

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

by

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 insurance profoundly. This market alteration has counterintuitively resulted in increased availability of D & O insurance coverage 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,”⁵ making coverage readily available. Carriers are now 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 by this soft D & O insurance market. In Part I, we describe the parameters of D & O liability and its deterrent effect.⁶ 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” D & O liability’s risk management tools. In Part IV, we conclude by analyzing whether these shocks have unhinged the overlapping efforts of D & O liability and D & O insurance in such a way that now, D & O insurance has the potential to undermine the deterrent effect.

I. D & O LIABILITY AND ITS DETERRENT EFFECT

It is commonly understood that “[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.”⁷ D & O liability is an offshoot of common law agency 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 . . .”⁸ 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.⁹ These lawsuits, commonly referred to as shareholder derivative suits, serve as the primary deterrent mechanism to prevent wrongful conduct and ensure directors and officers uphold their fiduciary duties.¹⁰ By placing personal liability on directors and officers for their actions (or inactions), the burden of corporate loss shifts, by way of shareholder derivative lawsuits, from shareholders to the decision makers.¹¹ Thus, derivative suits “raise the expected cost of the undesirable behavior” by the directors and officers and the potential for personal liability for their actions serves as a deterrent.¹²

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

As agents of a corporation, directors and officers are bound by certain duties;¹³ they must use care and diligence in their management and administration of the affairs of the corporation.¹⁴ When an officer or director breaches their duty to the corporation, shareholders of the corporation may seek to recover the 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.¹⁵ It is through these derivative lawsuits that directors and officers can be held liable to the corporation for losses that resulted from the breach of their duties.

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.¹⁶ 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.”¹⁷ The protection afforded to directors under the rule is notoriously difficult for plaintiffs to overcome.¹⁸ Nevertheless, there are situations where shareholders are able to recover against directors and officers for a breach of their duties of care, loyalty, or good faith.

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.’”¹⁹ Thus, courts determine whether the decision-making *process*, as opposed to the *substance* of the ultimate decision, was adequate.²⁰ 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.²¹ In addition, the duty of care is an affirmative duty; that is, directors must be active and inquire about the decision.²² Mere passive acquiescence is insufficient to satisfy the duty of care.²³

The outer limits of the duty of care were explored in *Smith v. Van Gorkom* and *Brehm v. Eisner*.²⁴ 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.²⁵ Yet, in *Eisner*, the court may have partially retreated from *Van Gorkom* in favor of greater judicial deference.²⁶ In *Eisner*, the board approved an immense severance package, complete with options that automatically vested upon a no-fault termination.²⁷ 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 in the board minutes addressed the package, the court found inadequate evidence that the directors failed to reasonably inform themselves.²⁸ 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.²⁹ Directors breach the duty of loyalty by using their “position of trust and confidence to further their private interests.”³⁰ Thus, they may not “do anything that would work injury to the corporation,” including the usurpation of a corporate opportunity.³¹ 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.³² 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.³³

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.³⁴ In these cases, the plaintiff must make “factual assertions of specific wrongdoing” as opposed to “conclusory allegations.”³⁵ 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.

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 1934.³⁶ Securities law claims generally focus on fraud or false or misleading representation made by the corporation in connection with a disclosure required by federal securities law.³⁷ The most common securities law claims arise under Rule 10b-5 in § 10(b) of the Exchange Act of 1934;³⁸ Sections 11 the Securities Act of 1933;³⁹ and 12(2) of the Securities Act of 1933.⁴⁰ 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. This liability – both professional and personal- of the directors and officers serves as a deterrent effect against errant and inappropriate conduct.

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

A. *Background on D & O Insurance*

Despite the deterrence goals of D & O liability, D&O insurance only 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 1934.⁴² Initially, few corporations purchased D&O insurance because indemnifying directors and officers was contrary to public policy.⁴³ 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."⁴⁴ By early to mid-1960, many states adopted new statutes explicitly permitting D & O insurance.⁴⁵ However, publicly held corporations in the United States did not widely purchase D&O insurance until the 1970s⁴⁶ when state legislatures permitted the indemnification of corporate directors and officers.⁴⁷ For D&O insurance, the 1970's presented a time of continued growth and relatively low costs.⁴⁸ Today, almost all publicly held corporations carry D & O insurance policies.⁴⁹

Three distinct types of D&O insurance exist: A-Side, B-Side, and C-Side coverage. A-Side Coverage, individual coverage, indemnifies corporate directors and officers for personal liability.⁵⁰ 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).⁵¹ B-Side coverage, institutional coverage, indemnifies payments the corporation may make to its directors and officers.⁵² 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.⁵³

While each D&O liability insurance policy includes unique characteristics, these policies "typically cover settlement amounts, legal fees, and compensatory damages."⁵⁴ In addition the policies contain three common exclusions: 1) claims for actual fraud; 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.⁵⁵

B. D & O Insurance as a Facilitator of Deterrence

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,⁵⁶ D & O insurance helps manage liability risk⁵⁷ and helps monitor the firms' officers.⁵⁸

D & O insurers act as an intermediary between the shareholders and management by covering the risk of shareholder derivative suits.⁵⁹ Because they cover the risk, D & O insurers engage in selective underwriting which furthers the deterrent effect on directors and officers.⁶⁰ D & O insurers carefully screen prospective corporations, rejecting or increasing premiums for those with a high risk of liability.⁶¹ D & O insurers also recommend changes to corporate governance practices of their insureds before covering potential losses.⁶² When lawsuits arise, the insurers manage the defense and settlement of derivative suits, along with defense costs. They also withhold insurance benefits from directors and officers who have engaged in fraudulent activity.⁶³ 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,⁶⁴ thus 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.⁶⁵ 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 limits⁶⁶ and that outside directors at larger firms as well as D & O insurers provide a source of monitoring for the firm's managers.⁶⁷ Similarly, firms with "greater inside ownership will purchase more insurance because of the insiders' risk aversion."⁶⁸

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.⁶⁹ In a study of Canadian firms, Chung & Wynn found that obtaining D & O insurance is associated with less conservative earnings reports by managers.⁷⁰ 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.⁷¹ 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.

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 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.⁷² Scholars have addressed the impact that large loss shocks have had on the insurance marketplace in previous cycles.⁷³ Specifically, probability updating theory⁷⁴ suggests that "demand is likely to increase as a result of actual or perceived increased in actuarial losses."⁷⁵ This section of the paper addresses the impact of the recent corporate governance shocks on the D & O liability insurance marketplace.

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*.⁷⁶ The lawsuits of the mid-1980's and the judicial interpretation of director and officer liability under federal securities laws brought increased exposure to directors, officers, and the corporation itself.⁷⁷ 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.⁷⁸ 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.⁷⁹

D & O liability insurance experienced a soft cycle during most of the 1990's.⁸⁰ During a soft cycle, insurers compete for business and corporations can obtain broader coverage at better prices.⁸¹ As the millennium approached, the market for D&O liability insurance began to harden once again.⁸²

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.⁸³ Commentators consider the pervasive fraud at Enron, a Texas-based energy company, the "granddaddy of all corporate fraud cases."⁸⁴ Under aggressive management, Enron engaged in risky investments, inflated accounting figures, and avoided full disclosures.⁸⁵ In a matter of time, Enron went from one of the leading companies on Wall Street to the biggest bankruptcy in U.S. history;⁸⁶ four thousand employees lost their jobs (many also lost their life savings) and investors lost billions.⁸⁷ Following the collapse and investigations by the Securities and Exchange Commission (SEC), fifteen former company executives plead guilty and received sentences.⁸⁸

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;⁸⁹ Adelphia, whose founder was convicted in 2004 of conspiracy, bank fraud, and securities fraud after hiding company debt, deceiving investors, and stealing company cash;⁹⁰ and Tyco, whose former CEO and CFO were convicted of stealing more the \$150 million of company funds.⁹¹

The unprecedented number of highly publicized scandals in the early twenty-first century rocked the D & O insurance industry.⁹² The number of lawsuits naming individual directors and officers increased dramatically, and damages, settlements, and the costs of litigation soared.⁹³

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),⁹⁴ declaring, "[n]o more easy money for corporate criminals; just hard time."⁹⁵ SOX raced through Congress, criminalizing new behavior and significantly increasing the penalties for existing crimes.⁹⁶ The Act added new requirements designed to increase corporate compliance with legal and ethical standards.⁹⁷

SOX responded directly to the multitude of scandals by including provisions tied to criminal wrongdoings revealed during the scandals⁹⁸ and by targeting punishments meant to deter future corporate misconduct.⁹⁹ In addition, the Act created personal accountability for the corporations' directors and officers with almost no forgiveness for financial inaccuracies and/or a lack of transparency.¹⁰⁰ Overall, lawmakers intended SOX to restore the integrity of the marketplace.¹⁰¹

In its effort to prevent future wrongdoing, SOX also created more liability risk for directors and officers.¹⁰² As a result, D & O insurance premiums increased approximately 30% in 2001 and 30% in 2002.¹⁰³ In 2003, premiums increased 33%.¹⁰⁴ Premiums for the largest companies, those with market capitalizations of \$5 billion or more, increased as much as 70% in 2004.¹⁰⁵ 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.¹⁰⁶ D & O liability insurance, which averaged \$329,000 prior to Sarbanes-Oxley and grew to \$639,000 afterwards,¹⁰⁷ 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.¹⁰⁸

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.¹⁰⁹ Not only did the shock result in a reexamination of corporate governance and reactionary legislation—the Sarbanes-Oxley Act,¹¹⁰ it also created a shock in the D&O insurance industry in that insurers reexamined their pricing behaviors.

1. 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 1995.¹¹¹ 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.¹¹²

Linck, Netter & Yang (2008) examine the effects of SOX on both the supply of and the demand for directors and officers insurance.¹¹³ 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.¹¹⁴ As insurer capacity deteriorated and insurers left the market, a large number of new insurers emerged to offer D & O coverage to public companies.¹¹⁵ Because demand rose between 2000 and 2003, more insurers entered the market, causing D & O premiums to fall.¹¹⁶ In addition, class actions against U.S. listed companies declined, resulting in reduced premiums.¹¹⁷ In a matter of a few years, a post-scandal hard cycle quickly turned soft.¹¹⁸

A 2006 Towers Perrin Directors and Officers Liability Survey reported a continuing soft market for D & O insurance.¹¹⁹ As a result, survey participants generally reported higher limits, slightly lower retentions and premiums, broader coverage, and fewer exclusions.¹²⁰ Potential corporate directors became more interested in an organization's D & O program and coverage.¹²¹ In 2006, premiums decreased by 6.5%, and 31% of participants reported an increase in coverage enhancements.¹²² In addition, over 99% of public companies purchased D & O insurance.¹²³

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.¹²⁴ For public companies, 38% reported purchasing such a policy.¹²⁵ 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 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 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.¹²⁶ 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.¹²⁷

E. Are we headed towards another "Shock"?

While the dust continues to settle from the corporate scandals at the beginning of the twenty-first century, we examined whether 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:

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

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.¹²⁸ The first group consists of industries most impacted by the corporate scandals of 2001–2002 and the second is those that were not impacted. “Impacted” industries include: banking, durable goods, non-banking financials, technology, transportation and communications and utilities. All other industries are deemed “non-impacted.”¹²⁹ This allows tracking of not only the overall marketplace, but the key industries closely related to the corporate governance failures.¹³⁰

The analysis of the D & O market on an industry level shows that scandal-based events are unique loss shocks that directly impact insurers pricing behavior. The analyses produced evidence of a new type of probability updating in the demand for D & O insurance; “as the likelihood of D&O liability exposure increases, purchasing firms increase their level of insurance coverage.”¹³¹ Further, the study found that “impacted” industries increased their level of coverage more than “non-impacted” industries during periods of uncertainty.¹³² 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.

As a result, professionals considering investing in D&O liability insurance should weigh whether they operate in an “impacted” or “non-impacted” industry because “non-impacted” less risky purchases of D & O insurance may be subsidizing more risky firms as a result of the lag-time on the supply side due to these loss shocks. As the study shows, subsidizing risky firms will result in higher premiums to “safer, non-impacted” industries.

Insurers need to be cognizant of this lag in premiums in response to demand because, depending on the industry, it will affect their bottom line as well. Businesses in “impact” industries may look to D & O insurance to hedge their losses against more calamities. Yet firms with “less than trustworthy” corporate governance may use this opportunity to purchase D & O insurance while premiums are low and engage in risky corporate governance. This activity ultimately harms insurers because it will increase the claims they will have to pay out to high-risk, low-premium insureds. On the other hand, businesses in “non-impact” industries that may have considered purchasing D&O insurance to protect themselves after the corporate governance scandals may decide against it because of high premiums and minimal coverage. Overall, the failure to purchase coverage will decrease the amount of new business to the insurers of D & O liability insurance.

The empirical research and models used in the study provide a broad discussion of the D & O insurance market. It is intuitive to think that after periods of corporate governance scandals that corporations would rush out and purchase insurance, thereby increasing demand, expecting supply to match the demand, and creating a fair price-point for all. The corporate governance loss shocks, however, have shed light on the D & O marketplace, and revealed that this is not the case. As a result, the deterrent effect of D & O liability insurance is not present and insurers must be cognizant so that both “impacted” and “non-impacted” industries are not paying for the faults of one another.

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. Also, the market is responding by allowing even better coverage for independent board members. 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. Recent cases provide 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.¹³³ 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*.¹³⁴ Shareholders of American International Group, Inc. (AIG) brought a derivative suit against former directors and officers of the company¹³⁵ 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.¹³⁶ 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.¹³⁷

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.¹³⁸ 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.¹³⁹ 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.¹⁴⁰

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.¹⁴¹ 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.¹⁴²

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."¹⁴³ The court dismissed the claims, holding the plaintiffs' conclusory claims did not show the directors failed to meet their oversight obligations.¹⁴⁴ 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.¹⁴⁵

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."¹⁴⁶ 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.¹⁴⁷

The plaintiffs cited *McCall v. Scott*¹⁴⁸ as support for their position.¹⁴⁹ 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.¹⁵⁰ 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.¹⁵¹ 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 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 whether the package was so "one-sided" and so disproportionately large and unconscionable as to be considered waste.¹⁵² 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.¹⁵³ Instead, plaintiffs must show that directors acted in bad faith, knowingly shirking

their duties.¹⁵⁴ 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 and 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.”¹⁵⁵ Cioffi 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.”¹⁵⁶ 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.¹⁵⁷ Prosecutors argued that Cioffi and Tannin committed fraud because they were aware that the fund was “anything but sound.”¹⁵⁸ 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.¹⁵⁹ 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.”¹⁶⁰ Cioffi and Tannin still face civil action by the Securities and Exchange Commission, but are not criminally liable for fraud.¹⁶¹

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.¹⁶² 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.¹⁶³ 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.¹⁶⁴

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.

Footnotes

* Associate Professor of Legal Studies, Georgia State University, Atlanta, Georgia.

** Professor of Legal Studies, Florida State University, Tallahassee, Florida.

*** Associate Professor of Risk Management and Insurance, Florida State University, Tallahassee, Florida.

**** PhD Candidate, Risk Management and Insurance, Florida State University, Tallahassee, Florida.

¹ EVAN ESAR, 20,000 QUIPS & QUOTES: A TREASURY OF WITTY REMARKS, COMIC PROVERBS, WISECRACKS, AND EPIGRAMS 827 (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 (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. So, if we have a goal of deterrence (and accountability) and we rely on insurance to act as the intermediary in accomplishing these goals (as it arguably has in the past), what happens when the market gets so soft that anyone can buy D & O insurance for anything at a low cost?” *Id.* at 488–89.

³ *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 1412 (8th ed. 2004). *See also* discussion *infra* note 73.

⁵ In a soft market, insurers loosen underwriting standards and profits typically decline. Further, D&O insurers are typically less selective when determining whether to issue a D&O liability policy and often give discounts. Baker & Griffith, *supra* note 2, at 507–08.

⁶ See discussion *infra* Part I.

⁷ Baker & Griffith, *supra* note 2, at 487, n.2; Reinier Kraakman, Hyun Park, & Steven Shavell, *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1738 (1994).

⁸ Joseph F. Johnston, Jr., *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993, 1994 (1978).

⁹ 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, available at <http://www.dcbabrief.org/vol210109art1.html>.

¹⁰ Kraakman, Park, & Shavell, *supra* note 7, 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. Kraakman, Park, & Shavell, *supra* note 7 at 1738; See also Jeff Gerrish, *What is Your Real Liability as a Director or Officer?*, A.B.A BANKING L.J. (March 15, 2010). 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 9.

¹¹ R. Link Newcomb, Note, *The Limitation of Directors' Liability: A Proposal for Legislative Reform*, 66 TEX. L. REV. 411, 434–35 (1987).

¹² 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 11, at 434–35. Often the prospect of a derivative lawsuit is enough to deter misconduct. Kraakman, Park, & Shavell, *supra* note 7, at 1738, 1740.

¹³ For discussion on the duties of care, loyalty, and good faith, see discussion *infra* Parts I.A.1–3.

¹⁴ 25 A.L.R.3d 941 (1969).

¹⁵ Baker & Griffith, *supra* note 2, at 494.

¹⁶ *Warshaw v. Calhoun*, 221 A.2d 487, 493 (Del. 1966) (defining the Business Judgment Rule); *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”).

¹⁷ *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).

¹⁸ See *In re Caremark Intern. Inc. S'holders 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.”); *Levien*, 280 A.2d at 720 (requiring “a showing of gross and palpable overreaching” to overcome the Business Judgment Rule once it attaches). 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.1–3.

¹⁹ *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985) (quoting *Kaplan*, 284 A.2d at 124).

²⁰ See, e.g., *Cinerama, Inc. v. Technicolor, Inc.*, 1991 WL 111134, at *8 (Del. Ch. 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).

²¹ See generally *Van Gorkom*, 488 A.2d 858 (ignoring directors' claims that the merger would benefit the company by converting otherwise unrealizable tax credits to realizable tax credits).

²² See, e.g., *In re Caremark Intern. Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996) (the influential Chancellor Allen suggesting in dicta that directors may be personally liable for failing to affirmatively inquire to ensure that an adequate internal control system exists); see also *Francis v. United Jersey Bank*, 432 A.2d 814 (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).

²³ See *Francis*, 432 A.2d at 823.

²⁴ *Van Gorkom*, 488 A.2d 858; *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

²⁵ *Van Gorkom*, 488 A.2d 858.

²⁶ See generally *Eisner*, 746 A.2d 244.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 358 (Del. 1993).

³⁰ *Id.*

³¹ *Id.* (stating that directors must not “deprive [the corporation] of profit or advantage which [their] skill and ability might properly bring to it”).

³² *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).

³³ See *In re Wheelabrator Tech., Inc.*, 663 A.2d 1194 (Del. Ch. 1995) (shifting burden back to plaintiffs because a fully informed shareholder vote approved the disputed merger).

³⁴ *Kamin v. Am. Express Co.*, 383 N.Y.S.2d 807, 815 (N.Y.Sup. 1976).

³⁵ *Id.*

³⁶ Securities Act of 1933, 15 U.S.C. § 77a et seq. (2009); Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq. (2009).

³⁷ *Baker & Griffith*, *supra* note 2, at 497.

³⁸ 15 U.S.C. § 77i (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.” See also *Baker & Griffith*, *supra* note 2, at 497; Hyeesoo J. Chung & Jinyoung P. Wynn, *Managerial Legal Liability Coverage and Earnings Conservatism*, 46 J. ACCT. & ECON. 135, 138 (2008).

³⁹ 15 U.S.C. § 77k (2009). Section 11 claims involve false registration statements made in connection with the sale of securities.

⁴⁰ 15 U.S.C. § 77l(a)(2) (2009). Section 12(2) claims may be brought against anyone who “offers or sells” a security by use of a prospectus or oral communication which contains an omission or false or misleading statement of a material fact.

⁴¹ *Dobiac*, *supra* note 9 at 491.

⁴² See *Id.* at 487, n.6; Joseph P. Monteleone, *Directors and Officers Liability Insurance: The Sarbanes-Oxley Act of 2002 and other Topical Issues*, 77 A.L.I.-A.B.A. 313 (2002).

⁴³ *Dobiac*, *supra* note 9 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).

⁴⁴ Monteleone & Conta, *supra* note 43, at 574.

⁴⁵ See Johnston, Jr., *supra* note 8, at 1995–2005.

⁴⁶ See *Dobiac*, *supra* note 9, at 488; Monteleone & Conta, *supra* note 43, at 574.

⁴⁷ “In 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.” 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, 374–75 (2007). See also Monteleone & Conta, *supra* note 43, at 574

⁴⁸ See *Dobiac*, *supra* note 9 at 488.

⁴⁹ See *Baker & Griffith*, *supra* note 2, at 487, n.2; *Dobiac*, *supra* note 9, at 488; 2006 Directors and Officers Liability Survey, Towers Perrin (2006), http://www.towersperrin.com/tp/getwebcachedoc?webc=HRS/USA/2007/200704/DO_Survey_Report2006_040507.pdf [hereinafter Perrin Survey].

⁵⁰ See *Dobiac*, *supra* note 9, at 491–92.

⁵¹ Sousa, *supra* note 47, at 374–75.

⁵² See Dobiac, *supra* note 9, 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, ch. 16, 666 (2007).

⁵³ See Dobiac, *supra* note 9, at 491–92; Falladori, *supra* note 52; Sousa, *supra* note 47, at 381.

⁵⁴ See Dobiac, *supra* note 9, at 492.

⁵⁵ See *Id.* at 492–93.

⁵⁶ 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*, 64 J. RISK & INS. 545, 547–50 (1997).

⁵⁷ See generally Core, *supra* note 56, at 68.

⁵⁸ See e.g. Core, *supra* note 56, at 67; O'Sullivan, *supra* note 56, at 547–50.

⁵⁹ 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.

⁶⁰ Baker & Griffith, *supra* note 2, at 488.

⁶¹ *Id.*

⁶² *Id.* at 489.

⁶³ *Id.* at 488.

⁶⁴ See discussion *supra* Part I.C; *but see* Dobiac, *supra* note 9, at 488; Tom Baker & Sean Griffith, *The Missing Monitor in Corporate Governance: The Directors & Officers Liability Insurer*, 95 GEO. L.J. 195 (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).

⁶⁵ Chalmers, Dann and Harford (2002) define 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 overvalued. 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).

⁶⁶ Core, *supra* note 56, at 84.

⁶⁷ O'Sullivan, *supra* note 56, at 552.

⁶⁸ Core, *supra* note 56, at 85.

⁶⁹ 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).

⁷⁰ Chung & Jinyoung, *supra* note 38, at 151.

⁷¹ Chalmers, Dann & Harford, *supra* note 65, at 633. See *contra* Martin Boyer, *Is the Demand for Corporate Insurance a Habit? Evidence from Directors and Officers Insurance*, (CIRANO discussion paper 2003s-42) at 3, available at <http://www.cirano.qc.ca/pdf/publication/2003s-42.pdf>.

⁷² Baker & Griffith, *supra* note 2.

⁷³ Stephen G. Fier, et al., *The Directors and Officers Insurance Marketplace: An Empirical Examination of Supply and Demand in Uncertain Times*, Working Paper, December 2009, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1524063.

⁷⁴ Fier, et al., *supra* note 73, at 6–7.

⁷⁵ Fier, et al., *supra* note 73, at 7.

⁷⁶ 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 47, at 375 (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* Smith v. Van Gorkom, 488 A.2d 848 (Del. 1985); 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, 19 (2004). 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. 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. 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. At the meeting, he gave an oral presentation but did not provide financial analysis or any written documentation, and did not disclose the circumstances of the negotiation process. The board asked very few follow-up questions before approving the merger. 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. The court based its conclusion on the finding that he board did not act on an informed basis when making its decision to proceed with the acquisition. 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.

⁷⁷ *See* Dobiac, *supra* note 9, at 488; Monteleone & Conta, *supra* note 43, at 574.

⁷⁸ *See* discussion *infra*, note 8; *see also* 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 507.

⁷⁹ Baker & Griffith, *supra* note 2, at 507.

⁸⁰ *See* Lockwood, *supra* note 78; Baker & Griffith, *supra* note 2, at 508; Dobiac, *supra* note 9, at 488.

⁸¹ *See* Lockwood, *supra* note 78; Baker & Griffith, *supra* note 2, at 508; Dobiac, *supra* note 9, at 488.

⁸² *See* Dobiac, *supra* note 9, at 489.

⁸³ *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, available at <http://www.forbes.com/2002/07/25/accountingtracker.html>; Fact File: *High Profile Corporate Scandals*, MSNBC, <http://www.msnbc.msn.com/id/7190086/> (last visited Mar. 11, 2010).

⁸⁴ 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 Reckoning*, CNN MONEY (May 25, 2006), http://money.cnn.com/2006/05/25/news/newsmakers/enron_verdict/index.htm (last visited May 28, 2010).

⁸⁵ *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. WEEK, Dec. 17, 2001, available at http://www.businessweek.com/magazine/content/01_51/b3762001.htm (last visited May 28, 2010).

⁸⁶ Pasha & Seid, *supra* note 84.

⁸⁷ *Id.*

⁸⁸ 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*, HOUSTON CHRON., June 18, 2007, available at <http://www.chron.com/disp/story.mpl/special/enron/4897649.html> (last visited May 28, 2010).

⁸⁹ *WorldCom’s Sorry Legacy: Its Downfall May Hurt Rivals and Kill Telecom Competition*, BUS. WEEK, Jul. 8, 2002, available at http://www.businessweek.com/magazine/content/02_27/b3790018.htm (last visited May 28, 2010). *See also* Patsuris, *supra* note 83.

⁹⁰ *Adelphia Founder John Rigas Found Guilty: After 8 Days of Deliberations, Jury Returns Partial Settlement*, MSNBC (Jul. 8, 2004), <http://www.msnbc.msn.com/id/5396406> (last visited May 28, 2010); Patsuris, *supra* note 83.

⁹¹ *Timeline of the Tyco International Scandal*, USA TODAY, Jun. 17, 2005, available at http://www.usatoday.com/money/industries/manufacturing/2005-06-17-tyco-timeline_x.htm (last visited May 28, 2010); Patsuris, *supra* note 83.

⁹² Anjali C. Das, *The ABCs of D & O Insurance: An Illinois Lawyer’s Guide*, 93 ILL. B.J. 304, 304 (2005); *see also* Kate Burgess, *Demand and Cost Set to Rise Directors’ and Officers’ Insurance: Kate Burgess Analyzes the Impact of Scandal*, FIN. TIMES (Eng.), April 25, 2006, at 3; Fairfax, *supra* note 76, at 415; 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*, Address before the Practicing Law Institute: D&O Liability & Insurance

in a Sarbanes-Oxley World (June 3, 2003), in PRACTICING LAW INST.: COM. LAW AND PRAC. COURSE HANDBOOK SERIES 217, 221 (2003); Sousa, *supra* note 47, at 375 (noting an increase in premiums after the Enron, Adelphia Communications, and Tyco scandals).

⁹³ 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).

⁹⁴ Sarbanes-Oxley Act of 2002 (SOX), Pub. L. No. 107-204, July 30, 2002, 116 Stat. 745 [hereinafter SOX].

⁹⁵ George W. Bush, President of the U.S., President Bush Signs Corporate Corruption Bill, <http://www.whitehouse.gov/news/releases/2002/07/20020730.html>.

⁹⁶ 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).

⁹⁷ See Rebecca Walker, *The Evolution of the Law of Corporate Compliance in the United States: a Brief Overview*, in ADVANCED CORPORATE COMPLIANCE WORKSHOP ch. 1, 43-44 (Practicing Law Institute ed., 2007).

⁹⁸ See e.g. SOX § 802 (criminal penalties for altering documents); SOX § 807 (criminal penalties for defrauding shareholders of publically traded companies); SOX § 903 (criminal penalties for mail and wire fraud).

⁹⁹ SOX § 1106 (increasing penalties for willful violations of the Securities Exchange Act of 1934).

¹⁰⁰ See e.g. SOX § 302 (requiring officers to certify reports required under the Securities Exchange Act of 1934).

¹⁰¹ Prentice & Spence, *supra* note 83, 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).

¹⁰² See Walker, *supra* note 97; see also Sousa, *supra* note 47, at 377–78.

¹⁰³ JOHN F. OLSON ET AL., DIRECTOR & OFFICER LIABILITY: INDEMNIFICATION AND INSURANCE § 4.26 (2007).

¹⁰⁴ *Id.*

¹⁰⁵ HAMILTON & MACEY, *supra* note 93, at 970. *But see* OLSON ET AL., *supra* note 103, at § 4.26 (stating premiums decreased in 2004).

¹⁰⁶ Wilkins, *supra* note 101, at 347.

¹⁰⁷ Wilkins, *supra* note 101, at 348.

¹⁰⁸ Wilkins, *supra* note 101, at 347.

¹⁰⁹ Benedict Sheehy, *Scrooge—The Reluctant Stakeholder: Theoretical Problems in the Shareholder-Stakeholder Debate*, 14 U. MIAMI BUS. L. REV. 193, 196–97, citing 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). See also Stephen J. Redner, *Thinking of Going Public? Think Twice, Then Read the Sarbanes-Oxley Act of 2002*, J. OF 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.”).

¹¹⁰ Redner, *supra* note 109, at 529; Wilkins, *supra* note 101, at 340.

¹¹¹ Chalmers, Dann & Harford, *supra* note 65.

¹¹² *Id.*

¹¹³ 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. FIN. STUD. 3287, 3288 (2009).

¹¹⁴ Fairfax, *supra* note 76, at 415.

¹¹⁵ See Mallon, *supra* note 92, at 20 (noting that Lloyd’s of London virtually ceased providing D & O insurance to public companies).

¹¹⁶ See Burgess, *supra* note 92, at 3.

¹¹⁷ Burgess, *supra* note 92, at 3.

¹¹⁸ Despite the current soft cycle, demand for protection remains unabated. *Id.*

¹¹⁹ Perrin Survey, *supra* note 49. The annual Towers Perrin D & O survey is based on a nonrandom, self-selecting sample of companies. It is also the only systematic source of information on D & O insurance purchasing patterns in the U.S.

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.*; Baker & Griffith, *supra* note 2, at 487, n.2.

¹²⁴ See Sousa, *supra* note 92, 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 52.

¹²⁵ Perrin Survey, *supra* note 49.

¹²⁶ See Kenneth Froot & Paul O'Connell, *The Pricing of U.S. Catastrophe Reinsurance*, NBER Working Paper No. 60443 at 7–8 (1997).

¹²⁷ 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).

¹²⁸ Fier, et al., *supra* note 73, at 5, 13, 14.

¹²⁹ *Id.* at 14.

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.* at 31–32.

¹³³ In re Am. Int'l Group, 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).

¹³⁴ In re Am. Int'l Group, Inc. Consol. Derivative Litig., 965 A.2d 763 (Del. Ch. 2009).

¹³⁵ *Id.* at 774.

¹³⁶ *Id.*

¹³⁷ Dominick T. Gattuso & Vernon R. Proctor, *Reining in Directors and Officers in Corporate America*, BUS. LAW TODAY, Feb. 19, 2010, at 46.

¹³⁸ In re Am. Int'l Group, Inc. Consol. Derivative Litig., 965 A.2d at 799; Gattuso & Proctor, *supra* note 137, at 46.

¹³⁹ In re Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009).

¹⁴⁰ *Id.* at 111.

¹⁴¹ *Id.* at 123.

¹⁴² *Id.* at 115, 124.

¹⁴³ *Id.* at 124.

¹⁴⁴ *Id.* at 126.

¹⁴⁵ *Id.* at 128; Gregory V. Varallo & Margot F. Alicks, *Recent Developments in Delaware Corporate Law*, 1774 PLI/Corp 83, 156-58 (Nov. 2009).

¹⁴⁶ In re Citigroup Inc. S'holder Derivative Litig., 964 A.2d at 129.

¹⁴⁷ *Id.*

¹⁴⁸ 239 F.3d 808 (6th Cir. 2001).

¹⁴⁹ In re Citigroup Inc. S'holder Derivative Litig., 964 A.2d at 129.

¹⁵⁰ *Id.*; McCall, 239 F.3d at 819–824.

¹⁵¹ 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.").

¹⁵² *Id.* at 138.

¹⁵³ *Id.* at 128; Varallo & Alicks, *supra* note 145, at 156-58.

¹⁵⁴ See In re Am. Int'l Group, Inc. Consol. Derivative Litig., 965 A.2d at 799.

¹⁵⁵ Dan Slater, *2 Bear Stearns Fund Leaders Are Acquitted*, N.Y. TIMES, A1, Nov. 11, 2009.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ United States v. Cioffi, No 08-CR-415 (FB) 2009 W.L. 3738314, (E.D.N.Y. Nov. 2, 2009).

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² 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).

¹⁶³ *Id.*

¹⁶⁴ *Id.*