/tp/getwebcachedoc?webc=HRS/USA/2007/200704/DO_Survey_Report2006_040507.pdf.

⁵³ TOM BAKER & SEAN J. GRIFFITH, *ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION* 14-15 (The University of Chicago Press 2010).

⁵⁴ See discussion *infra* Part II.B.

Three distinct types of D&O insurance exist: A-Side, B-Side,⁵⁵ and C-Side coverage.⁵⁶ A-Side Coverage, individual coverage, indemnifies corporate directors and officers for personal liability.⁵⁷

While each D&O liability insurance policy includes unique characteristics, these policies “typically cover settlement amounts, legal fees, and compensatory damages.”⁵⁸ In addition the policies contain three common exclusions: 1) claims for actual fraud⁵⁹; 2) claims in which the director or officer committed the acts at issue prior to the start of the policy; and 3) claims between named insureds on the policy, such as when the corporation sues a director or officer.⁶⁰

B. D&O Insurance as a Facilitator of Deterrence

D&O insurers facilitate deterrence through a variety of mechanisms including exclusions, selective underwriting, offering input for the company’s corporate governance, and withholding coverage from fraudulent directors and officers. The exclusions deter wrongdoing because there is no risk management mechanism and you bear the risk. On a corporate level, the D&O literature provides explanations for why firms purchase D&O insurance as well as its potential relation to the quality of firm governance;⁶¹ D&O insurance helps manage liability risk⁶² and helps monitor the firms’ officers.⁶³

⁵⁵ B-Side coverage, institutional coverage, indemnifies payments the corporation may make to its directors and officers. See Dobiac, *supra* note 11, at 491–92; MARC H. FALLADORI, STOCK OPTION BACKDATING — REGULATORS AND PLAINTIFFS TAKE THE CONTROVERSY TO THE NEXT LEVEL, IN PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 666 (2007).

⁵⁶ C-Side coverage, or “entity coverage,” provides coverage for the corporation’s actual liability to shareholders in suits where the corporation itself is a named party. See Dobiac, *supra* note 11, at 491–92; Falladori, *supra* note 55; Sousa, *supra* note 50, at 381.

⁵⁷ See Dobiac, *supra* note 11, at 491–92. A-Side Coverage protects directors and officers even when the corporation is financially unable to (due to insolvency or bankruptcy), or is legally unable to (due to prohibitions under state corporate law or the corporation’s own by-laws or articles of incorporation). Sousa, *supra* note 50, at 374–75. While Side-B and Side-C coverages typically include retention or co-insurance provisions, Side-A typically does not. Thus individual officers and directors are indemnified from the first dollar, while the corporation typically assumes the liability risk up to a dollar ceiling. See Baker & Griffith, *supra* note 2, at 500.

⁵⁸ See Dobiac, *supra* note 11, at 492.

⁵⁹ The fraud exclusion typically defines fraud in a way that excludes any “dishonest or fraudulent act or omission or any criminal act or omission or any willful violation of any statute, rule, or law.” Baker & Griffith, *supra* note 2, at 500 n.58 (internal citations omitted).

⁶⁰ See *id.* at 492–93.

⁶¹ See John E. Core, *On the Corporate Demand for Directors’ and Officers’ Insurance*, 64 J. RISK & INS. 63, 68 (1997); Noel O’Sullivan, *Insuring the Agents: The Role of Directors’ and Officers’ Insurance in Corporate Governance*,

D&O insurers act as an intermediary between the shareholders and management by covering the risk of shareholder derivative suits.⁶⁴ Because they cover the risk, D&O insurers engage in selective underwriting which furthers the deterrent effect on directors and officers.⁶⁵ D&O insurers carefully screen prospective corporations, rejecting or increasing premiums for those with a high risk of liability.⁶⁶ However, when a number of underwriters, D&O insurance claims managers, actuaries and risk managers were interviewed⁶⁷ and asked “whether underwriters do a good job of pricing D&O risks, several of [them] were openly skeptical.”⁶⁸ The interviewees indicated that the D&O “underwriters did not have a consistent system of evaluation that applie[d] the same factors in the same way over time.”⁶⁹ This lack of uniformity in method or quantum of

64 J. RISK & INS. 545, 547–50 (1997).

⁶² See generally Core, *supra* note 61, at 68.

⁶³ See Core, *supra* note 61 at 67–68; O’Sullivan, *supra* note 61, at 547–50.

⁶⁴ Baker & Griffith, *supra* note 2, at 487–88. Shareholders seek to recover value of the corporation lost due to actions (or inaction) by the directors and officers through a derivative lawsuit—suing the directors and officers on behalf of the corporation. Derivative suits hold the directors and officers personally accountable for their actions. This need for personal liability arises from several sources including a desire for retribution, a need to deter similar future misconduct, and the difficulty inherent in preventing an enterprise from corporate misconduct.

⁶⁵ *Id.* at 488. Deterrence is based on the premise that “the burden of liability fall more heavily on bad actors.” *Id.* at 533. But with D&O insurance that may not be the case. The difference between premiums of high risk and low risk companies are not as large as they should be because of market forces. *Id.*

⁶⁶ *Id.*

⁶⁷ BAKER & GRIFFITH, *supra* note 53, at 14–15 (conducting a study from 2005 to 2007 by interviewing twenty-one underwriters from fourteen companies, twelve claims managers from ten D&O insurance companies, twenty-three lawyers who specialize in shareholder litigation, ten lawyers who specialize in representing D&O insurance companies in monitoring and settling shareholder litigation, six brokers, four risk managers, three D&O actuaries, five policyholder coverage counsel, three mediators of shareholder litigation settlements, two experts in shareholder litigation damages, and two claims advisors).

⁶⁸ *Id.* at 98 (attributing some of the difficulty in assessing D&O risk with the inherent nature of the insureds, the CEOs and CFOs who are able to deceive sophisticated company board members and investors are likely going to be able to deceive the underwriters as well).

⁶⁹ Underwriters consider a variety of factors in assessing D&O liability risk. Baker & Griffith, *supra* note 2, at 508. The underwriters place significant weight on corporate governance, a reflection of its importance in predicting liability risk. *Id.* at 517. In particular, underwriters look at both the character of individual officers and directors and how strong the “norm of compliance” is within the firm. *Id.* Underwriters also consider a number of factors that are not directly related to corporate governance, such as the type of industry, the size of the corporation, whether the industry is in a start-up, growth, or mature industry, the nature of the product or service that the firm sells, and various accounting ratios. *Id.* at 494–95, 514–15.

information used in underwriting D&O insurance policies undermines the efficacy of selective underwriting.⁷⁰

D&O insurers can also recommend changes to corporate governance practices of their insureds before covering potential losses.⁷¹ When lawsuits arise, the insurers can manage the defense and settlement of derivative suits, along with defense costs.⁷² Again, when actual insurers and brokers were interviewed, they indicated that the insurance market and consumer preference limited them from actively monitoring the insureds or having much power in the litigation process.⁷³

Insurers will also withhold insurance benefits from directors and officers who have engaged in fraudulent activity.⁷⁴ These practices deter officers and directors from engaging in harmful conduct or otherwise violating their duties in a way that is likely to trigger litigation,⁷⁵ thus

⁷⁰ Dobiac, *supra* note 11, at 506–07. According to Dobiac, “[D&O underwriting] is frequently driven more by intuition than by an automated or computerized underwriting scheme.” *Id.* at 502. With so many options in how to underwrite a D&O insurance policy and so many potential outcomes, it is getting increasingly more difficult to properly gauge the risk. *Id.* at 506. Dobiac argues that because there is a threat to the efficacy of a D&O liability underwriter’s judgment due to the “large number of compromises and rapid processing of noisy information,” the value of individual underwriting may not be superior and may even create greater variability in outcomes than traditional underwriting. *Id.* Selective underwriting is also weakened by the fact that underwriting departments “are not perfect agents of the insurance company as a whole.” BAKER & GRIFFITH, *supra* note 53, at 99. Underwriters will make imprudent underwriting decisions when under pressure to generate immediate revenues despite the fact that it will result in a loss several years later. *Id.*

⁷¹ Baker & Griffith, *supra* note 2, at 489.

⁷² This provides more deterrence to directors and officers who might not want to cede control to insurers who could “vigorously fight and stubbornly refuse to settle nuisance claims and, in the event that genuine corporate wrongdoing is uncovered, insist on a greater contribution to settlement from the corporate insured. BAKER & GRIFFITH, *supra* note 53, at 129.

⁷³ *Id.* at 105–51.

⁷⁴ Baker & Griffith, *supra* note 2, at 501.

⁷⁵ See discussion *supra* Part I.C; but see Dobiac, *supra* note 11, at 512 (arguing that increased premiums is not enough for “high risk firms to change their governance structure because the cost of doing so would be higher than the savings associated with lower premiums.”); See Tom Baker & Sean Griffith, *The Missing Monitor in Corporate Governance: The Directors & Officers Liability Insurer*, 95 GEO. L.J. 1795 (2007) (noting that while D&O insurance acts to deter directors and officers from committing social wrongs, the D&O insurance does not have a strong enough effect on corporate governance to change behavior). D&O insurance often costs very little in comparison to overall costs such that the company can easily absorb the expense without taking it into account as a significant part of the budget or something to focus on for cost savings. Dobiac, *supra* note 11, at 512–13. According to the 2008 Towers Watson survey, the average premium paid by public organizations was \$482,089. PERRIN SURVEY, *supra* note 52, at 27. For organizations with assets between \$5 and \$10 billion the average total premium was \$1,454,607, and for organizations with assets between \$100 million and \$400 million the average total premium was \$381,162. *Id.* at 30. For a \$10 billion company, that

marrying the deterrent effect and D&O liability with the market for D&O insurance.

Scholars have used D&O coverage to infer information about the overall quality of firm governance.⁷⁶ Their research provides a variety of explanations for why firms obtain D&O insurance, including the concepts that firms with higher risk are more likely to purchase coverage with higher limits⁷⁷ and that outside directors at larger firms as well as D&O insurers provide a source of monitoring for the firm's managers.⁷⁸ Similarly, firms with "greater inside ownership will purchase more insurance because of the insiders' risk aversion."⁷⁹

It is worth noting that this scholarship is not consistent. Other research finds that D&O premiums are positively related to excess CEO compensation, implying weak corporate governance.⁸⁰ In a study of Canadian firms, Chung & Wynn found that obtaining D&O insurance is associated with less conservative earnings reports by managers.⁸¹ These questionable reports include the timely reporting of bad news. Further, in their analysis of a sample of IPOs, Chalmers *et al.* find that firms purchasing insurance in conjunction with an IPO are likely to have lower stock price performance three years after the transaction, suggesting that perhaps D&O purchases are likely to reveal opportunistic behavior from managers.⁸² This scholarship reflects that D&O insurance is not always directly tied to deterrence in every respect. Nonetheless, the overall correlation between selective underwriting in the marketplace and deterrence remains.

means that the premium could be 0.01% of the of company assets, and for a \$400 million company, the premium might be less than 0.1% of the company assets. *Id.* at 30-34. Although the survey does not make a distinction between companies who have a history of good versus bad company practices, it is questionable that such premiums, or even premiums that are double or triple the average premium reported, would be consequential enough to impact the behavior of directors and officers.

⁷⁶ See John M.R. Chalmers, Larry Y. Dann & Jarrad Harford, *Managerial Opportunism? Evidence from Directors' and Officers' Insurance Purchases*, 57 J. FIN. 609 (2002) (defining managerial opportunism as management's use of inside information to gain private benefits). For example, management may issue an IPO when the shares may be over-valued. See generally John M.R. Chalmers, Larry Y. Dann & Jarrad Harford, *Managerial Opportunism? Evidence from Directors' and Officers' Insurance Purchases*, 57 J. FIN. 609 (2002).

⁷⁷ Core, *supra* note 61, at 84.

⁷⁸ O'Sullivan, *supra* note 61, at 552.

⁷⁹ Core, *supra* note 61, at 85.

⁸⁰ John E. Core, *The Directors' and Officers' Insurance Premium: An Outside Assessment of the Quality of Corporate Governance*, 16 J.L. ECON. & ORG. 449, 475 (2000).

⁸¹ Chung & Jinyoung, *supra* note 39, at 151.

⁸² Chalmers, Dann & Harford, *supra* note 76, at 633; but see Martin Boyer, Cirano, *Is the Demand for Corporate Insurance a Habit? Evidence from Directors and Officers Insurance* 3 (2003) available at <http://www.cirano.qc.ca/pdf/publication/2003s-42.pdf>.

III. RECENT CORPORATE SCANDALS AND THEIR "SHOCKING" IMPACT

The dramatic series of events associated with the corporate scandals of the early twenty-first century arguably created a "shock" in the D&O insurance marketplace profoundly and unexpectedly altering the market. These corporate scandals interrupted the typical D&O insurance cycle in extreme ways. The onslaught of corporate scandals in the early 2000's brought an increase in the assessment of losses that could be associated with the actions of directors and officers.⁸³ Scholars have addressed the impact that large loss shocks have had on the insurance marketplace in previous cycles.⁸⁴ Specifically, prior literature suggests that demand may increase "as a result of an actual or perceived increase in actuarial losses covered by a given contract," a concept referred to as probability updating.⁸⁵ This section of the paper addresses the impact of the recent corporate governance shocks on the D&O liability insurance marketplace so that we can later address impact on the deterrent effect.

A. Effect of Liability Cycles

Liability insurance goes through "hard" and "soft" cycles which can be driven by broad market forces or by specific events. D&O insurance is no exception. For example, in 1985, the Delaware Supreme Court changed the landscape of D&O insurance in its landmark case *Smith v. Van Gorkom*.⁸⁶ The lawsuits of the mid-1980's and the judicial interpretation

⁸³ Baker & Griffith, *supra* note 2.

⁸⁴ See J. David Cummins & Patricia M. Danzon, *Price, Financial Quality, and Capital Flows in Insurance Markets*, 6 J. FIN. INTERMEDIATION 3, 3-38 (1997); Anne Gron, *Capacity Constraints and Cycles in Property-Casualty Insurance Markets*, 25 J. ECON. 110, 110-27 (1994); Gene C. Lai et al., *Great (and Not So Great) Expectations: An Endogenous Economic Explication of Insurance Cycles and Liability Crises*, 67 J. RISK & INS. 617, 617-52 (2000); Mary A. Weiss & Joon-Hai Chung, *U.S. Reinsurance Prices, Financial Quality, and Global Capacity*, 71 J. RISK & INS. 437, 437-67 (2004).

⁸⁵ Kenneth A. Froot & Paul G. J. O'Connell, *The Pricing of U.S. Catastrophe Reinsurance*, in THE FINANCING OF CATASTROPHE RISK 195- 96 (Kenneth A. Froot ed., 1999).

⁸⁶ *Van Gorkom*, 488 A.2d 858. The 1985 case, *Smith v. Van Gorkom*, was a landmark decision in the United States as it clarified the requisites for a breach of the fiduciary duty of care. *Van Gorkom* involved the sale of Trans Union Corporation. *Id.* Jerome Van Gorkom, the CEO and a significant stockholder of Trans Union, discussed selling the company with some of his fellow executives, but only preliminarily. As part of these discussions, he received basic financial data on financing the buyout *Id.* at 865. Using this information, Van Gorkom approached the potential buyer who offered to purchase Trans Union. Van Gorkom called a meeting of the Trans Union board on only two days notice. *Id.* at 867. At the meeting, he gave an oral presentation but did not provide financial analysis or any written documentation, and did not disclose the

of director and officer liability under federal securities laws brought increased exposure to directors, officers, and the corporation itself.⁸⁷ Due to a variety of factors including an increased frequency of lawsuits and increased risks facing corporate directors and officers, the D&O insurance liability industry entered a hard cycle.⁸⁸ In a hard cycle, underwriters become more selective, more interested in higher attachment points, less willing to offer high limits, less willing to negotiate contract terms, and able to command dramatically higher prices for what amounts to less coverage.⁸⁹

As depicted in Figure 1,⁹⁰ D&O liability insurance experienced a soft cycle during most of the 1990's.⁹¹ During a soft cycle, insurers compete

circumstances of the negotiation process. *Id.* The board asked very few follow-up questions before approving the merger. *Id.* at 868. The Delaware Supreme Court found that the board's actions violated the duty of care and that the board acted in a grossly negligent manner in deciding to accept the offer. *Id.* at 873. The court based its conclusion on the finding that the board did not act on an informed basis when making its decision to proceed with the acquisition. *Id.* at 873-74. Before *Van Gorkom*, courts did not find directors personally liable absent a conflict of interest. However, in *Van Gorkom*, the court found the directors liable based solely on the breach of the duty of care. *Id.* at 893. See discussion *supra* Part I.A; William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, n. 49 (2001) (noting that after *Van Gorkom*, the D&O insurance industry sharply increased their premiums, and in some cases threatened to stop writing D&O insurance policies); Henry N. Butler, *Smith v. Van Gorkom, Jurisdictional Competition, and the Role of Random Mutations in the Evolution of Corporate Law*, 45 WASHBURN L.J. 267, n.19 (2006) ("The initial effect of *Van Gorkom* was to increase directors and officers insurance rates or to make D&O insurance unavailable."); Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 415 (2005); Justice Jack. B. Jacobs, *The Vanishing Substance-Procedure Distinction in Contemporary Corporate Litigation: An Essay*, 41 SUFFOLK U. L. REV. 1, 8 (2007) ("*Van Gorkom's* . . . impact was to create a national directors and officers liability insurance crisis. The insurance industry reacted to the decision by raising the cost of D&O liability insurance to almost prohibitive levels, and in some cases, stopped providing D&O insurance altogether."); Sousa, *supra* note 50, at 374 (stating that the *Van Gorkom* decision caused insurance companies to become "skittish" about issuing liability insurance coverage for a corporation's directors and officers). See also Lloyd L. Drury, III, *What's the Cost of a Free Pass? A Call for the Re-Assessment of Statutes that Allow for the Elimination of Personal Liability for Directors*, 9 TRANSACTIONS: TENN. J. BUS. L. 99, 105-07 (2007); Florence Shu-Acquaye, *Smith v. Van Gorkom Revisited: Lessons Learned in Light of the Sarbanes-Oxley Act of 2002*, 3 DEPAUL BUS. & COM. L.J. 19 (2004).

⁸⁷ See Dobias, *supra* note 11, at 488; Monteleone & Conta, *supra* note 46, at 574.

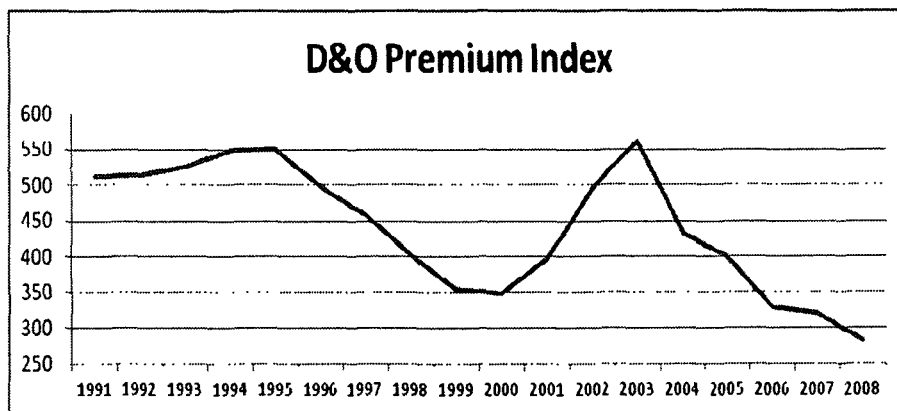
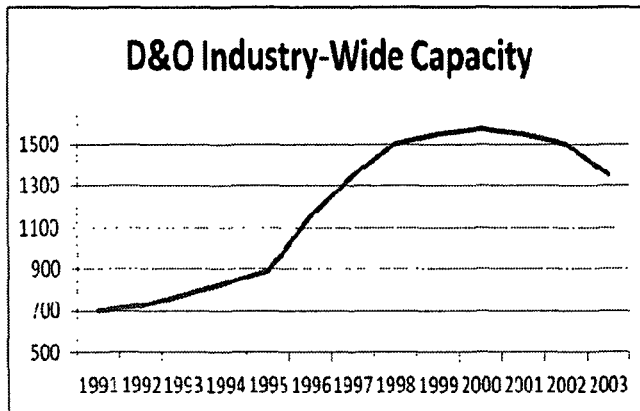
⁸⁸ See discussion *infra*, Part I; Baker & Griffith, *supra* note 2, at 507.

⁸⁹ Baker & Griffith, *supra* note 2, at 507.

⁹⁰ Capacity and premium data used for the construction of Figure 1 graphs are obtained from annual Towers Perrin Directors and Officers Liability surveys. See PERRIN SURVEY, *supra* note 52. Capacity data are only available from 1991 to 2003 and D&O Premium Index data are available from 1991 to 2008. The D&O Premium Index is based on a "typical" for-profit survey respondent and is provided on an aggregate basis. Both premium and capacity data used in the creation of the graphs in Figure 1 represent median values.

for business and corporations can obtain broader coverage at better prices and terms.⁹² As insurers compete for new business during a soft market, underwriting standards may diminish and insurers may be willing to accept greater risks than would otherwise be acceptable without increasing competitive pressures. As the millennium approached, the market for D&O liability insurance began to harden once again as corporate scandals associated with weak corporate governance resulted in legal action against directors and officers.⁹³

Figure 1



⁹¹ See Gary Lockwood, *D&O Insurance: Cycle of Change*, PLUS Journal, vol. XVI, No. 10, at 3 (2003), available at http://www.lordbissell.com/Newsstand/Lockwood-D&OInsurance-PLUS_10-2003.pdf; Baker & Griffith, *supra* note 2, at 508; Dobiac, *supra* note 11, at 488.

⁹² See Lockwood, *supra* note 91; Baker & Griffith, *supra* note 2, at 508; Dobiac, *supra* note 11, at 488.

⁹³ See Dobiac, *supra* note 11, at 488-89.

B. Effect of Corporate Scandals on the Market

Beginning with Enron, the new millennium, however, unleashed intense corporate scandals that are well documented in the literature.⁹⁴ Commentators consider the pervasive fraud at Enron, a Texas-based energy company, the “granddaddy of all corporate fraud cases.”⁹⁵ Under aggressive management, Enron engaged in risky investments, inflated accounting figures, and avoided full disclosures.⁹⁶ In a matter of months, Enron went from one of the leading companies on Wall Street to the biggest bankruptcy in U.S. history;⁹⁷ four thousand employees lost their jobs (many also lost their life savings) and investors lost billions.⁹⁸ Following the collapse and investigations by the Securities and Exchange Commission (SEC), fifteen former company executives pled guilty and received sentences.⁹⁹

In the midst of the Enron scandal, numerous other corporate scandals emerged. Examples include WorldCom, where more than \$3.8 billion in accounting fraud resulted in SEC fraud charges;¹⁰⁰ Adelphia, whose founder was convicted in 2004 of conspiracy, bank fraud, and securities fraud after hiding company debt, deceiving investors, and stealing company cash;¹⁰¹ and Tyco, whose former CEO and CFO were convicted of stealing more the \$150 million of company funds.¹⁰²

⁹⁴ See, e.g., Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?*, 95 GEO. L.J. 1843, 1892–96 (2007); Penelope Patsuris, *The Corporate Scandal Sheet*, FORBES (Aug. 8, 2002, 5:30 PM), <http://www.forbes.com/2002/07/25/accountingtracker.html>.

⁹⁵ Cheryl L. Wade, *Corporate Governance Failures and the Managerial Duty of Care*, 76 ST. JOHN'S L. REV. 767, 767 (2002); Shaheen Pasha & Jessica Seid, *Lay and Skilling's Day of Red reckoning*, CNN MONEY (May 25, 2006, 7:35 PM), http://money.cnn.com/2006/05/25/news/newsmakers/enron_verdict/index.htm.

⁹⁶ *The Fall of Enron: How Ex-CEO Jeff Skilling's Strategy Grew So Complex That Even his Boss Couldn't Get a Handle On It*, BUS. WK., Dec. 17, 2001, available at http://www.businessweek.com/magazine/content/01_51/b3762001.htm.

⁹⁷ Pasha & Seid, *supra* note 95.

⁹⁸ *Id.*

⁹⁹ Kristen Hays, *A Sordid Chapter on Enron is Ending: Kenneth Rice is the Final Figure to Be Punished After Pleading Guilty to Crimes in the Scandal*, HOUS. CHRON., (June 18, 2007, 5:30 AM), <http://www.chron.com/disp/story.mpl/special/enron/4897649.html>.

¹⁰⁰ *WorldCom's Sorry Legacy: Its Downfall May Hurt Rivals and Kill Telecom Competition*, BUS. WK., Jul. 8, 2002, at 38, available at http://www.businessweek.com/magazine/content/02_27/b3790018.htm. See also Patsuris, *supra* note 94.

¹⁰¹ *Adelphia Founder John Rigas Found Guilty: After 8 Days of Deliberations, Jury Returns Partial Settlement*, CORPORATE SCANDALS ON MSNBC (Jul. 8, 2004, 6:07 PM), <http://www.msnbc.msn.com/id/5396406>; Patsuris, *supra* note 94.

¹⁰² *Timeline of the Tyco International Scandal*, USA TODAY, (Jun. 17, 2005 4:11 PM), available at http://www.usatoday.com/money/industries/manufacturing/2005-06-17-tyco-timeline_x.htm; see also Patsuris,

The unprecedented number of highly publicized scandals in the early twenty-first century rocked the D&O insurance industry.¹⁰³ The number of lawsuits naming individual directors and officers increased dramatically, and damages, settlements, and the costs of litigation soared.¹⁰⁴

C. The Sarbanes-Oxley Act: Federal Response to Corporate Government Scandals

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (SOX),¹⁰⁵ declaring, “[n]o more easy money for corporate criminals; just hard time.”¹⁰⁶ SOX raced through Congress, criminalizing new behavior and significantly increasing the penalties for existing crimes.¹⁰⁷ The Act added new requirements designed to increase corporate compliance with legal and ethical standards.¹⁰⁸

SOX responded directly to the multitude of scandals by including provisions tied to criminal wrongdoings revealed during the scandals¹⁰⁹ and by targeting punishments meant to deter future corporate misconduct.¹¹⁰ In addition, the Act created personal accountability for the

supra note 94.

¹⁰³ Anjali C. Das, *The ABCs of D&O Insurance: An Illinois Lawyer's Guide*, 93 ILL. B.J. 304, 304 (2005); Fairfax, *supra* note 86, at 415; Sousa, *supra* note 50, at 375-76 (noting an increase in premiums after the Enron, Adelphia Communications, and Tyco scandals); see also Kate Burgess, *Directors' and officers Insurance: Set to Rise*, FIN. TIMES (April 24, 2008, 5:41 PM), <http://www.ft.com/cms/s/1/1bfc7040-d39b-11da-b2f3-0000779e2340.html>; Mairi Mallon, *U.S. D&O Lulled into a False Sense of Security?*, Reinsurance Magazine, Nov. 1, 2006, at 20; Randy Paar, *Insurance Coverage in the World of Sarbanes-Oxley* 852 PLI/COMM 217 (June 2003).

¹⁰⁴ Baker & Griffith, *supra* note 2, at 510; ROBERT W. HAMILTON & JONATHAN R. MACEY, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 970 (9th ed. 2005).

¹⁰⁵ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 903(a)-(b), 2002 U.S.C.C.A.N. (116 Stat.) 745, 805 (to be codified at 18 U.S.C. §§ 1341, 1343).

¹⁰⁶ Press Release, George W. Bush, President of the U.S., President Bush Signs Corporate Corruption Bill (July 30, 2002), at <http://georgewbush-whitehouse.archives.gov/news/releases/2002/07/20020730.html>.

¹⁰⁷ Paul Fiorelli, *Organizational Sentencing: Federal Guidelines and the Benefits of Programs to Prevent and Detect Violations of Law*, 39 WAKE FOREST L. REV. 565, 572-73 (2004).

¹⁰⁸ See Rebecca Walker, *The Evolution of the Law of Corporate Compliance in the United States: A Brief Overview*, 1623 PLI/CORP 13, 40-41 (2007).

¹⁰⁹ See, e.g., Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 802, 116 Stat. 745, 800-801 (2002) (criminal penalties for altering documents); *Id.* § 807 (criminal penalties for defrauding shareholders of publicly traded companies); *Id.* § 903 (criminal penalties for mail and wire fraud).

¹¹⁰ See *Id.* § 1106 (increased criminal penalties under Securities Exchange Act of 1934).

corporations' directors and officers with almost no forgiveness for financial inaccuracies and/or a lack of transparency.¹¹¹ Overall, lawmakers intended SOX to restore the integrity of the marketplace.¹¹²

In its effort to prevent future wrongdoing, SOX also created more liability risk for directors and officers.¹¹³ As a result, D&O insurance premiums increased approximately 30% in 2001 and 30% in 2002.¹¹⁴ In 2003, premiums increased 33%.¹¹⁵ Premiums for the largest companies, those with market capitalizations of \$5 billion or more, increased as much as 70% in 2004.¹¹⁶ In an attempt to quantify the costs of Sarbanes-Oxley, a survey of mostly mid-cap companies found that the cost of being public almost doubled, from \$1.3 million to almost \$2.5 million.¹¹⁷ D&O liability insurance, which averaged \$329,000 prior to Sarbanes-Oxley and grew to \$639,000 afterwards,¹¹⁸ accounted for approximately two thirds of the increased expense. The personal liability of the CEO and CFO, who must sign off on the company's financial statements, is largely credited with the increased premiums.¹¹⁹

D. Corporate Governance Scandal's "Shock" to the D&O Insurance Market

The corporate scandals of the early twenty-first century altered our perspective on corporate liability and interrupted the typical D&O insurance cycle in extreme ways, arguably creating a "shock." A "shock" is a dramatic event or series of events that causes a reexamination of assumptions and rules.¹²⁰ Not only did the shock result in a

¹¹¹ See, e.g., *Id.* § 302 (requiring officers to certify reports required under the Securities Exchange Act of 1934).

¹¹² Prentice & Spence, *supra* note 94, at 1868; J. Brent Wilkins, *The Sarbanes-Oxley Act of 2002: The Ripple Effects of Restoring Shareholder Confidence*, 29 S. ILL. L.J. 339, 340 (2005).

¹¹³ See Walker, *supra* note 108; see also Sousa, *supra* note 50, at 377–78.

¹¹⁴ JOHN F. OLSON ET AL., DIRECTOR & OFFICER LIABILITY: INDEMNIFICATION AND INSURANCE § 4.26 (2011).

¹¹⁵ *Id.*

¹¹⁶ HAMILTON & MACEY, *supra* note 104, at 970. But see OLSON ET AL., *supra* note 114, at § 4.26 (stating premiums decreased in 2004). But see OLSON ET AL., *supra* note 114, at § 4.26 (stating premiums decreased in 2004).

¹¹⁷ Wilkins, *supra* note 112, at 347.

¹¹⁸ Wilkins, *supra* note 112, at 348.

¹¹⁹ Wilkins, *supra* note 112, at 347.

¹²⁰ See Benedict Sheehy, *Scrooge—The Reluctant Stakeholder: Theoretical Problems in the Shareholder–Stakeholder Debate*, 14 U. MIAMI BUS. L. REV. 193, 196 (2005); see also A. A. Sommer, Jr., *Whom Should the Corporation Serve? The Berle–Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP. L. 33, 33 (1991); Stephen J. Redner, *Thinking of Going Public? Think Twice, Then Read the Sarbanes-Oxley*

reexamination of corporate governance and reactionary legislation—the Sarbanes-Oxley Act;¹²¹ it also created a shock in the D&O insurance industry in that insurers reexamined their pricing behaviors.¹²²

E. D&O Insurance Coverage Obligations after SOX

Studies have examined the effect of legislative changes on the D&O marketplace. For example, in a study of the impact of legislation before SOX, Chalmers *et al.* (2002) provide evidence that D&O premiums declined following both the introduction and enactment of the Private Securities Litigation Reform Act of 1995.¹²³ These results suggest that insurers updated the probability of D&O related claims downward following the passage of this Act, which ultimately resulted in a reduction in overall premiums.¹²⁴

Linck, Netter & Yang (2008) examine the effects of SOX on both the supply of and the demand for directors and officers insurance.¹²⁵ As a result of Sarbanes-Oxley and increased shareholder litigation, “some of the largest commercial insurance companies reduced their D&O coverage obligations by increasing deductibles and lowering limits on overall coverage,” thus exposing directors to higher liability.¹²⁶ As insurer capacity deteriorated and insurers left the market, a large number of new insurers emerged to offer D&O coverage to public companies.¹²⁷ Because demand rose between 2000 and 2003, more insurers entered the market, causing D&O premiums to fall.¹²⁸ In addition, class actions against U.S.

Act of 2002, 6 J. SMALL & EMERGING BUS. L. 521, 529 (2002) (“The shock of the corporate scandals involving formerly highly respected and revered executives and auditing firms has led to reactionary legislation.”).

¹²¹ Redner, *supra* note 120, at 529; Wilkins, *supra* note 112, at 340.

¹²² Past Towers Perrin D&O Liability surveys revealed that in 2001, 2002, and 2003, premiums for D&O Liability insurance were increasing at an alarming rate. *The Success Premium – D&O Insurance Coverage*, Practising Law Institute, 1 No. 24 PLI-CC 1 (July 26, 2004). Some insurance companies made D&O policies more restrictive, and others dropped D&O coverage altogether. *Id.*

¹²³ Chalmers, Dann & Harford, *supra* note 76, at 24.

¹²⁴ *Id.*

¹²⁵ James S. Linck, Jeffrey M. Netter & Tina Yang, *The Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand for Directors*, 22 REV. FINAN. STUD. 3287, 3288 (2008).

¹²⁶ Fairfax, *supra* note 86, at 415.

¹²⁷ See Mallon, *supra* note 103, at 20 (noting that Lloyd’s of London virtually ceased providing D&O insurance to public companies).

¹²⁸ See Burgess, *supra* note 103, at 3.

listed companies declined, resulting in reduced premiums.¹²⁹ In a matter of a few years,¹³⁰ a post-scandal hard cycle quickly turned soft.¹³¹

A 2006 Towers Perrin Directors and Officers Liability Survey reported a continuing soft market for D&O insurance.¹³² "As a result, survey participants generally reported higher limits, slightly lower retentions and premiums, broader coverage, and fewer exclusions."¹³³ Potential corporate directors became more interested in an organization's D&O program and coverage.¹³⁴ In 2006, premiums decreased by 6.5%, and 31% of participants reported an increase in coverage enhancements.¹³⁵ In addition, over 99% of public companies purchased D&O insurance.¹³⁶

The Survey also reported an increased interest in Side A of D&O insurance that covers individual directors and officers when they are not indemnified by their organization.¹³⁷ For public companies, 38% reported purchasing such a policy.¹³⁸ Further, the Survey provided the following data representing the types of D&O allegations from shareholder claimants against public companies: accounting fraud 2%; breach of duty

¹²⁹ *Id.*

¹³⁰ Between 2004 and 2005, the D&O coverage standardized premium index indicated that coverage costs decreased approximately 9% on average, illustrating the softening market. TOWERS WATSON, DIRECTORS AND OFFICERS LIABILITY: 2005 SURVEY EXECUTIVE SUMMARY 1 (Towers Perrin 2005), available at http://www.towersperrin.com/tp/getwebcachedoc?webc=TILL/USA/2006/200601/DO_2005_Exec_Sum.pdf. Among repeat participants of the 2005 Towers Perrin survey, the average premium reported was 8% lower than the previous year. *Id.* at 2. The 2005 survey also reported that coverage restrictions were continuing to ease with 25% of U.S. participants reporting that they had increased enhancements and 10% of participants reporting that they had less exclusions. *Id.* at 4.

¹³¹ Despite the current soft cycle, demand for protection remains unabated. *Id.*

¹³² PERRIN SURVEY, *supra* note 52, at 7. The annual Towers Perrin D&O survey is based on a nonrandom, self-selecting sample of companies. *Id.* at 9. It is also the only systematic source of information on D&O insurance purchasing patterns in the U.S. *Id.*

¹³³ *Id.* at 7.

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.*; Baker & Griffith, *supra* note 2, at 487, n.2.

¹³⁷ See Sousa, *supra* note 50, at 379-80. Specifically, "Side A" Coverage provides liability coverage directly to the officers and directors of a corporation for claims asserted against them for their wrongful acts, errors, omissions, or breaches of duty. A-Side Coverage insures the corporate directors and officers in the event that the corporation does not or cannot indemnify them under any applicable corporate documents or laws. A-Side Coverage is significant because it protects directors and officers where the corporation is financially unable to indemnify due to insolvency or bankruptcy, or is legally unable to indemnify due to prohibitions under state corporation law or the corporation's own by-laws or articles of incorporation. *Id.* In contrast, "Side B" coverage provides reimbursement to the corporation for amounts paid as indemnification to its directors and officers, and "Side C" coverage, also known as entity coverage, protects the company itself against various claims made directly against it. Falladori, *supra* note 55.

¹³⁸ See Perrin Survey, *supra* note 52.

to minority shareholders 4%; dishonest/fraud 3%; general breach of fiduciary duty 12%; inadequate disclosure including financial reporting 37%; and stock and other public offering 19%. The 2009 Towers Perrin¹³⁹ report on D&O Liability Insurance indicated that like 2007, the 2008 results continued to show a soft insurance market for D&O liability insurance.¹⁴⁰ The literature supports these figures. For example, Froot & O'Connell propose the theory of probability updating, whereby demand for insurance shifts considerably when insureds significantly increase their assessment of the real or perceived likelihood of loss.¹⁴¹ Similarly, Lai *et al.* argue that insurers may also experience a change in expectation about future losses or expenses that will impact price and/or supply of coverage.¹⁴²

F. The Latest "Shock"

While the dust continues to settle from the corporate scandals at the beginning of the twenty-first century, the U.S. is in the midst of another perceived loss shock that is likely to impact the D&O liability insurance marketplace. The following chart illustrates how the marketplace has changed over time indicating that we are in a period of uncertainty:

¹³⁹ Towers Perrin merged with Watson Wyatt Worldwide in 2009 and is now called Towers Watson.

¹⁴⁰ TOWERS WATSON, DIRECTORS AND OFFICERS LIABILITY: 2008 SURVEY OF INSURANCE PURCHASING TRENDS (2009), <http://www.towerswatson.com/assets/pdf/2791/2791.pdf>. Premiums continued to decrease during 2008, although not as much as seen in 2007. *Id.* at 5. Repeat participants reported an average decline in premiums of 5%, a 21% decline in average retention, and a 6% increase in average limits. *Id.* Coverage enhancements were down from the prior year, and only 3% of respondents reported a decrease in policy exclusions, down from 34% in 2007. *Id.* at 6. Furthermore, the Towers Watson premium index was down by 14%. *Id.* Also noteworthy was the change in A-Side coverage purchasing. The 2008 survey indicated a 33% increase in purchases for A-Side coverage among repeat public company participants—43% of public companies purchased A-Side only coverage which was 179 participants. *Id.* at 5. 15% of organizations with assets over \$10 billion, or 4 out of 15 participants, only purchased A-Side coverage. "Some industry observers have commented that many large financial institutions facing potential large D&O claims from the current financial crisis only purchase Side A coverage." *Id.*

¹⁴¹ See Kenneth Froot & Paul O'Connell, *The Pricing of U.S. Catastrophe Reinsurance* 7-8, (Nat'l Bureau of Econ. Research, Working Paper No. 60443, 1997).

¹⁴² Gene C. Lai *et al.*, *Great (and Not So Great) Expectations: An Endogenous Economic Explication of Insurance Cycles and Liability Crises*, 67 J. RISK & INS. 617, 620 (2000).

Years	Period Characteristics
1991–2000	Benchmark Period of Relative Certainty and Lack of Scandals
2001–2003	Corporate Scandals/Uncertainty
2003	Implementation of SOX
2004–2006	Post-SOX Relative Certainty
2007	New Period of Uncertainty
2012	Financial Crisis and Uncertainty

To fully understand the recent effects to the marketplace, this period of uncertainty is best analyzed on an industry level. To date, no studies have examined the ability/tendency of insurers to adjust the price and availability of D&O insurance coverage across industries. Fier, *et al.* derived a model which divides the marketplace into two groups in order to better understand the shift in the market.¹⁴³ The first group (“impacted”) consists of those industries most associated with the scandals (and presumably weak governance) that occurred during 2001 and 2002, while the second group (“non-impacted”) consists of those industries that were not typically associated with the corporate scandals. This allows tracking of not only the overall marketplace, but the key industries closely related to the corporate governance failures.¹⁴⁴

The analysis of the D&O market on an industry level suggests that scandal-based events are unique loss shocks that directly impact the demand for D&O insurance. insurers pricing behavior. The analyses produced evidence of a new type of probability updating in the demand for D&O insurance, as those industries most associated with the corporate scandals of the early 2000s typically carried greater levels of insurance coverage during periods characterized by greater uncertainty. More specifically, the results suggest that during periods of uncertainty (i.e., 2001 to 2002 and 2007 to 2008) industries most associated with corporate scandals and a lack of corporate governance generally purchased greater levels of D&O insurance than those industries less associated with these

¹⁴³ Fier, *et al.*, *supra* note 5, at 13.

¹⁴⁴ *Id.* at 5, 13–14.

events, but a statistical difference does not exist with respect to insurance demand during periods of calm or certainty.¹⁴⁵ Overall, the findings suggest that the shocks resulting from the corporate scandals and enactment of SOX provided a distinct type of loss shock that impacted the various industry segments of the D&O marketplace differently.

IV. WHAT EFFECT DOES D&O LIABILITY HAVE ON DETERRENCE TODAY?

Past and present scandals have affected D&O liability and the availability of coverage for such claims. Increased shareholder class action lawsuits, high damage awards in those lawsuits, and claims related to the restatement of earnings have had strong impacts on carriers. Nonetheless, the D&O market has softened faster than many would have expected, driving coverage for claims up and the cost for coverage down.

These factors seem to have created a more traditional soft market response with D&O insurance – lower premiums and increased access to coverage. Fundamental changes in liability law, however, do not appear forthcoming. On the contrary, a lack of successful prosecutions under Sarbanes-Oxley and the resulting regulations seems, in and of itself, to have alleviated much anxiety over the risk that directors and officers may bear. But, the current credit crisis may revive that anxiety.

In the wake of the current credit crisis, we are potentially in the midst of yet another shock. In 2008, despite an increase of dismissals, courts began approving increasingly higher monetary values in securities class action settlements.¹⁴⁶ In 2009, securities class action settlements amounted to \$3.8 billion, compared to \$2.7 billion in 2008, “represent[ing] more than a 35 percent increase” in the total value of settlements.¹⁴⁷ An average settlement of \$37 million in 2009 demonstrated that courts were serious about enforcement and deterrence.¹⁴⁸ These high value settlements may provide hard-hitting

¹⁴⁵ Periods of relative certainty and uncertainty are defined as discussed in the chart provided above.

¹⁴⁶ Cornerstone Research, *Securities Class Action Filings: 2010 Mid-Year Assessment 2* (2010), http://www.cornerstone.com/files/Publication/a4e3e805-e0c7-4c6f-9f1c-3cee924a6b19/Presentation/PublicationAttachment/28990788-04f9-4ffd-938f-419be91146b6/Cornerstone_Research_Filings_2010_Mid_Year_Assessment.pdf (stating 2009 total settlement dollars were “more than 35 percent higher” than 2008).

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 2. The financial crisis produced three of the largest settlements of this decade: World Com, Inc. (\$6.2 billion), Enron Corp. (\$7.2 billion), and Tyco International (\$3.2 billion). Although 2009 settlements did not reach the previous billion dollar range, the settlement amounts came dangerously close

deterrence if D&O insurance is not high enough to cover the settlement and out of pocket liability becomes a reality for directors and officers.¹⁴⁹ Conversely, if D&O insurance coverage surpasses the settlement amount, D&O liability may not create significant deterrence.¹⁵⁰ Even if these high settlement amounts do not result in deterrence, securities class actions are often filed with companion shareholder derivative actions which result in mandatory changes to corporate governance practices and therefore have the ability to substantially alter the behavior of directors and officers.¹⁵¹

Recent cases provide further insights into the current state of affairs for D&O liability. In 2009, the Delaware Chancery Court considered two important cases regarding directors' and officers' oversight liability.¹⁵² These decisions reinforce the high burden of proof plaintiffs must meet in overcoming the Business Judgment Rule, but also warn that a showing of bad faith and intentional misconduct may be enough to find directors liable for corporate losses. The Delaware court also hints at a significant new development that could hold directors and officers involved in prior financial scandals to a higher standard of care with regard to their duties to shareholders.

A. In re American International Group, Inc. Consolidated Derivative Litigation

The Delaware Chancery Court considered oversight liability in the recent case, *In re American International Group, Inc. Consolidated Derivative Litigation*.¹⁵³ Shareholders of American International Group, Inc. (AIG)

when courts approved settlements up to \$925,500,000. *Id.* at 18 n.2.

¹⁴⁹ Bernard Black et al., *Outside Director Liability*, 58 STAN L. REV. 1055, 1061 (2006) (explaining out-of-pocket liability may arise if a company lacks D&O insurance or carries "insufficient coverage").

¹⁵⁰ *Id.* Between 1980 and 2006, "only thirteen cases resulted in outside directors paying out-of-pocket for damages, settlement, or their own legal expenses." *Id.* at 1064.

¹⁵¹ Cornerstone Research, *Securities Class Action Settlements: 2009 Review and Analysis* 11 (2009), http://www.cornerstone.com/files/News/5412f893-24de-4de1-8be7-15af788de16a/Presentation/NewsAttachment/fc277c05-a487-42c8-8e4b-76ef2dea0615/Cornerstone_Research_Settlements_2009_Analysis.pdf (stating "slightly more than 45 percent of cases settled in 2009 were accompanied by a derivative action filing"); see also Jessica Erickson, *Corporate Misconduct and the Perfect Storm of Shareholder Litigation*, 84 NOTRE DAME L. REV. 75, 90,91 (discussing the myriad of securities class actions and derivative suits that Merrill Lynch faced which were based upon "strikingly similar" complaints); see *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949) (explaining that a derivative suit was "long the chief regulator of corporate management.").

¹⁵² See *In re Am. Int'l Grp., Inc. Consol. Derivative Litig.*, 965 A.2d 763 (Del. Ch. 2009); *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).

¹⁵³ *In re Am. Int'l Group, Inc. Consol. Derivative Litig.*, 965 A.2d 763 (Del. Ch. 2009).

brought a derivative suit against former directors and officers of the company¹⁵⁴ alleging that intentional misconduct by several of AIG's top officers resulted in materially misleading financial statements which overstated the value of the corporation by billions of dollars.¹⁵⁵ The misstatements led to \$1.6 billion in fines and penalties, \$440 million in settlement payments, \$800 million in lost profits and penalties, and a \$3.5 billion "hit" to shareholders' equity.¹⁵⁶

The court found that at least two of the defendants knew and approved of much of the financial wrongdoing occurring in the company, and had thus had breached their duty of loyalty by knowingly failing to monitor internal controls.¹⁵⁷ In essence, this decision demonstrates the ongoing need for deterrence and for D&O insurance to support, rather than undermine, that deterrence.

B. In re Citigroup Inc. Shareholder Derivative Litigation

The Delaware Chancery Court considered oversight liability in a second case, *In re Citigroup Inc. Shareholder Derivative Litigation*, but with a different result.¹⁵⁸ Citigroup shareholders brought a derivative action against current and former directors and officers seeking to recover for losses sustained from exposure to the subprime lending market.¹⁵⁹

The plaintiffs brought claims for breach of fiduciary duty and waste. First, under a breach of fiduciary claim, the plaintiffs alleged that the defendants were liable for oversight liability because they failed to monitor Citigroup's business risk and its exposure to the subprime mortgage lending market.¹⁶⁰ Further, the plaintiffs claimed the directors and officers should have been put on notice of the struggling economic market by "red flags," including newspaper articles stating the housing market bubble was about to burst and increased bankruptcy filings by mortgage companies and hedge funds.¹⁶¹

¹⁵⁴ *Id.* at 774.

¹⁵⁵ *Id.*

¹⁵⁶ Dominick T. Gattuso & Vernon R. Proctor, *Reining in Directors and Officers in Corporate America*, 19 BUS. LAW TODAY 46 (2010).

¹⁵⁷ *In re Am. Int'l Group, Inc. Consol. Derivative Litig.*, 965 A.2d at 799; Gattuso & Proctor, *supra* note 156, at 46.

¹⁵⁸ *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).

¹⁵⁹ *Id.* at 111.

¹⁶⁰ *Id.* at 123.

¹⁶¹ *Id.* at 115, 124.

The court analyzed the breach of fiduciary duty claims under the business judgment rule, with a “focus on the decision making process rather than on a substantive evaluation of the merits of the decision.”¹⁶² The court dismissed the claims, holding the plaintiffs’ conclusory claims did not show the directors failed to meet their oversight obligations.¹⁶³ In contrast to the AIG’s directors’ failure to oversee or correct fraudulent conduct in the previous case, the Citigroup directors’ failure to take notice of the “red flags,” constituted, at most, evidence that the directors had made a bad business decision to invest in the subprime mortgage market.¹⁶⁴

The plaintiffs argued that nine of the directors, who had been involved with the Enron financial scandal, should have been “especially sensitive” to the “red flags.”¹⁶⁵ The court rejected the plaintiffs’ attempt to hold these directors to a higher standard of liability because the plaintiffs failed to show how the Enron scandal was relevant to the Citigroup subprime mortgage losses.¹⁶⁶

The plaintiffs cited *McCall v. Scott*¹⁶⁷ as support for their position.¹⁶⁸ In the *McCall* case, the Sixth Circuit held that a “significant factor” in its decision that the plaintiff’s facts created a reasonable doubt as to the directors’ disinterestedness was the director’s involvement in prior instances of the *same type* of questionable billing procedures.¹⁶⁹ In contrast, the plaintiffs in *In re Citigroup* did not show there were any specific similarities between the directors’ involvement in the Enron scandal and Citigroup’s losses.¹⁷⁰ The court alluded, however, that there *may* be situations where directors would be held to a higher standard due to their exposure to previous scandals.

The court also considered the plaintiffs’ corporate waste claims, dismissing all but one of the waste claims. In an unusual move for the

¹⁶² *Id.* at 124.

¹⁶³ *Id.* at 126.

¹⁶⁴ *Id.* at 128; see also Gregory V. Varallo & Margot F. Alicks, *Recent Developments in Delaware Corporate Law*, 1774 PLI/Corp 83, 156-58 (2009).

¹⁶⁵ *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d at 129.

¹⁶⁶ *Id.*

¹⁶⁷ *McCall v. Scott*, 239 F.3d 808 (6th Cir. 2001).

¹⁶⁸ *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d at 129.

¹⁶⁹ *Id.*; *McCall*, 239 F.3d at 819-824.

¹⁷⁰ *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d at 129 (“Plaintiffs have not shown how involvement with the Enron related scandals should have in any way put the director defendants on a heightened alert to problems in the subprime mortgage market. Additionally, the use of SIVs in the Enron related conduct would not serve to put the director defendants on any type of heightened notice to the unrelated use of SIVs in structuring transactions involving subprime securities.”).

historically pro-business tribunal, the court held the plaintiffs' allegations regarding a large severance package for retiring CEO Charles Prince, who was at least partially to blame for the billions of dollars lost at Citigroup, raised a reasonable doubt as to whether the package was so "one-sided" and so disproportionately large and unconscionable as to be considered waste.¹⁷¹ The Delaware Chancery Court recognized that there is an "outer limit" to the discretion of directors in setting executive compensation—at some point the compensation is so disproportionately large as compared to the executive's contribution that it constitutes waste.

Following the recent *AIG* and *Citigroup* cases, the general principle remains that the business judgment rule protects decisions by the board of directors. In addition, to prove a claim that directors and officer have violated their oversight duties, plaintiffs must allege more than mere "red flags" that should have swayed the directors' decision making.¹⁷² Instead, plaintiffs must show that directors acted in bad faith, knowingly shirking their duties.¹⁷³ It is yet to be seen whether plaintiffs will be able to hold directors with prior exposure to financial scandals to a higher standard, as alluded in to the *In re Citigroup* case. What impact do these cases have on the D&O insurance market—what is the deterrent effect?

C. Bear Stearns

In the summer of 2007, several hedge funds, heavily invested in mortgage securities and managed by Bear Stearns, collapsed as the financial crisis loomed on the horizon. As a result of the collapse, investors lost 1.6 billion dollars. "The fiasco presaged the financial turmoil that would later upend Wall Street and the broader economy."¹⁷⁴ Cioffio and Tannin, hedge fund managers at Bear Stearns, were arrested in June 2008, after being accused of lying to investors about the "precarious state of the funds they oversaw."¹⁷⁵ The case filed by the New York District Attorney turned on emails between Cioffi and Tannin and their investors in the fund, assuring the investors that their investments were sound.¹⁷⁶ Prosecutors argued that Cioffi and Tannin committed

¹⁷¹ *Id.* at 138.

¹⁷² *Id.* at 128; Varallo & Alicks, *supra* note 164, at 156-58.

¹⁷³ See *In re Am. Int'l Group, Inc.*, 965 A.2d 763, 799 (Del. Ch. 2009).

¹⁷⁴ Zachery Kouwe and Dan Slater, *2 Bear Stearns Fund Leaders Are Acquitted*, N.Y. TIMES, Nov. 11, 2009, at A1.

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

fraud because they were aware that the fund was “anything but sound.”¹⁷⁷ On November 2, 2009, the United States Federal District Court for the Eastern District of New York acquitted Ralph R. Cioffi and Matthew M. Tannin, hedge fund managers from Bear Stearns, of securities fraud.¹⁷⁸ As one of the jurors explained, “There was a reasonable doubt on every charge. We just didn’t feel that the case had been proven.”¹⁷⁹ Cioffi and Tannin still face civil action by the Securities and Exchange Commission, but are not criminally liable for fraud.¹⁸⁰

D. MF Global Holdings Ltd.

More recently, in December 2011, regulators commenced an investigation into whether MF Global Holdings Ltd. intentionally used customer funds to cover the bankrupt firm’s margin payments on European government bond trades. The Securities and Exchange Commission, the Justice Department, the Commodity Futures Trading Commission and the bankruptcy trustee have been reviewing the brokerage’s accounts seeking proof of fraud, which would allow them to recover some of the lost \$1.2 billion.¹⁸¹ MF Global filed the eighth-largest bankruptcy in U.S. history on October 31, 2011 after investors lost confidence in the capital position of the firm and demanded their money.¹⁸² According to an e-mail that rating agency Standard & Poor’s provided to the House Financial Services Subcommittee on Oversight and Investigations, the Chief Financial Officer of MF Global, Henri Steenkamp, told Standard & Poor’s that the company had “never been stronger” just a week before the collapse of the company.¹⁸³

On December 8, 2011, a trading firm led by the vice-chairman of the Chicago Mercantile Exchange filed suit against MF Global’s Chief Executive Officer at the time of its collapse, former U.S. Senator and New Jersey Governor, Jon Corzine, alleging that he violated laws that prohibited using customer money to fund trading activities, a practice that

¹⁷⁷ *Id.*

¹⁷⁸ *United States v. Cioffi*, 668 F. Supp. 2d 385 (E.D.N.Y. 2009).

¹⁷⁹ Zachery Kouwe and Dan Slater, *2 Bear Stearns Fund Leaders Are Acquitted*, N.Y. TIMES, Nov. 11, 2009, at A1.

¹⁸⁰ *Id.*

¹⁸¹ Jim Spencer, *MF Global woes ripple into heartland*, STAR TRIBUNE, December 2, 2011, at 1D.

¹⁸² Zeke Faux & Phil Mattingly, *MF Global Told S&P “Never Been Stronger” as failure loomed*, BLOOMBERG BUS. WK, January 30, 2012, <http://www.businessweek.com/news/2012-01-30/mf-global-told-s-p-never-been-stronger-as-failure-loomed.html>.

¹⁸³ *Id.*

allegedly led to the disappearance of the over \$1.2 billion in customer funds.¹⁸⁴ Six other traders are listed as plaintiffs in the lawsuit and they are seeking class action status.¹⁸⁵ This lawsuit is among a “variety of litigation” against MF Global’s former officers and directors that is expected to result from the firm’s bankruptcy.¹⁸⁶

CONCLUSION

As more scandal emerges that shocks the D&O insurance marketplace and both lawmakers and investors demand more accountability, directors and officers will seek to transfer the risk of liability rather than bear that risk personally.¹⁸⁷ Transferring risk in such an environment, however, has the potential to create a scenario where the existence of insurance alters the incentive to minimize wrongdoing.¹⁸⁸ In fact, when an insured knows that the insurance will cover any harm caused, the probability of loss actually increases, thereby undermining the deterrent effect.¹⁸⁹

With D&O liability, increased risk transference in a soft market has the potential to increase loss probability. Increased loss probability is particularly troubling considering that we are arguably inside of another shock – on the contrary, deterrence seems to be of the highest importance. As a result, it remains critical that the marketplace continues selective underwriting so that risk transference supports, rather than undermines, the deterrent effect of D&O liability.

¹⁸⁴ David Roeder, *CME Group vice chairman sues former MF Global leader Corzine*, CHICAGO SUN-TIMES, December 16, 2011, at 30.

¹⁸⁵ *Id.*

¹⁸⁶ Jonathan Stempel, *MF Global employee lawsuits to be led by one firm*, REUTERS, January 30, 2012, available at http://newsandinsight.thomsonreuters.com/Securities/News/2012/01_-_January/MF_Global_employee_lawsuits_to_be_led_by_one_firm/.

¹⁸⁷ Joan T.A. Gabel, Nancy R. Mansfield & Gregory Todd Jones, *The Peculiar Moral Hazard of Employment Practices Liability Insurance: Realignment of the Incentive to Transfer Risk with the Incentive to Prevent Discrimination*, 20 NOTRE DAME J.L. ETHICS & PUB. POL’Y 639 (2006).

¹⁸⁸ *Id.*

¹⁸⁹ *Id.*

