REVIEWS

Ensuring Corporate Misconduct

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Tom Baker and Sean J. Griffith Ensuring Corporate Misconduct: How Liability Insurance Undermines Shareholder Litigation. Chicago and London, The University of Chicago Press 2010, 285 pages, ISBN 978-0-226-0315-4.

In their book Tom Baker and Sean Griffith explore how effective shareholder litigation is in regulating corporate conduct.

Baker and Griffith start with the observation that shareholder litigation forms an important part of the structure of law and regulation affecting American business. Shareholder litigation is important because public regulators cannot oversee every company at every moment; they cannot even respond to every report of a (potential) wrong. Investors who find themselves wronged by a corporation in which they have invested can sue to right these wrongs. These lawsuits exert their regulatory effect through the mechanism of deterrence. Prospective wrongdoers realise that they will have to account for damages they cause. Directors and corporate officers will refrain from engaging in conduct that will harm investors and induce them to sue. This is how shareholder litigation is thought to regulate corporate conduct. The problem with this line of reasoning is that most officers and directors are covered by a form of insurance, known as 'Directors' and 'Officers' liability insurance' or 'D & O insurance' (*bestuurdersaansprakelijkheidsverzekering*). Baker and Griffith's central argument of is that D & O insurance significantly erodes the deterrent effect of shareholder litigation and undermines its effectiveness in regulating corporate conduct.

The book is structured systematically and is very readable. Even technical insurance issues are clearly explained. The authors employ an interdisciplinary approach. For all issues they discuss the legal frame and theories and findings from law and economics literature. But the authors did more than merely review the literature. They empirically investigated what D & O insurance companies, underwriters and businesses do and why, and how this fits in with the theoretical assumptions from the literature. Between 2005 and 2007 the authors conducted semi-structured interviews with over 100 people working in and around the fields of D & O insurance and securities litigation. They also participated in numerous conferences and discussions with industry professionals and academics. The goals of the empirical research are to test the hypotheses about insurance and deterrence and to learn about the role of D & O insurance in shareholder litigation. For me, this combination of theoretical assumptions and empirical research is the strong point of this book. In the remainder of this review I will first summarise the analysis of Baker and Griffith. Next I will give some comments.

The authors start with a legal analysis of the various claims that can be brought by shareholder plaintiffs (Chapter 2). They proceed by explaining D & O insurance: what is it, what is covered, what is excluded and what does the D & O market look like (Chapter 3)? A D & O insurance package typically consists of three parts: coverage to protect the individual officers and directors (level A), coverage to reimburse the corporation for indemnifying its officers and directors (level B) and coverage of the corporate entity itself (level C) (pp. 46-48). Most publicly traded corporations in the United States buy D & O insurance that includes all types of cover.

In Chapter 4 Baker and Griffith deal with what they call their 'first puzzle': Why do so many corporations buy entity-level coverage (level B en C)? The authors argue that this D & O coverage appears to be irrational: the costs are not outweighed by the advantages. Shareholders have a cheaper way to spread the risk of loss: a diversified portfolio of investments.[1] Moreover, D & O insurance introduces a moral hazard concern. The concept of moral hazard refers to the tendency of insurance to increase loss by reducing an insured's incentive to avoid loss (because a loss is covered by the insurance). This seriously decreases the deterrence effect of shareholder litigation. Baker and Griffith conclude, 'Our essential story is simple enough: managers want corporate protection included in D & O insurance, shareholders don't, managers win. Not a cheerful story.' (p. 75).

The next chapters discuss available mechanisms to constrain the moral hazard problem and to reinvigorate the deterrence effect of shareholder litigation. Three traditional tools of the insurance trade are evaluated empirically: 1) pricing coverage to risk, 2) monitoring corporate conduct and 3) control over defence and settlement. Making insurance expensive for high risks could reintroduce the deterrence function of shareholder litigation. Firms have an incentive to avoid high costs. Screening and selecting risk is indeed a key aspect of D & O insurance underwriting. In assessing risks, underwriters use various sources of information concerning the riskiness of the prospective insured: financial information, news reports, extensive application forms and interviews with directors and officers. The underwriter evaluates the financial risks and the risks of corporate governance, and attaches a price to it. So, D & O insurers do attempt to price risks. However, the authors do not conclude that this is sufficient to reintroduce deterrence. Underwriters make mistakes in pricing and the cyclical nature of the insurance market suggests that risk selection is only important in hard markets (and less important in soft markets). Moreover, D & O insurance expenses are too small in relation to the overall costs of the company, and the difference between premiums paid by good and bad firms may not be sufficiently large to force bad firms to improve. 'Instead, all firms will simply pay their D & O premiums, whatever they are, and continue with business as usual.' (p. 104 (Chapter 5)).

A second means by which insurers may reintroduce deterrence is insurance monitoring and loss-prevention programmes. Baker and Griffith expected D & O

1 Also De Jong 2010, p. 374.

insurers to monitor insured firms for three reasons. For economists, monitoring is one of the explanations why corporations buy insurance while for the insurer it is part of the answer to the moral hazard problem. Historical and sociological studies documented the loss-prevention role of insurance in other contexts. For example, insurance companies have contributed to the increasing safety in the shipbuilding and construction industry. Other examples include home security, management of physical disabilities, the motion-picture business and sexual harassment in the workplace. Prior literature on D & O insurance has claimed that D & O insurance provides a monitoring function (p. 108).[2] The interviews reveal that D & O insurers in fact do almost nothing to monitor the corporations they insure, and insured corporations are not required to install a loss-prevention programme. In all interviews only one publicly traded corporation changed a business practice in response to a governance concern from a D & O insurer (p. 109). Loss-prevention conditions and advice are frequently provided in the private and non-profit D & O insurance market. In that market D & O insurance is sold as part of a package that also includes employment liability risks. Loss-prevention efforts focus on employment practices (p. 110).

Several respondents mentioned a small specialised insurance company with a reputation for emphasising loss prevention. They had developed an extensive loss-prevention guide. However, this loss-prevention effort did not work. The company could not prove the connection between loss-prevention program and reduced loss and could not offer reduced premiums to firms that complied with the guidelines. Companies chose to buy D & O insurance from a competing insurer without loss-prevention requirements. As a result the company was forced to drop its loss-prevention programme (pp. 111-113). This story points to the explanation Baker and Griffith offer for why D & O insurers do not offer loss-prevention services. Top executives buy D & O insurance, with their shareholder money, to make it easier and more profitable for them to keep their jobs. But they do not want to hand over some of their powers to insurers (Chapter 6).

After the conclusion that D & O insurers do not succeed in deterring the kinds of bad corporate acts that lead to shareholder litigation at the time the insurance is purchased (pricing) and during the life of the insurance contract (monitoring), claim management is another opportunity for the insurer to force a bad corporate actor to pay for its bad acts. Once a claim has arisen, the insurer can attempt to exert control over defence and settlement of the claim. D & O insurance coverage usually includes costs of defence as well as costs of a settlement or payment of damages. Insurance companies tend to take over control over the defence of the claim, for example, vehicle and general liability insurance. Instead, D & O insurance policies put the policyholder in charge and D & O insurers have little ability to control the costs of defence and settlement of claims. Defence lawyers and plaintiffs' lawyers cooperate to place pressure on insurers to pay. Shareholder claims are easy to settle because the settlement is largely funded by insurance

2 Also Weterings 2010, p. 167.

companies. 'Other people's money, our respondents confirmed, is often viewed as easy money' (p. 136, (Chapter 7)).

Chapter 8 explores what matters in the settlement of shareholder litigation. The authors discuss five key features that influence settlement values: investor loss, insurance limits and structure, 'sex appeal' (cases that arouse scandal, media attention), litigation dynamics (such as chemistry among parties) and statistical information from other settlements. Chapter 9 investigates the potential dispute between defendants and the D & O insurers about coverage defences.

> [T]he coverage dispute is the last opportunity for a D & O insurance to force a corporate actor to pay for the harm it has caused. (...) Simply stated, corporate actors may be more likely to be good because they will understand that if they are very bad, then their liabilities may not be covered by D & O insurance. (pp. 178-179).

Once the policyholder gives notice of the lawsuit, the insurer typically responds with a 'reservation of rights' letter. Most D & O policies contain exclusions for fraudulent or criminal acts and for unjust-enrichment. These exclusions do in fact not prevent moral hazard because plaintiffs' lawyers plead strategically to avoid handing the insurer a valid coverage defence (framing as reckless misstatements rather than intentional fraud). 'Finally, insurers understand that, in the long run, their D &O insurance market will dry up if they press too hard on the fraud exclusion' (p. 188). Baker and Griffith conclude 'it seems that D & O insurance carriers are willing to cover honest fraud' (p. 188). Although D & O insurers will often have a coverage defence and rescission may be an option legally, it will often be a bad idea from a business perspective. Several respondents illustrated this through an anecdote involving the Genesis Insurance Company. Genesis sought to rescind its D & O policy asserting fraud in the application. The court ultimately sided with Genesis and the policy was fully rescinded. This victory in litigation, however, was a Pyrrhic victory. Genesis soon failed because of its negative reputation of being overzealous in avoiding the payment of claims.
Coverage defences thus are rarely used to avoid payment but they are used to reduce the amount that insurers must ultimately pay at settlement. Baker and Griffith conclude: 'in claims management, as in underwriting and during the life of the insurance contract, insurers in fact are able to do relatively little to reintroduce the deterrence function of shareholder litigation' (p. 199).

The last chapter offers solutions to improve the deterrence function of shareholder litigation. The authors do not propose to abolish either shareholder litigation or D & O insurance. They recommend three solutions: 1) mandatory disclosure of D & O policy details (price, coverage, exclusions, etcetera) in order to signal information to the capital market, 2) co-insurance in order to give the corporation a financial incentive to monitor managerial conduct and to limit settlement costs, and 3) disclosure of information at settlement in order to provide capital market participants a window into the merits of claims. The authors 'believe that these proposals may serve to reinvigorate the deterrence function of shareholder litigation' (p. 234).

Baker and Griffith give a fascinating glimpse behind the scenes of the world of American D & O insurance. If you are interested in this hidden world you should absolutely read this book. However, some questions remain after reading the book.

The picture of insurance companies without much control over the corporations and the risks they insure is rather disturbing. Why do insurers act this way? I would expect that an insurance company needs to have control over (at least part of) the key factors that determine profit. But D & O insurers seem to have a low level of control over corporate conduct, risks, defence costs, settlements and prices (cyclical). So why do they offer D & O insurance? Maybe the prices are high enough, even in highly competitive markets at the bottom of the business cycle, to make this insurance profitable? Or is D & O part of a package with other more controllable risks?

The policy recommendations seem to rest on the same assumptions that, according to the previous chapters, did not in fact work. For example, the authors advocate mandatory disclosure of D & O policy details because this would signal information to capital markets. This recommendation assumes that underwriters and insurers value risks accurately to make policy premiums and conditions a good indicator for the quality of corporate governance. However, Chapter 5 showed that D & O insurers try their best to assess the risks, but that they only partly succeed in doing so. The last chapter seems to rely on wishful thinking rather than on the results of the investigation.

The question whether a director or officer who is legally liable is really sued is not brought up. Sociological investigations in different fields show each time that people generally tend to avoid mobilising the law. This applies to individual citizens in claiming their rights[3] as much as it does to firms that normally do not legally enforce contract compliance in deliverance and supply transactions.[4] Several factors contribute to the reticence of firms to take a business partner to court: no quick solution of the problem and long uncertainty because of lengthy legal proceedings and high litigation costs. Particularly important is the risk that an appeal to the law will disrupt long-lasting business relations and will trouble future business transactions. Comparable processes will make suing directors or officers in cases of corporate misconduct unattractive. This is in line with the caselaw published in 10 years of the Dutch corporate law journal *Jurisprudentie Onderneming & Recht*.[5] External liability claims were mostly submitted after bankruptcy of the corporation, either by shareholders whose shares lost their value or by unpaid creditors. Sitting directors hardly ever submit a claim against a fellow

3 Blankenburg 1995; Havinga 2010a, 2010b; Miller & Sarat 1981; Niemeijer & Klein Haarhuis 2008.
4 Macaulay 1963; Jettinghoff 2001.
5 Internal memo by B.J. de Jong.

director or officer holding them liable for loss. Generally it is a trustee in bankruptcy that submits a liability claim. Occasionally (newly installed) directors sue a former director or officer. Armour et al. found that lawsuits against directors of public companies alleging breach of duty are virtually non-existent in the United Kingdom. The United States is more litigious, but only a small percentage of public companies face lawsuits against directors alleging a breach of duty that is sufficiently contentious to result in a reported judicial opinion, and a substantial portion of these cases are dismissed.[6]

The book is strong in its logical structure and clear message. But it is precisely this clear message that induced a shadow of doubt: did the authors perhaps structure their argument too much around their clear message instead of presenting all available (also contradictory) information? It's hard to tell.

In discussing this book during the Law and Society meeting in San Francisco and in her subsequent book review, Miriam Baer argues that Baker and Griffith assume that D & O liability claims involve '*ordinary fraud*' that is beyond the pale of public enforcement.[7] Baer sees three causes of shareholder loss: 1) '*incompetence and bad decision-making*', 2) '*ordinary fraud*', that is misconduct that is not so harmful to draw public (enforcement) attention, 3) '*extraordinary fraud*' which involves severe losses and many victims and therefore triggers criminal and civil investigations by public authorities. The boundary between ordinary and extraordinary fraud is porous. Once upon a time Madoff's investment may have seemed to be ordinary fraud; in 2009 his conduct turned into a huge scandal. The fact that extraordinary fraud elicits substantial public sanctions that alter managerial conduct together with the difficulty of distinguishing between ordinary and extraordinary fraud, fill some of the vacuum left by D & O insurance according to Baer.[8]

What about D & O insurance in the Netherlands? Dutch civil law also provides a basis for liability of corporate officers and directors for damages caused by improper performance of duties (*onbehoorlijke taakvervulling*). Dutch courts tend to accept liability in cases of serious accusations (*ernstig verwijt*).[9] Usually liability suits involve claims from shareholders or creditors. Under Dutch law a shareholder can bring a suit against a director or officer on the basis of loss to him- or herself, as an individual or as a class action. However, derivative suits (shareholder sues on behalf of the corporation) are not possible under Dutch law.[10]

6 Armour et al.2009.
7 Baer 2012.
8 Baer 2012, p. 950.
9 See HR 8 december 2006, *NJ* 2006, 659 (Ontvanger/Roelofsen), HR 20 juni 2008, *NJ* 2009, 21 (Willemsen/NOM) and Lennarts & De Valk 2012 on Rb Utrecht 15 februari 2012 (Kortekaas/Fortis).
10 Kroese 2004.

D & O insurance has become more important in the Netherlands recently.[11] Almost all corporations in the Dutch Top 500 buy D & O insurance, whereas at a rough estimate 40% of the other large and medium-sized companies are insured for D & O liability. The number of claims and notifications is increasing, in particular after bankruptcy. The number of lawsuits and awarded damages is still limited.[12] Nevertheless, Eshuis et al.[13] found 70 cases in 10 years of published case law, in which a corporation sued a director, a former director or officer for being liable for losses of the corporation.

Weterings' description of the D & O insurance practice in the Netherlands deviates from the picture presented by Baker and Griffith. Weterings states that 'the incentives from liability law are partly taken over by D & O insurance. The insurer monitors the insured corporations more closely than other insurances. Insurers use screening during application and during the insurance. Insurance is only for 12 months in order to allow adaptation of premiums, insured value and conditions.'[14] How can we account for this different picture of Dutch D & O insurance? Have D & O insurers in the Netherlands succeeded in restoring the deterrence function? Or did Baker and Griffith do more in-depth research, thereby getting below the surface of the public image of the D & O insurance industry? Will shareholder litigation in the Netherlands develop in the direction of US shareholder litigation? A recent decision of the Utrecht court made Lennarts and De Valk fear for a new trend: shareholders claiming collective damages against directors and officers of publicly traded corporations because of misrepresentation.[15] Because damages in liability claims may amount to considerable sums of money, they advise directors and officers to provide for good D & O insurance![16]

The investigation by Baker and Griffith clearly shows that economic theories and models do not always predict accurately what happens in reality. Business people do not only act as a *homo economicus*, rationally calculating pros and cons. *Ensuring corporate conduct* offers a lively picture of the complex interrelationships between insurance companies, underwriters and insured corporations.

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11 Weterings 2010.
12 Weterings 2010.
13 Eshuis 2012, p. 49.
14 Weterings 2010, p. 171.
15 Lennarts & De Valk 2012.
16 Lennarts & De Valk, p. 733.

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