# CHANGING GUARDS: IMPROVING CORPORATE GOVERNANCE WITH D&O INSURER ROTATIONS

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*Almost all public companies buy insurance for their directors and officers. D&O insurers should be active gatekeepers for the corporation, since they lose money if executives misbehave, but all available evidence suggests the opposite: insurers protect executives from liability for bad management, and they encourage wasteful settlement of even meritless lawsuits.*

*This Article diagnoses the failure of D&O insurance as a form of pernicious relational contracting. Insurers ignore even the worst corporate governance because they can recoup losses in the years to come. This recognition unlocks a potential solution: mandatory rotation. If insurers had only a few years to recoup any losses, they would seek to limit those losses by serving as an active gatekeeper.*



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## INTRODUCTION

In a typical year, managers of corporations representing about 10% of America's big public corporations are sued by their investors.[1] These suits cost billions of dollars to litigate and settle.[2] Proponents of shareholder

[1] Securities Class Action Filings: 2019 Year in Review, Cornerstone Research 13, https://securities.stanford.edu/research-reports/1996-2019/Cornerstone-Research-Securities-Class-Action-Filings-2019-YIR.pdf [https://perma.cc/PD8P-YL84] (reporting 10% of S&P 500 by market cap was sued for securities violations in 2019). Last year brought slightly fewer. Securities Class Action Filings: 2021 Year in Review, Cornerstone Research 15, https://www.cornerstone.com/wp-content/uploads/2022/02/Securities-Class-Action-Filings-2021-Year-in-Review.pdf. [https://perma.cc/4JGL-35SH]. This 10% figure plainly understates the scope of litigation, since many investors' suits are derivative actions with no securities violation component, but comprehensive data for derivative suits are not available.

In this Article, I use the word "manager" to refer to both officers and directors.

[2] Alice Uribe & Leslie Scism, Companies Are Paying a Lot More to Insure Their Directors and Officers, Wall St. J. (June 21, 2020, 5:30 AM), https://www.wsj.com/articles/companies-are-paying-a-lot-more-to-insure-their-directors-and-officers-11592731801?mod=hp_listc_pos2 [https://perma.cc/93HE-LMK9] (reporting that D&O litigation expenses are approaching $1 billion annually, not including jury verdicts or settlements).

litigation argue that America's corporate directors and officers are prone to gross negligence, bad faith, and self-dealing.[3] Critics argue that these are attorney-driven "strike suits."[4]

Nearly everyone agrees that directors' and officers' insurance ("D&O insurance") is part of the problem.[5]

Essentially all public companies buy insurance to protect their managers from the cost of shareholder litigation, and it is easy to see how widespread insurance can cause problems.[6] Insured officers and directors are protected against the legal consequences of their mismanagement and recklessness.[7] They can behave badly without ever seeing the bill. The insurance company pays the bill. Indeed, managers may ask insurers to pay lucrative settlements, even in meritless cases, just to minimize the hassle and cost of litigation.[8] And it is insurers' reputation as honeypots that draws plaintiffs' lawyers to concoct meritless suits.[9] Thus, D&O insurance serves to clog up dockets with stories of misbehavior, both encouraged and imagined.

[3] E.g., Eugene V. Rostow, To Whom and For What End is Corporate Management Responsible?, *in* The Corporation In Modern Society 48 (Edward S. Mason ed., 1959) (characterizing derivative suits as "the most important procedure the law has yet developed to police the internal affairs of corporations"); Robert B. Thompson & Randall S. Thomas, The Public and Private Faces of Derivative Lawsuits, 57 Vand. L. Rev. 1747, 1786–87 (2004) (finding data that derivative suits play a valuable monitoring role in duty of loyalty cases and that the tool combats unscrupulous directors); see also Jill E. Fisch, Teaching Corporate Governance Through Shareholder Litigation, 34 Ga. L. Rev. 745, 746 (2000) (explaining how the rules of shareholder litigation can "deter[] corporate misconduct").

[4] See Rostow, supra note 3; Stephen M. Bainbridge, Fee-Shifting: Delaware's Self-Inflicted Wound, 40 Del. J. Corp. L. 851, 852–53 (2016); Roberta Romano, The Shareholder Suit: Litigation without Foundation?, 7 J.L. Econ. & Org. 55, 84 (1991); Sean J. Griffith, Correcting Corporate Benefit: How to Fix Shareholder Litigation by Shifting the Doctrine on Fees, 56 B.C. L. Rev. 1, 2 (2015).

[5] Dain C. Donelson, Justin J. Hopkins & Christopher G. Yust, The Role of Directors' and Officers' Insurance in Securities Fraud Class Action Settlements, 58 J.L. & Econ. 747, 748 (2015); see Sean J. Griffith, Uncovering A Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies, 154 U. Pa. L. Rev. 1147, 1189 (2006).

[6] Griffith, supra note 5, at 1168.

[7] Id. at 1163.

[8] Tom Baker & Sean J. Griffith, How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements, 157 U. Pa. L. Rev. 755, 797–98 (2009).

[9] See Richard M. Phillips & Gilbert C. Miller, The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers, 51 Bus. Law. 1009, 1014–15 (1996).

This critique is strange because it is at odds with a plausible theory of gatekeeper behavior.[10] Why would insurers sign up to be punching bags?[11] Insurers have strong incentives to watch for warning signs and drop customers before the hammer drops, or at least to increase insurance premiums vividly when clients stand on the precipice of trouble.[12] They have strong incentives to monitor their insureds for dangerous risk. They have strong incentives to retain control of individual suits to fight meritless ones. All of these risk-controlling practices are commonplace when insurers offer nearly any other kind of multi-million-dollar coverage.[13] Critics of D&O insurance tacitly assume that these insurers are uniquely negligent in protecting themselves from moral hazard, adverse selection, and predation.[14]

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[10] The "gatekeeper" idea is that trusted professionals near the corporation can be used as external checks on fraud and mismanagement. See John C. Coffee, Jr., The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and Governance of Accounting 11–13 (Colum. L. Sch., Ctr. For L. & Econ. Stud., Working Paper No. 191, 2001), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=270944 [https://perma.cc/LM3D-3T6H].

[11] See Joseph A. Grundfest, Punctuated Equilibria in the Evolution of United States Securities Regulation, 8 Stan. J.L. Bus. & Fin. 1, 7–8 (2002) ("D&O insurers could today easily make the retention of insurer-approved auditors a condition of coverage. They could today also require an element of control over the audit process. Yet they don't. Why?").

[12] Such responses were once common. Roberta Romano, What Went Wrong With Directors' and Officers' Liability Insurance?, 14 Del. J. Corp. L. 1, 12 (1989). Professor Romano's article diagnosed insurer responses to a sudden increase in liability exposure, so it is unsurprising that insurers reacted in this way. Id. at 13. There is no indication that this tendency to withdraw is still commonplace.

[13] Richard V. Eicson & Aaron Doyle, Uncertain Business: Risk, Insurance and the Limits of Knowledge 94–211 (2004) (reporting research from a variety of contexts including building construction and disability management); Steven Shavell, On Liability and Insurance, 13 Bell J. Econ. 120, 121–22 (1982) (modeling the relationship between liability and insurance and concluding that, "[a]lthough the purchase of liability insurance changes the incentives created by liability rules, the terms of the insurance policies sold in a competitive setting would be such as to provide an appropriate substitute (but not necessarily equivalent) set of incentives to reduce accident risks").

[14] Moral hazard is the tendency of insured parties to engage in riskier conduct. Kenneth J. Arrow, Uncertainty and the Welfare Economics of Medical Care, 53 Am. Econ. Rev. 941, 961 (1963); Daniel Schwarcz, Reevaluating Standardized Insurance Policies, 78 U. Chi. L. Rev. 1263, 1283 (2011). With respect to health insurance, smoking has been described as the "classic moral hazard." Thomas R. McLean, International Law, Telemedicine & Health Insurance: China as a Case Study, 32 Am. J.L. & Med. 7, 25 (2006). Adverse selection is the tendency of the costliest clients to seek out coverage offered at a given price. Cf. George A. Akerlof, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, 84 Q.J. Econ. 488, 488 (1970) (setting out a canonical adverse selection model in a non-insurance commercial setting); Peter Siegelman, Adverse Selection in Insurance Markets: An Exaggerated Threat, 113 Yale L.J. 1223, 1223 (2004) (explaining that adverse selection is a

For now, it appears the critics are right and theory is wrong. D&O insurers *do not* drop their clients regularly; instead, renewal rates approach 100%.[15] D&O insurers *do not* penalize risky clients with much higher premiums; instead, premium increases are almost lockstep.[16] D&O insurers *do not* monitor clients' quality of governance and risk-exposure; instead, insurers devote essentially zero effort to monitoring existing clients.[17] Insurers *do not* fight weak claims; instead, they cede control over litigation to the client and agree to settle essentially every well-pleaded complaint.[18] Far from gatekeepers, insurers have become cheerful doormen for those who would cart the insurer's wealth, and that of the corporate client, out the door.[19]

Why? And what can be done to fix it? This Article explains the failure of the D&O insurance market and a solution. The analysis is moderate in that it accepts the good and bad of D&O insurance and tries to tilt the

process where "insureds utilize private knowledge of their own riskiness when deciding to buy or forgo insurance").

[15] Aon, Quarterly D&O Pricing Index: Fourth Quarter and Full Year 2018, at 9 (2018), https://www.aon.com/getmedia/20bfac85-dce6-4902-91cb-c61265abcd7e/2018-Q4-DO-Pricing-Index.aspx [https://perma.cc/PR58-CPUT] (95.7% annual retention); Aon, Quarterly D&O Pricing Index: Fourth Quarter and Full Year 2017, at 9 (2017), https://www.aon.com/attachments/risk-services/d-o_pricing_index/2017_Q4_DO_Pricing_Index.pdf [https://perma.cc/V33R-ZY9U] (93.2% annual retention); Aon, Quarterly D&O Pricing Index: Fourth Quarter and Full Year 2016, at 8 (2016), https://www.aon.com/attachments/risk-services/d-o_pricing_index/2016_Q4_DO_Pricing_Index.pdf [https://perma.cc/HRY4-4HTA] (95.3% annual retention); Aon, Quarterly D&O Pricing Index: Fourth Quarter and Full Year 2015, at 8 (2015), https://www.aon.com/attachments/risk-services/d-o_pricing_index/2015_Q4_DO_Pricing_Index.pdf [https://perma.cc/J5WG-K6QQ] (95% annual retention); Aon, Quarterly D&O Pricing Index: Fourth Quarter and Full Year 2014, at 8 (2014), https://www.aon.com/attachments/risk-services/d-o_pricing_index/2014_Q4_DO_Pricing_Index.pdf [https://perma.cc/8CDA-MSYG] (93.7% annual retention); Aon, Quarterly D&O Pricing Index: Fourth Quarter and Full Year 2013, at 3 (2013), https://www.aon.com/attachments/risk-services/d-o_pricing_index/2013_Q4_DO_Pricing-Index.pdf [https://perma.cc/22DW-YDPB] (94.9% annual retention) Aon, Quarterly D&O Pricing Index: Fourth Quarter and Full Year 2012, at 3 (2012), https://www.aon.com/attachments/risk-services/d-o_pricing_index/2012_4Q_DandOPricingIndex.pdf [https://perma.cc/4GJU-4PKG] (94% retention for Q4).

[16] Alicia Davis Evans, The Investor Compensation Fund, 33 J. Corp. L. 223, 261 (2007) ("Currently, competitive pressures appear to make it impossible for D&O insurer premium prices to reflect governance risk fully.").

[17] Infra Section II.C.

[18] Baker & Griffith, supra note 8, at 797–804.

[19] Cf. Grundfest, supra note 11, at 7 (noting that "the current structure of D&O insurance and auditor liability has failed to give rise to incentives" to address fraud risks even though "D&O insurers could today easily make the retention of insurer-approved auditors a condition of coverage").

balance,[20] rather than, say, banning D&O insurance altogether.[21] This Article's argument contains four premises.

First, insurance (D&O and otherwise) can be operated in an "active" or "passive" fashion.[22] An active insurer seeks to address clients' risks by discovering current risk level, setting premiums that reflect it, and discouraging excessively risky behavior.[23] By contrast, a passive insurer does little vetting, risk-pricing, or monitoring. Instead, the passive insurer just seeks to recoup losses on a costly client by charging that client more in the future.[24]

Second, active insurance is socially preferable at the margin. Active insurers encourage least-cost avoiders to avoid risks. They force their customers to internalize their expected costs.[25] And they generate information about the magnitude of risks.[26] At a minimum, the board may ask the chief executive officer ("CEO") for an explanation if insurance costs treble. Conversely, passive insurers are more problematic. They protect bad managers from the cost of their bad conduct, and muddy the signal litigation might otherwise send, by spreading the cost of managerial

[20] See Shauhin A. Talesh, Insurance Companies as Corporate Regulators: The Good, The Bad, and the Ugly, 66 DePaul L. Rev. 463, 467 (2017) ("The debate going forward is not whether insurers are good risk regulators as prior scholars theorize, but more precisely, examining under what conditions can insurers make positive regulatory interventions into corporate behavior and nudge corporations toward a governance structure in line with societal values of fairness, equality, transparency, and safety."); Chen Lin, Micah S. Officer, Thomas Schmid & Hong Zou, Is Skin in the Game a Game Changer? Evidence from Mandatory Changes of D&O Insurance Policies, 68 J. Acct. & Econ. 1–2 (2019) (arguing that the structure of insurance policies matters).

[21] See, e.g., Merritt B. Fox, Civil Liability and Mandatory Disclosure, 109 Colum. L. Rev. 237, 288–89 (2009) (calling for an end to D&O insurance for certain securities violations).

[22] Most insurers do not embrace a purely active or passive strategy, and it can be difficult to distinguish them in many cases. An insured who makes a costly claim may see her future premium rise from either an active or passive insurer, but for very different reasons. The active insurer raises the rate insofar as the claim signals information about the client's type and future riskiness. The passive insurer raises the rate simply because that is the deal: the insurer pays now and recoups later, even if the claim was a fluke and signals nothing about the insured's risk.

[23] Daniel Schwarcz, Coverage Information in Insurance Law, 101 Minn. L. Rev. 1457, 1487 (2017) ("[T]he risk of moral hazard only exists when the insurer does not observe policyholder levels of activity or care after purchase . . . .").

[24] Infra Section III.A.

[25] Omri Ben-Shahar & Kyle D. Logue, Outsourcing Regulation: How Insurance Reduces Moral Hazard, 111 Mich. L. Rev. 197, 228 n.102 (2012).

[26] See Tom Baker & Sean J. Griffith, Predicting Corporate Governance Risk: Evidence from the Directors' and Officers' Liability Insurance Market, 74 U. Chi. L. Rev. 487, 489–90 (2007) (arguing that insurance premiums can publicize problematic governance).

malfeasance into distant future periods. For that reason, society will tend to be better served by relatively more active insurance and managers will tend to prefer relatively more passive insurance.

Third, the passive method is viable only if the market for insurance is rather uncompetitive and illiquid, because it requires customers to submit themselves to years of premiums that exceed the actuarially fair rate.[27] If the insureds often switched under those circumstances, the passive insurance model would collapse. Passive insurance requires enduring relationships between insured and insurer, but it can thrive under those conditions.

Fourth, the existing insurance market is consistent with an excessive degree of passive insurance, owing to agency costs and transaction costs.[28] Insurance relationships are long-lasting; switching insurers is rare. For a firm to switch from its longstanding passive insurer to a lower-priced active insurer, directors and officers must approve the change. But directors and officers would be exposed to greater pressure and transparency from an active insurer. At the same time, contracting conventions and market structure impose frictions on competition. Managers can cite these frictions as a reason to retain the passive insurer they like best.

These premises lead to the descriptive conclusion that insufficient client turnover has led D&O insurance to insufficiently address client risk. The normative conclusion is that we should impose mandatory D&O insurance rotation.

Insurers should be permitted no more than five years with a given client, at which time they must take their underwriting elsewhere. Mandatory rotation renders the passive insurance model impractical. Insurers can never hope to insure passively and then recoup their losses down the line. Every insurer will have to actively vet insureds for risks pending over the next few years, to monitor for abrupt changes during that period, and to take steps to limit a corporation's slide toward increased risk; the result is that corporations and their managers will be more likely to internalize the expected cost of their harmful behaviors and, thus, take those harms more seriously.

Mandatory rotation has been used in other areas of law to destabilize corrupt relationships that compromise gatekeepers and fiduciaries.

[27] Infra Sections III.B. & C.
[28] Infra Sections II.C. & III.D.

Auditing partners must rotate every five years.[29] The theory is that genuine auditing can jeopardize a long relationship, but auditors who know they will soon lose their client anyway are freer to audit honestly. Similar intuitions drive term limits for elected officials.[30] The temptation to buckle to special interests is greater if it secures reelection. If reelection is impossible, the politician is freer to act according to her best judgment of the public interest. Likewise, career diplomats with the foreign service are permitted only three years in a given foreign country.[31] While these changes may diminish some country-specific expertise, the alternative of long-service may tempt foreign service officers to strike implicit bargains with their host country that undermine America's interests.

The deep economic intuition behind mandatory insurance rotation is that passive D&O insurance is a relational contract.[32] Relational contracts are agreements that motivate cooperation without recourse to legal enforcement, but are instead embedded in a relationship.[33] For example, a long-term supply agreement may include an unwritten term that the seller may sometimes deliver goods late or mark up prices to reflect rising costs, and the buyer may happily honor that agreement even if no court would enforce it, because the buyer wants to preserve an ongoing profitable relationship.[34] Relational contracts are widespread, but they

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[29] Infra Subsection IV.B.1.

[30] Infra Subsection IV.B.2.

[31] Infra Subsection IV.B.3.

[32] See Jay M. Feinman, The Insurance Relationship as Relational Contract and the "Fairly Debatable" Rule for First-Party Bad Faith, 46 San Diego. L. Rev. 553, 556–57 (2009) ("The insurance contract is a relational contract par excellence. The relation created by the contract extends over time; although a typical policy term is a year, the rate of renewal is very high, often in the order of ninety percent, so a typical relation extends over years or even decades."). Note that Feinman was not addressing D&O insurance.

[33] See Robert E. Scott, Conflict and Cooperation in Long-Term Contracts, 75 Calif. L. Rev. 2005, 2007–08 (1987); Morten Hviid, Long-Term Contracts and Relational Contracts, *in* 5 The Encyclopedia of Law and Economics 54 (Boudewijn Bouckaert & Gerrit De Geest eds., 1999) ("Relational contract theory can be seen as an attempt to generate a model able to explain when transacting parties do not resort to contracts and by what means they ensure that each party fulfils their obligations. The theory focuses on the relationship between the 'contracting' parties and posits that this leads to cooperation and to implicit obligations being self-enforcing."); Benjamin E. Hermalin, Avery W. Katz & Richard Craswell, Contract Law, *in* 1 Handbook of Law and Economics 123 (A. Mitchell Polinsky & Steven Shavell eds., 2007) ("Within the literature, self-enforcing contracts are often known as relational contracts." (emphasis omitted)).

[34] For examples of this kind, see, e.g., Stewart Macaulay, Non-Contractual Relations in Business: A Preliminary Study, 28 Am. Socio. Rev. 55, 61–67 (1963); Ian R. MacNeil, The Many Futures of Contracts, 47 S. Cal. L. Rev. 691, 721, 732 (1974); H. Beale & T. Dugdale,

only succeed when certain fragile conditions are met.[35] Importantly, relational contracts require some mechanism for overcoming the "last period problem."[36]

In relational contracts, enforceable contract rights underdetermine the parties' relationship.[37] Cooperation is possible nevertheless because one party can detect and subsequently penalize defection by the other.[38] Fear of reprisal keeps both parties cooperative. However, defection again becomes rational in the last period of a long game because reprisal becomes impossible.[39] Passive insurance is a relational contract in which the managers agree (on behalf of the entity) to pay a higher-than-competitive rate in the future, and the insurer agrees to cover claims without any effort to expose or reduce governance problems. If both parties knew that the relationship was going to end soon, the insurer would have reason to breach the informal agreement by reducing its costs through monitoring and increasing its premiums *now*. And since they know they won't get the cozy treatment that they want anyway, managers will no longer cheerlead an overpriced premium.

Part of what is interesting about this project is exploring the dark side of relational contracts. Most often, scholars of relational contracts adopt a laudatory tone: *Is it not amazing that parties can accomplish their goals without much law*?[40] But parties' ability to informally secure a result is

Contracts Between Businessmen: Planning and the Use of Contractual Remedies, 2 Brit. J.L. and Soc'y 45, 45–46, 51, 53 (1975).

[35] E.g., Hviid, supra note 33, at 55 ("Repeated interaction may enable cooperation, because of the potential for a current deviation to be punished in the future. For this to work, four conditions must be met.").

[36] Sean J. Griffith, Afterward and Comment: Towards an Ethical Duty to Market Investors, 35 Conn. L. Rev. 1223, 1239 (2003) ("The last period problem is a concept drawn from game theory and experimental economics to explain individual defections from cooperative enterprises in the last period of a repeated situation.").

[37] Charles J. Goetz & Robert E. Scott, Principles of Relational Contracts, 67 Va. L. Rev. 1089, 1091 (1981) ("A contract is relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations.").

[38] Hviid, supra note 33, at 55 ("Any deviation must be observable and it must be punishable. This punishment must be credible so that it is clear that when required the punishment will be carried out, and the parties must be patient in the sense that the future matters to them.").

[39] Christine Jolls, Contracts as Bilateral Commitments: A New Perspective on Contract Modification, 26 J. Legal Stud. 203, 231–32 (1997).

[40] See, e.g., Robert C. Ellickson, Order Without Law: How Neighbors Settle Disputes 1, 1 (1991); Lisa Bernstein, Beyond Relational Contracts: Social Capital and Network Governance in Procurement Contracts, 7 J. Legal Analysis 561, 561–62 (2015) (discussing how master supply agreements, a type of relational contract between business firms, are designed to "keep

only laudatory if we would have been happy to honor their agreement had they made it formal. And not all contracts are of this sort. Business cartels use relational contracts to tacitly enforce restraints of trade that we would never countenance as formal contracts.[41] Mob bosses use relational contracts to reward and govern their lieutenants.[42] And D&O insurers promise to help paper over managers' mistakes and abuses in return for wastefully large insurance premiums. Relational contracts can allow parties to coordinate in ways we would never tolerate from formal contracts.

The structure of this Article is as follows. Part I introduces the practice and industrial organization of D&O insurance. Part II discusses the link between insurance and risk: while insurance can reduce riskiness, D&O insurers actually appear to exacerbate client risks, doing almost no monitoring or vetting. Part III provides a stylized introduction to two ways that D&O insurance business can operate—actively and passively. That Part shows that the market likely operates to generate excessive levels of passive insurance, and it explains that manager opportunism is central to the problem. Accordingly, Part IV presents a solution intended to increase the proportion of active D&O insurance: mandatory rotation of D&O insurers. It also explains analogies to other domains of law and addresses objections.

## I. HOW D&O IS BOUGHT AND SOLD

### *A. Demand*

Directors and officers owe fiduciary duties of care and loyalty to their corporation and its shareholders.[43] Managers who injure the corporation through their gross negligence, bad faith, or self-dealing can be personally liable to the entity.[44] While managers ordinarily decide what lawsuits the

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the law . . . largely out of their relationship" and can "create a space in which private order can flourish.").

[41] Hermalin et al., supra note 33, at 122 ("It has long been understood from the repeated games literature that some agreements are self enforcing in the context of an ongoing relationship. The most prominent example of such 'agreements' is tacit collusion among competing firms.").

[42] Curtis J. Milhaupt & Mark D. West, The Dark Side of Private Ordering: An Institutional and Empirical Analysis of Organized Crime, 67 U. Chi. L. Rev. 41, 43, 66 (2000).

[43] Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

[44] E.g., Fed. Deposit Ins. Corp. v. Loudermilk, 826 S.E.2d 116, 118 (Ga. 2019) (certifying questions by a circuit court concerning $5 million judgment).

corporation will pursue (and rarely consider it in the corporation's interest to sue themselves), shareholders are sometimes permitted to sue in the name of the corporation.[45] These "derivative suits" are costly to litigate and threaten managers of large companies with multi-million-dollar liability.[46] Alleged manager wrongdoing can also subject the managers and entity to suits for violations of federal securities laws.[47]

Fear of litigation may lead to inferior manager selection and performance.[48] A director adjudged liable for harm to a large corporation faces liability many times greater than her compensation.[49] Even honest and hardworking directors may be concerned because civil litigation is not completely accurate, and innocent individuals are sometimes erroneously adjudged liable. Even if directors were never wrongly penalized, the cost to litigate a complex shareholder suit can easily run into the millions of dollars. Rational directors would look at the frequency of shareholders suits and cringe—risk averse directors might run for the hills.[50]

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[45] See Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

[46] Large settlements in derivative suits have spanned from $62.5 million to $310 million. Kevin LaCroix, Largest Derivative Lawsuit Settlements, The D&O Diary (last updated Nov. 7, 2021), https://www.dandodiary.com/2014/12/articles/shareholders-derivative-litigation/largest-derivative-lawsuit-settlements/ [https://perma.cc/U264-HQXG].

[47] The median securities action settlement in 2019 was $11.5 million. Securities and Class Action Settlements, 2019 Review and Analysis, Cornerstone Research, https://securities.stanford.edu/research-reports/1996-2019/Cornerstone-Research-Securities-Class-Action-Filings-2019-YIR.pdf [https://perma.cc/RP8L-HVYP]. Half of those cases involved derivative suits. Id. at 10.

[48] Although this article is focused on D&O coverage for derivative suits, it plainly includes securities suits, too. And there is no reason that the analysis in this Article is not equally applicable to other kinds of suits, such as allegations of mistreatment of subordinate employees. See generally Daniel Hemel & Dorothy S. Lund, Sexual Harassment and Corporate Law, 118 Colum. L. Rev. 1583, 1587–89 (2018) (describing the liability of managers for workplace misconduct).

[49] In 2017, the highest average compensation for board members of an S&P 500 company was $2.58 million, and only three S&P 500 companies paid their directors more than $1 million. Paul Ausick, 25 Companies That Pay Their Board Of Directors A Shocking Amount, USA Today (Dec. 14, 2018, 6:00 AM), https://www.usatoday.com/story/money/business/2018/12/14/how-much-do-corporate-boards-pay-companies-highest-compensation/38637377/ [https://perma.cc/GQW4-URVB]. Average independent director pay for an S&P 500 firm is about $300,000. Spencer Stuart, 2021 U.S. Spencer Stuart Board Index 8 (2021), https://www.spencerstuart.com/research-and-insight/us-board-index [https://perma.cc/P7AJ-7ZX3].

[50] Richard MacMinn, Yayuan Ren & Li-Ming Han, Directors, Directors and Officers Insurance, and Corporate Governance, 35 J. Ins. Issues 159, 161 (2012) ("[T]he corporate purchase of D&O insurance does not change the directors' monitoring actions but does influence their decisions to accept the job.").

Those directors who remain may behave differently in light of their precarious position. They might manage bureaucratically, running every business decision by a team of lawyers. They might nix risky but valuable projects, reasoning that the surest path to a lawsuit is any kind of stock drop based on bad news.[51]

D&O insurance mollifies risk-averse executives by transferring their risk to more comfortable risk-bearers.[52] By purchasing insurance, corporations can ensure managers that they will not lose more than their deductible if they are later accused of garden-variety wrongdoing.[53] Under some circumstances, the risk-pooling function of D&O insurance may make sense as something that helps good companies function even better.[54]

[51] In re Cornerstone Therapeutics Inc, S'holder Litig., 115 A.3d 1173, 1185 (Del. 2015) (explaining the "well understood" fear "that directors who faced personal liability for potentially value-maximizing business decisions might be dissuaded from making such decisions").

[52] Although corporations are not psychologically risk averse, it is sometimes rational for them to buy insurance for themselves as if they are. Bankruptcy is costly, and it can be rational for entities to buy insurance against risks that could precipitate such a slide. It may also be easier for investors to evaluate the health of a venture if it divorces itself from risks that are not core to the business. Side B and Side C insurance help the corporation achieve both purposes by limiting the corporation's own exposure to the litigation. See David Mayers & Clifford W. Smith, Jr., On the Corporate Demand for Insurance, 55 J. Bus. 281, 293 (1982) (concluding that corporate demand for liability insurance derives partly from the ability of insurance contracts to allocate risk to claimholders in a superior position to bear risk and lower the transaction costs of bankruptcy). A plausible alternative hypothesis for the use of Side B and Side C insurance is to permit managers to amortize the shock of litigation expenses over time, thus protecting their contingent-pay packages and employment prospects from shareholder backlash. See Sean J. Griffith, Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies, 154 U. Pa. L. Rev. 1147, 1172–73 (2016).

[53] Indemnification also serves this function, but indemnification gives less assurance to the manager since (1) more acts can be insured than indemnified, due to public policy limits on indemnification and (2) indemnification is sometimes unavailable due to the corporation's insolvency or obstinacy. Lynn M. LoPucki & Andrew Verstein, Business Associations: A Systems Approach 482 (2020); Tom Baker & Sean J. Griffith, How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements, 157 U. Pa. L. Rev. 755, 830 (2009).

[54] See, e.g., Shih-Chung Chang, Yayuan Ren & Jason Yeh, The Role of Information: When Is Directors' and Officers' Insurance Value-Added?, 97 J. Banking & Fin. 189, 190 (2018) (arguing that D&O insurance improves governance where directors are well informed); see also Chun-Yuan Chen, Functions of Directors' and Officers' (D&O) Liability Insurance and Litigation Risk: An Empirical Legal Study of Taiwan, 12 Nat'l Taiwan U. L. Rev. 1, 6 (2017) (finding that D&O insurance predicts better corporate governance in Taiwan and identifying factors "such as the design of corporate governance structures, the prevalence of D&O

### *B. Supply*

Nearly all public companies purchase D&O insurance.[55] They do so by contacting an insurance broker. The broker solicits offers from one or more insurance companies.[56] The winning insurance company pays the brokers a percentage of the premiums.[57] The insurance company simultaneously—often with help from the broker—arranges for "excess insurers" to protect them from some of the risk.[58] The base policies insurers sell to corporations run for a single year, though renewals with a small premium increase are normal.[59] Corporations almost always renew with their existing carrier.[60]

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insurance, the development of the litigation system and so on" that distinguish results from U.S. context).

[55] See Beverly Bell Godbey, De-Mystifying D&O: A Primer for Texas Lawyers, 75 The Advoc. (Texas) 32, 32 (2016) ("Today, nearly 100% of public companies and between 75% and 80% of private companies purchase some form of D&O insurance.").

[56] Five insurers (AXA, AIG, Chubb, Tokio Marine US, and CNA Financial) make up over half of the D&O market. Syed Salman Shah & Hailey Ross, IPO, M&A-Related Suits Continue to be Headaches for D&O Insurers in 2018, S&P Global (April 25, 2019), https://www.spglobal.com/marketintelligence/en/news-insights/trending/1IISFnnhRTtCTFbNcFwTLg2 [https://perma.cc/C8ZL-TKV7].

[57] Paulita Pike, The Must Know of D&O, Fund Board Views (Apr. 26, 2018), http://fundboardviews.com/Content_Free/Viewpoints-Pike-DO-insurance.aspx [https://perma.cc/V334-HYG5]; see also Mark Roellig & Tim Burns, Preparing for the Worst: D&O Protection and the Major Corporate Lawsuit, ACC Docket, May 2011, at 32, 39 ("Insurance brokers are hired in connection with D&O insurance purchases, and they are paid 8-12 percent of the cost of D&O insurance – often hundreds of thousands of dollars for large corporations."); Broker and Independent Agent Compensation, Chubb, https://www.chubb.com/us-en/agents-brokers/producer-compensation.aspx [https://perma.cc/7GL8-RZTC] (last visited June 25, 2020) (noting that "Chubb has entered into a number of contingent commission arrangements based on premium volume, premium retention and/or loss ratio with its brokers[,]" and that ranges for standard commission paid by Chubb to brokers of liability insurance, including D&O liability policies, span from 0%–35%).

[58] The combination of a primary insurer and its complimentary excess insurers is known as a "tower." Patrick Conroy & Jordan Miley, United States: Insurance Coverage Towers and Predicted Settlements, Mondaq (Feb. 28, 2012), https://www.mondaq.com/unitedstates/class-actions/166244/insurance-coverage-towers-and-predicted-settlements [https://perma.cc/4YXZ-7UW2].

Excess insurance is similar to reinsurance, in that it reduces the exposure of the primary insurer. Scott M. Seaman & Charlene Kittredge, Excess Liability Insurance: Law and Litigation, 32 Tort & Ins. L.J. 653, 656 (1997). The excess insurers are liable for claims above a designated threshold (and, usually, below some other threshold).

[59] Kevin LaCroix, Executive Protection: Indemnification and D&O Insurance – The Basics, The D&O Diary (July 23, 2010), https://www.dandodiary.com/2010/07/articles/d-o-insurance/executive-protection-indemnification-and-do-insurance-the-basics/ [https://perma.cc/VB8L-NRQK].

[60] Supra text accompanying note 15.

Although there is no single "standard" D&O policy used by all insurers, there are somewhat standard terms. D&O policies usually include three types of coverage. "Side A" coverage is purchased by the corporation but lists managers as recipients. This coverage obliges the insurer to pay the managers as they incur litigation, settlement, and judgment costs.[61] Most Side A coverage includes no deductible and pays all of the relevant costs up to the policy limit. [62]

Some corporations prefer to pay their managers' litigation expenses themselves and then seek reimbursement from an insurance company.[63] "Side B" insurance allows the corporation to do so.

Thus, an executive covered by Side A and Side B coverage might apply to the entity for advancement of her legal expenses. If the entity agrees to pay, it could then ask the insurer to repay some of the cost under the Side B policy. If not, the executive could demand payment directly from the insurer pursuant to the Side A coverage. Side A and Side B coverage are partial substitutes, but most D&O policies include both.

Finally, "Side C" coverage protects the entity against its own litigation, settlement, and judgment expenses—most typically in securities cases where the managers' conduct could make the entity liable in its own capacity.[64]

While many forms of liability insurance grant to the insurance company control over the litigation process, D&O insurance avowedly does not. The covered executive may select her own attorney and craft her own litigation strategy.[65] The insurer is generally involved only when the executive asks it to write a check. And at that point, the insurer has little ability to resist settlement of a plausibly-covered claim.[66]

[61] Eighty-three percent of Willis Towers Watson's respondents' publicly traded companies purchased both ABC and separate Side A coverage. 2018 Willis Towers Watson Management Liability (Directors and Officers) U.S. Survey, Willis Towers Watson 8 (2018), https://www.willistowerswatson.com/en-US/Insights/2018/07/2018-management-liability-d-o-us-survey [https://perma.cc/454J-HVHQ]. See generally Godbey, supra note 55, at 32–33 (explaining the difference between the three forms of coverage).

[62] See, e.g., Bernard Black, Brian Cheffins & Michael Klausner, Outside Director Liability, 58 Stan. L. Rev. 1055, 1085, n.99 (2006) (explaining that almost no D&O policies include deductibles).

[63] Del. Code Ann. tit. 8, § 145 (2020) sets the terms and process for corporate indemnification. In the Model Business Corporations Act it is §§ 8.50–59.

[64] See Godbey, supra note 55, at 32–33.

[65] Tom Baker & Sean J. Griffith, Ensuring Corporate Misconduct: How Liability Insurance Undermines Shareholder Litigation 130 (2010).

[66] See Richard Squire, How Collective Settlements Camouflage the Costs of Shareholder Lawsuits, 62 Duke L.J. 1, 52 (2012).

This insurance can cover both the litigation expenses as well as the cost of judgment or settlement. The terms of the insurance are set by the contract,[67] checked only in the most extreme cases by public policy limitations on insurability. Common limitations include "self-dealing, bad faith, knowing violations of the securities act or other willful misconduct."[68] However, even these limitations are of limited importance. At the point that a defendant and plaintiff have decided to settle a case, both have an incentive to present the subject matter to the insurance company as involving only covered conduct. In principle, insurance companies could dispute the client's characterization, but such quibbling is rare.[69]

## II. D&O WORSENS GOVERNANCE

While insurance plausibly helps corporations retain qualified managers and encourages managers to take sensible risks, it has predictable downsides. Insured managers can make litigation and settlement decisions, spending someone else's money. This sets the stage for mischief, as Section A indicates. Insurers are aware of this possibility and can take steps to protect themselves and limit waste and risk-seeking by customers. Section B discusses the risk-controlling efforts insurers can take.

Unfortunately, Section C explains that there is little evidence that D&O insurers actually attempt to address much risk, suggesting that D&O insurance may play an unintended role in exacerbating bad corporate governance. Section D addresses and rejects two deflationary explanations for the forgoing anomaly: perhaps D&O insurers have no cost-justified options for controlling client's risks, or the only options they have are better taken by other gatekeepers.

### *A. The Risk of Worsening Governance*

It is a well-known feature of insurance economics that individuals will tend to take more risks once they obtain insurance. This is known as *moral*

[67] Joshua Phares Ackerman, Comment, A Common Law Approach to D&O Insurance "In Fact" Exclusion Disputes, 79 U. Chi. L. Rev. 1429, 1429, 1436 n.35 (2012) (describing contractual exclusions).

[68] Paul J. Galanti, Annotation, Director and Officer Insurance, 19 Ind. Prac., Business Organizations § 26.10 (2019); see also Cal. Ins. Code § 533 (1935) ("An insurer is not liable for a loss caused by the wilful act of the insured . . . .").

[69] Baker & Griffith, supra note 65, at 196.

*hazard*. For example, if people can buy cheap flood insurance, they are more willing to build fancy houses in hurricane-prone areas.[70] They might not build these homes if they stood the chance of losing everything with a single storm, and society might be better off without the precarious structures.

Analogously, D&O insurance encourages executives to take risky actions by reducing their personal exposure to the negative consequences. In the D&O context, risky actions are those that may result in a costly lawsuit later by investors who feel that executives have neglected their fiduciary duties. Insured executives may make hasty, ill-informed decisions rather than cancelling social engagements to devote enough time to learning the details of transactions.[71] They may approve transactions that enrich them personally at the entity's expense.[72] They may juice accounting results to meet earnings targets, immunized against subsequent attention.[73] Even if a given manager is not tempted to misbehave, insurance may cause her to take governance best practices less

[70] Omri Ben-Shahar & Kyle D. Logue, The Perverse Effects of Subsidized Weather Insurance 2–3 (Coase-Sandor Institute for L. & Econ., Working Paper No. 714 (2d Series), 2015).

[71] In *Smith v. Van Gorkom*, 488 A.2d 858, 879 (Del. 1985), the CEO and director signed a merger agreement without reading it during a party he hosted at Chicago's grandest opera house. The board likewise supported the proposed sale of the company with only a few hours' discussion and negligible paperwork. Id. at 869. The directors in *Van Gorkom* were subsequently indemnified by the purchaser. Stephen M. Bainbridge, Corporate Law Stories 225 (J. Mark Ramseyer ed., 2009); see also Chen Lin, Micah S. Officer & Hong Zou, Directors' and Officers' Liability Insurance and Acquisition Outcomes, 102 J. of Fin. Econ. 507, 508 (2011) (finding that merger and acquisition ("M&A") decisions result in lower abnormal returns to companies with more D&O insurance, suggesting that D&O insurance may encourage worse M&A transactions).

[72] In *In re Hollinger International, Inc. Securities Litigation*, No. 04C 0834, 2006 WL 1806382, at *5, *8–*9 (N.D. Ill. June 28, 2006), the CEO repeatedly sold corporate assets at fire sale prices to himself and to third parties who promised kickbacks, thinly disguised as payments for non-compete agreements.

[73] Abstract, Tzu-Ching Weng, Guang-Zheng Chen & Hsin-Yi Chi, Effects of Directors and Officers Liability Insurance on Accounting Restatements, 49 Int'l Rev. Econ. & Fin. 437, 437 (2017) ("The results show that when managers are covered by relatively higher levels of D & O insurance, they are more likely to restate their financial reports."); Hyeesoo H. Chung, Jinyoung P. Wynn & Han Yi, Litigation Risk, Accounting Quality, and Investment Efficiency, 29 Advances Int'l Acct. 180, 180 (2013) ("Consistent with extant evidence, [the authors] confirm a negative association between abnormal D&O coverage limits and accruals quality.").

seriously.[74] Executives who can quickly settle any scandalous allegation have less reason to behave well.[75]

Insured executives may act in ways that multiply the number of meritorious shareholder suits, but they may also encourage meritless ones. If a plaintiff brings a weak claim against an uninsured executive, the executive may have good reason to litigate rather than pay an out-of-pocket settlement. But if an insurance company pays, the executive can settle the claim without having to endure a distracting, stressful, and embarrassing deposition.[76] Plaintiffs' lawyers know that executives can spend someone else's money to settle the case, which encourages the lawyers to bring nettlesome suits.[77] The tendency to settle, and thus encourage, low-quality suits for too much money is a byproduct of ex post moral hazard created by liability insurance.

It is more than just intuitive that executives will demonstrate lower-quality governance when insured; the empirical evidence generally confirms the intuition.[78] But this factor must not be viewed in isolation because there is also a potential for insurance to reduce risk.

[74] Perhaps a gatekeeper (such as a lawyer, banker, or accounting professional) suggests that the board add another high-powered, informed, independent director—perhaps diversifying the perspectives on the board and reducing groupthink. It may be an uncomfortable hassle to do so. The spur of potential liability from an oversight failure may help the existing managers see the value in this proposal.

[75] Baker & Griffith, supra note 8, at 3 ("As it is currently structured, D&O insurance significantly erodes the deterrent effect of shareholder litigation, thereby undermining its effectiveness as a form of regulation."); accord James Barrese & Nicos Scordis, Managerial Bias in Corporate Governance and the Effect of D&O Insurance: A Literature Review and Synthesis, 3 Int'l J. Disclosure & Governance 185, 190 (2006).

[76] I do not suggest that it is always disloyal to settle a low-merit lawsuit; the distraction and expense of litigation can genuinely cost the firm more than the settlement in some cases. But D&O insurance permits executives to escape an annoying lawsuit, even when fighting it would be cost-justified, because they do not pay for the settlement.

[77] This is the "third-party payer" problem familiar to many domains of insurance. Matthew D. Mitchell, Do Certificate-of-Need Laws Limit Spending? 11–12 (Mercatus Ctr. Geo. Mason U., Working Paper, 2016) https://www.mercatus.org/system/files/mercatus-mitchell-con-healthcare-spending-v3.pdf [https://perma.cc/NTU3-G56N] (describing how third-party payments can lead to overspending on healthcare).

[78] See, e.g., Weng et al., supra note 73, at 437; Zhihong Chen, Oliver Zhen Li & Hong Zou, Directors' and Officers' Liability Insurance and the Cost of Equity, 61 J. Acct. & Econ. 100, 100 (2015) ("Overall, our evidence is consistent with the notion that D&O insurance weakens the disciplining effect of shareholder litigation, leading to an increase in the cost of equity."); Chung et al., supra note 73, at 180.

### *B. The Promise of Addressing Governance Risk*

Some scholars have posited that this apparent *bug* of D&O insurance—that executives can misbehave with the insurer's money—might really be a *feature*.[79] When putting their necks on the line, insurers have an incentive to address the risks that they will bear. If they can counteract the bad effects of moral hazard, insurers get to keep more of the money they charged as premiums. If they can spot risks in advance, they can charge a large premium, which might encourage the customer to reduce its risks. Smart insurers will take a number of active steps to help themselves, and these steps inure to society's benefit as harmful conduct by executives is reduced.

The spirit of this theory is that D&O insurers are gatekeepers, like attorneys and accountants, who can use their clout and expertise to buttress the corporation against governance breakdowns.[80] This gatekeeping theory turns a weakness of the arrangement—that the insurers protect executives from the cost of wrongdoing or excessive settlement—into a strength.[81] "D & O insurance is not only designed to provide financial security for the individual insureds, but also plays an important role in corporate governance in America."[82]

At a high level, D&O insurers can perform four different functions: discovery, pricing, control, and disclosure of risk.

Risk discovery means taking steps to identify the existence, probability, and cost of potential risks. This risk discovery operation may involve simple steps (like asking the customer to disclose known risks),

[79] E.g., Sullivan, infra note 85, at 545.

[80] The emphasis on gatekeepers traces to Jack Coffee's discussion of auditors. John C. Coffee, Jr., The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting 11–14 (Colum. L. Sch., Ctr. for L. & Econ. Stud., Working Paper No. 191, 2001), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=270944 [https://perma.cc/Z4CY-LL45]. Numerous scholars have offered affirmative proposals for how insurance could be used to discipline and improve the quality of corporations or their associated actors. Larry Cunningham has two such proposals. Lawrence A. Cunningham, Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability, 52 UCLA L. Rev. 413, 417 (2004); Lawrence A. Cunningham, Securitizing Audit Failure Risk: An Alternative to Caps on Damages, 49 Wm. & Mary L. Rev. 711, 713 (2007); see also Evans, supra note 16, at 242 (proposing a scheme whereby D&O insurers are involved in deciding a company's fraud risk rating); Joshua Ronen, Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited, 8 Stan. J.L. Bus. & Fin. 39, 54 (2002) (proposing insurance scheme intended to improve audit quality).

[81] On D&O insurers as gatekeepers, see Sean J. Griffith, Deal Insurance: Representation and Warranty Insurance in Mergers and Acquisitions, 104 U. Minn. L. Rev. 1839, 1912–15 (2020).

[82] In re WorldCom, Inc. Sec. Litig., 354 F. Supp. 2d 455, 469 (S.D.N.Y. 2005).

intermediate tasks (such as asking expert third parties to opine on the customer's risks), or extensive tasks (such as undertaking their own forensic analysis, interviewing employees, and reviewing documents). Whatever the form of risk discovery, it will be viewed through the prism of the insurer's expertise. The insurer may have many years' experience insuring clients like these and will surely have professional ties to other insurance firms and data providers whose wisdom and analytic tools will help them contextualize whatever firm-specific information they acquire.

Having sussed out the current level of risk for a given client, the insurer can propose insurance premiums that reflect those risks. An insurer with high and growing risks should have high and growing premiums.

High and growing premiums provide some incentive for insureds to reduce their risk.[83] Insurers can provide other mechanisms to encourage risk reduction, which we can call risk control. First, they may tell the insured which aspects of their business are red flags, promising reduced premiums if the trouble areas are addressed. If that carrot is not sufficient, the insurer can instead use a stick: excluding certain activities from coverage or dropping the insured altogether.[84] Third, the insurer can require or encourage the customer to partake in specific risk-reduction activities.[85] For example, the insurer could encourage or require the customer to attend seminars explaining best practices for conflict-of-interest transactions, add an independent director to the board, or get a third-party fairness opinion for a related party transaction. The empirical accounting and corporate governance literatures provide new sources of wisdom every year to buttress the artisan wisdom of corporate governance experts;[86] insurers could evaluate these literatures and lessons and insist clients take seriously whatever insights the insurer takes seriously.

[83] See Clifford G. Holderness, Liability Insurers as Corporate Monitors, 10 Int'l Rev. L. & Econ. 115, 116 (1990) (arguing that D&O insurers improve corporate governance by monitoring clients).

[84] Ben-Shahar & Logue, supra note 25, at 215; David J. Marchitelli, Annotation, Construction and Application of Directors and Officers Insurance Policy, Exclusive of Exclusion and Notice of Claim Provision, 22 A.L.R.6th 113, 140 (2007) ("[E]xclusions are designed to discourage particular types of conduct that would expose insurers to excess risk if allowed to remain within the coverage . . . .").

[85] Noel O'Sullivan, Insuring the Agents: The Role of Directors' and Officers' Insurance in Corporate Governance, 64 J. Risk & Ins. 545, 549 (1997) (arguing that D&O insurers contribute to corporate governance by demanding appointment of independent directors).

[86] Consider the research on interlocking boards. See generally Michal Barzuza & Quinn Curtis, Board Interlocks and Corporate Governance, 39 Del. J. Corp. L. 669 (2015). Boards of two companies are said to be interlocking when directors of one company are also directors

Finally, having learned the insureds' risk level, set premiums, and observed responses to risk-control efforts, the insurer could share information about that risk level with others.[87] An extreme example would be for an insurer to call shareholders or the SEC when a client exhibits dangerous corporate governance markers. More moderately, the insurer could require or allow its premium to be disclosed—with a high and risking premium itself a potential red flag for other patrons of the firm.

Performing these four functions can help an insurer.[88] If an insurer accurately detects risk, it can price, control, and disclose the risk. If an insurer prices risk accurately, it avoids paying large claims on clients it has undercharged. It can also undercut competition for safe clients by offering them a discount. If an insurer controls risk, it can convert risky clients into safe ones. This can save the insurer on claims when premiums have already been paid. Even when premiums are later adjusted to reflect reduced risk, an insurer who saves money on claims and lowers rates for safe clients will grow its clientele at the expense of competitors. And an insurer that discloses risk information encourages third parties, such as

of the other company. An intuitive but repeated finding is that governance-related practices are spread from one company to another through these interlocks. For example, a company is likely to exhibit poor accounting practices—the sorts of manipulation that lead to restatements and lawsuits—if many of its directors sit on the boards of other problematic firms. Thomas C. Omer et. al., Do Director Networks Matter for Financial Reporting Quality? Evidence from Audit Committee Connectedness and Restatements, 66 Mgmt. Sci. 3361, 3363 (2020). This research suggests insurers could protect themselves by noting which firms are interlocked with their client and approximating their accounting quality. Insurers could avoid clients with worrisome interlocks or insist that directors not straddle other boards that are likely to be embroiled in trouble. Insurers would not forbid interlocks altogether, since interlocks can also transmit good practices—and on average seem to do so. Id. at 3371. The point of this example is not to unduly emphasize the recent research on interlocking boards and accounting quality; perhaps subsequent studies will deemphasize the role of interlocks, or perhaps studies of other governance drivers would be more fruitful. Rather, the point is that research of this sort is constantly produced, and each article offers an underwriting strategy for savvy insurers.

[87] Baker & Griffith, supra note 26, at 531 (noting that "there is no question" that "corporate governance information works its way into pricing") (quotations omitted); see also René Otto & Wim Weterings, D&O Insurance and Corporate Governance: Is D&O Insurance Indicative of the Quality of Corporate Governance in a Company?, 24 Stan. J.L. Bus. & Fin. 105, 125 (2019) ("The premium, therefore, can serve as an *indirect* signal on corporate governance."); Chen, supra note 54, at 11–12 (noting that most opponents who argue no relationship exists between the purchase of D&O liability insurance and corporate governance nevertheless admit that D&O insurance can convey an important signal to the market).

[88] Ben-Shahar & Logue, supra note 25, at 204.

creditors and shareholders, to use their influence to control the corporation's risks.

These are the potential channels for risk-control an insurer could contribute and the reasons why they might do so. These are not novel discoveries—a long literature identifies insurance companies as risk-controllers.[89]

In fact, D&O insurers do almost none of these things, as the next Section describes.

### *C. Unaddressed Risk*

When insurers take steps at the start of a client relationship to address risk, we can call it "vetting." When the steps are taken later, such as during a policy year or at renewal, we can call it "monitoring." D&O insurers do a moderate amount of vetting in the form of risk discovery and pricing. They do essentially no monitoring.

When onboarding a new potential client, D&O insurers engage in some vetting of the client.[90] They consult third-party governance ratings, scrutinize insider ownership and pay packages, and judge the independence of purportedly independent directors and committees.[91] The result of the initial vetting is that premiums bear some relationship to risk.[92] However, there is no suggestion that these differences in premiums are large enough to actually influence corporate conduct and induce better

[89] See, e.g., Kyle D. Logue, Encouraging Insurers to Regulate: The Role (If Any) for Tort Law, 5 U.C. Irvine L. Rev. 1355, 1357 (2015).

[90] Baker & Griffith, supra note 26, at 512.

[91] Id. at 513, 522.

[92] John E. Core, The Directors' and Officers' Insurance Premium: An Outside Assessment of the Quality of Corporate Governance, 16 J.L. Econ. & Org. 449, 449 (2000) (finding "significant association" between premiums paid for D&O insurance and the quality of the firm's corporate governance "by showing that measures of weak governance implied by the D&O premium are positively related to excess CEO compensation"); accord Ning Wang, Directors' and Officers' Liability Insurance Pricing and Corporate Governance, 21 J. Fin. & Acct. 1, 3 (2016).

governance.[93] And premiums are not publicly disclosed,[94] so the signal is visible only to the managers least interested in heeding it.

While D&O insurers do a moderate amount of work in detecting risk levels and customizing premiums when they onboard a new client, that is often where their efforts end.[95] Once the vetting stage is over and the monitoring stage begins, insurers essentially cease discovering risk and pricing it, and they continue not to control or disclose it. This is the key takeaway from Baker and Griffith's extensive qualitative interviews:

> In practice, D&O insurers do almost nothing to monitor the public corporations they insure, and D&O insurers do not condition the sale of insurance on compliance with loss prevention requirements in any systematic way. Although D&O insurers do occasionally provide loss

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[93] Baker & Griffith, supra note 26, at 531. The "average cost of D & O insurance for large market cap companies . . . represents far less than 1% of their total value." Joshua Dobiac, Comment, I Came, I Saw, I Underwrote: D & O Liability Insurance's Past Underwriting Practices and Potential Future Directions, 14 Conn. Ins. L.J. 487, 512 (2008); see also Jun Sun Park, A Comparative Study of D&O Liability Insurance in the U.S. and South Korea: Protecting Directors and Officers from Securities Litigation, Chi.-Kent J. Int'l & Compar. L., Jan. 2010, at 15 ("[P]remiums have a weak influence on the net income of a corporation . . . ."). But see Baker & Griffith, supra note 26, at 534 (stating that average annual premiums "may be large enough to affect the behavior of some firms"); Willis Towers Watson, Insuring the Unprecedented Risks Facing Directors and Officers 3 (2018), https://www.wtwco.com/-/media/WTW/Insights/2018/07/2018-management-liability-d-o-us-survey-executive-summary.pdf?modified=20180718162312 [https://perma.cc/4AN4-3UQ2] (reporting that only 1% of respondent companies considered premium costs "not too important").

[94] Stephen Perreault, Does Disclosure of D&O Liability Insurance Policies Influence Investor Perceptions of Earnings Management?, 7 J. Forensic & Investigative Acct. 83, 83 (2015). Canada does require disclosure of D&O insurance information. M. Martin Boyer, Three Insights from the Canadian D&O Insurance Market: Inertia, Information and Insiders, 14 Conn. Ins. L.J. 75, 80 (2008). On occasion, scholars do obtain disclosure of D&O insurance information, see, e.g., John M. R. Chalmers, Larry Y. Dann & Jarrad Harford, Managerial Opportunism? Evidence From Directors' and Officers' Insurance Purchases, 57 J. Fin. 609, 615 (2002) (using proprietary sample of D&O insurance purchases). Scholars have found that the presence of insurance may communicate some information about unobserved litigation risk. See, e.g., Narjess Boubakri & Lobna Bouslimi, Directors' and Officers' Liability Insurance and Analyst Forecast Properties, 19 Fin. Res. Letters 22, 23 (2016). But this discovery does not leverage the insurer's private information, expertise, or skin in the game, so it is a weak signal quite distinct from the lofty ambitions of the gatekeeper theory.

[95] But see Rongli Yuan, Jian Sun & Feng Cao, Directors' and Officers' Liability Insurance and Stock Price Crash Risk, 37 J. Corp. Fin. 173, 190 (2016) (finding a positive governance effect of D&O insurance in China, in contrast to results for developed economies).

> prevention advice . . . [it is not] in any way binding on corporations, for example, by being made a condition of policy renewal.[96]

The most salient way to engage in monitoring is to learn about changes in risk and incorporate that information into underwriting decisions at renewal time. Insurers generally do not do this. Once a client is on board, the insurer does not check for slips in risk-control and governance quality on an ongoing basis.[97]

One easy way to acquire and use risk information on an ongoing basis is to just ask for it. As Kevin LaCroix (perhaps the leading commentator on contemporary D&O practice) explains:

> When new coverage or increased limits are being put in place, the insurer appropriately can ask the so-called "warranty question" – that is, whether the applicant is aware of any fact, situation or circumstances that might reasonably be expected to give rise to a claim. (The actual wording of the representation required varies among insurers and applications.) Any matters disclosed pursuant to the warranty statement will be excluded from coverage.[98]

The information disclosed could be used to set premiums, provide expert advice, or demand governance changes. Do insurers request this information when renewing policies? Only "sometimes."[99]

Nor do premiums adjust much in response to changing risks detected. Except for some increase in the years after a costly suit, premiums

[96] Tom Baker & Sean J. Griffith, The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer, 95 Geo. L.J. 1795, 1808 (2007).

[97] Id.

[98] Kevin LaCroix, D&O Insurance: Executive Protection – The Policy Application, The D&O Diary (Sept. 9, 2010), https://www.dandodiary.com/2010/09/articles/d-o-insurance/do-insurance-executive-protection-the-policy-application/ [https://perma.cc/F332-ANTL].

[99] Id. Interestingly, LaCroix thinks even sometimes is too often: "Because the policyholder is entitled to expect complete continuity of coverage in successive policy years, the warranty question emphatically is not appropriate in connection with the renewal of existing coverage." Id. But why is that not the case for other corporate insurance? And, if the market is well-functioning, why does the insured need continued coverage from the same insurer?

LaCroix's objection is based on an explicitly relational rationale. Selling insurance in one year entitles the customer to future years of insurance on similar, non-risk-adjusted terms. That is consistent with the thesis of this Article—that socially-inefficient relational contracts blunt the potential for insurer qua gatekeeper.

increase mostly in lockstep, reflecting market-wide insurance conditions.[100]

It is not like insurers are incapable of learning about and evaluating governance risks.[101] We know from the prior discussion of vetting that they have procedures for gathering information and they have identified certain categories of information worth discovering to build their initial pricing for a client. They just don't use these techniques on existing clients. The research methods they consider valuable when onboarding a client, and the information they consider probative, simply are not an important part of the relationship in subsequent years.

Apart from what vetting techniques they don't use to monitor, there is an even longer list of things they don't do with either new or existing clients. D&O insurers could, but do not, offer seminars in governance best practices.[102] They could lobby for legal changes that would protect clients and themselves from exposure.[103] Insurers could insist upon being

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[100] Baker & Griffith, supra note 26, at 531; Dain C. Donelson & Christopher G. Yust, Insurers and Lenders as Monitors During Securities Litigation: Evidence From D&O Insurance Premiums, Interest Rates, and Litigation Costs, 86 J. Risk & Ins. 663, 692 (2017) (authors' study examining "the ability of insurers and lenders to monitor securities class action litigation and respond through pricing" found that D&O insurance premiums "increase significantly" in situations where cases eventually settle but not when cases are dismissed).

[101] See supra text accompanying notes 90–91.

[102] Baker and Griffith describe some willingness to participate in governance-related conferences, but they emphasize that nothing was ever required of customers. Baker & Griffith, supra note 96, at 1810. Interviewees also told Baker and Griffith that they disseminate loss prevention booklets, but that these communications merely point out issues, rather than offering solutions or promising better prices to reward certain behavior. Id. at 1809–10.

[103] Compare Baker & Swedloff, Regulation by Liability Insurance: From Auto to Lawyers Professional Liability, 60 UCLA L. Rev. 1412, 1426–27 (2013) (noting that D&O insurers tend not to engage with public regulation) with Maura Calsyn, Kellan Baker & Topher Spiro, For the Insurance Lobby, Old Habits Are Hard to Break, Center for American Progress (Feb. 15, 2017), https://www.americanprogress.org/issues/healthcare/news/2017/02/15/415237/for-the-insurance-lobby-old-habits-are-hard-to-break/ [https://perma.cc/3LJ3-SHS3] (arguing that health insurers seek to influence laws in ways that lower their expected payments). And that is certainly the case for tort liability insurers who led the charge for "tort reform" in the latter part of the 20th century. Paul H. Rubin & Martin J. Bailey, The Role of Lawyers in Changing the Law, 23 J. Legal Stud. 807, 812 (1994) ("Insurance companies have also been relatively successful at lobbying for changes that benefit them, such as damage caps and statutes of limitation and repose.").

One possible exception to the absence of insurer voices in corporate law has been in regard to forum selection bylaws, where insurance companies played a role in litigating the *Salzberg v. Sciabacucchi* decision. 227 A.3d 102 (Del. 2020). The best explanation for this break is that it is the sort of legal chance that insurers and managers can both support. Boardroom Governance With Evan Epstein, Joe Grundfest: Without Luck, Nothing Good Happens, (May apprised of new risks for an insured, even if they arise mid-year, and some right to suggest loss-mitigating strategies, even before someone has sued. In principle, the insurer could even demand to review or preclear highly risky transactions.[104] Insurers could consult the growing empirical literature in both accounting and corporate governance on what reduces litigation risks for companies, and insurers could use this literature as a growing checklist for potential grounds for improvement.

Yet insurers do none of these things. Baker and Griffith's extensive research hinted at only a single case where an insurer's concerns about governance risk led it to insist that a client change its behaviors in any way.[105] Baker and Griffith conclude, "The participants in our study unanimously reported that D&O insurers do not offer real loss prevention services or otherwise monitor corporate governance."[106]

The list of potential risk-addressing strategies is limited only by the imagination. It does not follow that these monitoring ideas would be valuable. But the absence of any meaningful monitoring effort is suspicious, suggesting either that insurers are not looking for valuable monitoring opportunities or that they have looked and found all of them meritless. The next Section rules out the latter possibility.

### *D. Insurers Could Address Risk*

The fact that D&O insurers do little vetting and practically no monitoring is surprising and requires an explanation.

12, 2020), https://boardroom-governance.simplecast.com/episodes/without-luck-nothing-good-happens [https://perma.cc/G7K5-MSZH].

[104] This is obviously a speculative suggestion; I do not suggest that any D&O insurer is currently equipped to provide this function. Yet, given the strong association between mergers and shareholder suits, Matthew D. Cain, Jill Fisch, Steven Davidoff Solomon & Randall S. Thomas, Essay, The Shifting Tides of Merger Litigation, 71 Vand. L. Rev. 603, 604 (2018) ("In recent years, over 96% of publicly announced mergers have attracted a shareholder lawsuit, with many mergers attracting suits in multiple jurisdictions."); Jessica Erickson, The Lost Lessons of Shareholder Derivative Suits, 77 Wash. & Lee L. Rev. 1131, 1144–45 (2020) (explaining that in 2013 "nearly all mergers and acquisitions were challenged in court," a dramatic increase from 1999 and 2000 when only 10% of mergers were challenged), one might imagine that the insurer would want a seat at the table in deciding whether and how to engage a merger.

[105] Baker & Griffith, supra note 96, at 1808.

[106] Id. at 1799; accord Vanessa Finch, Personal Accountability and Corporate Control: The Role of Directors' and Officers' Liability Insurance, 57 Mod. L. Rev. 880, 908 (1994) (documenting relatively low levels of monitoring in UK insurers).

One possible explanation is that there is no monitoring they could do that would be worth the cost. Insurers may lack the ability to cheaply discover, price, control, and disclose risk. That is something like the explanation that Baker and Griffith come to:

> We explained the absence of loss prevention in D&O largely by reference to information asymmetry. Unlike fire prevention information, which is broadly generalizable, information on how a particular company might minimize the risk of shareholder litigation is idiosyncratic and in the possession of that company alone. It would be costly for an insurer to acquire the information, and the value of the information, if not broadly applicable across the insurer's portfolio, might not enable the insurer to recoup its cost.[107]

Yet it is implausible that insurers lack cost-justified ways to do any monitoring, in large part for reasons implicit in Baker and Griffith's own work: "The underwriters reported that they understood why we might think that they would be actively involved in corporate governance. Some even reported that they had tried."[108] One insurance executive they interviewed explained that their company tried in 2003 to conduct reviews in exchange for the potential for better terms or prices. The company was met with extreme reluctance by both clients and brokers.[109] If executives understand why risk control might be part of their job, and some executives even try to do that job, it seems unlikely that insurers lack modes of valuable active engagement.

Moreover, insurers undertake vetting of new clients,[110] which is consistent with them being able to spot trouble with would-be clients. It would seem implausible that insurers can spot warning signs ex ante, but that ability disappears at the monitoring stage. And it seems implausible that someone who can spot problems has no ability to counsel improvement. For example, some insurers care about the number of independent directors on the board and the nature of their independence.[111] If low independence matters enough to warrant a higher premium, the insurer could check the independence at renewal or insist upon more independence as a condition of coverage. The precise

[107] Baker & Griffith, supra note 96, at 1891.
[108] Id. at 1809.
[109] See id.
[110] See supra text accompanying notes 90–91.
[111] Supra text accompanying note 90.

implementation may require expertise, but there is every reason to think that insurers can play some role after the initial underwriting decision.

More generally, D&O insurers prove capable of discovering and pricing risk ex ante. It is only ongoing efforts to discover, price, control, and disclose risk that seem to elude insurers. Why should their talents end after the first period? Insurers use extremely affordable techniques to detect and price risk, such as asking potential clients to disclose pending claims.[112] They use these techniques on new clients but not on repeat clients. Low-hanging fruit goes unpicked.

Abstracting away from the details of D&O insurance, we can note that insurers in many other domains are quite able to perform these risk-addressing functions.[113] Consider some examples: insurers of police departments design training sessions, write guidebooks, monitor for problematic cultures, and drop clients who appear unwilling to improve their practices.[114] Fire insurers insist upon sprinklers and other loss prevention techniques to reduce fire risks.[115]

Insurers even monitor when they go to the cinema. When Nicole Kidman was cast in *Cold Mountain*, Miramax sought insurance against the possibility that Kidman's knee problems could interfere with shooting. Casting insurance companies were happy to help, but they wished to control their risk:

> [S]he agreed to wear a support bandage on her knee during the preproduction and filming of *Cold Mountain* . . . . For their part, the producers agreed to substitute a double for any activity, even bending down, that might stress her knee . . . .

[112] Supra text accompanying notes 98–99.

[113] Ben-Shahar & Logue, supra note 25, at 199–201; Shauhin A. Talesh, Insurance Companies as Corporate Regulators: The Good, The Bad, and the Ugly, 66 DePaul L. Rev. 463, 472–73 (2017); Victor P. Goldberg, The Devil Made Me Do It: The Corporate Purchase of Insurance, 5 Rev. L. & Econ. 541, 543 (2009); Haitao Yin, Howard Kunreuther & Matthew W. White, Risk-Based Pricing and Risk-Reducing Effort: Does the Private Insurance Market Reduce Environmental Accidents?, 54 J.L. & Econ. 325, 326–33 (2011).

[114] John Rappaport, How Private Insurers Regulate Public Police, 130 Harv. L. Rev. 1539, 1548, 1555, 1575 (2017). One particularly vivid example is an insurer that visits "cop bars" incognito to gather information. Id. at 1548.

[115] Andrew Verstein, Enterprise Without Entities, 116 Mich. L. Rev. 247, 266 (2017); see also Schwarcz, supra note 14, at 1281–82 (describing a property insurance policy that, likely because of the risk encouragement, includes an intentional loss provision which could exclude coverage for arson).

> Insurers may require periodic medical examinations during shooting, including testing for illegal drugs, or even continuous medical treatment for some actors. (Kidman, for example, was required to take daily doses of medicine for her thyroid gland.) They also place stringent restrictions on what actors can do off the set—no motorcycles, surfing, or flying planes. As for what happens on set, the insurer analyzes every shot in the script for potential risks. Once the production starts, they also station hawk-eyed agents, called loss-control reps, on location to make sure that the stars are not put in harm's way. If a shot presents the slightest danger of causing an injury that might delay shooting, the reps bar actors from participating in them. Either a stunt person substitutes for the actor or the shot is changed to eliminate the danger.[116]

Insurance companies demonstrate value-adding expertise in police procedure, architecture, the intersection of filmmaking and physiology, and myriad other domains. It is implausible that the determinates of shareholder litigation are entirely beyond them.

Another possible explanation for the absence of monitoring is that insurers have nothing to add that other professionals have not already added.[117] For risks that executives have misstated their financial statements, auditors are the clear experts. For risk of managerial misdealings, internal and external lawyers are experts fully capable of detecting and addressing risks. We could add other gatekeepers, such as investment bankers, to the list. For more general signs of good and bad governance, proxy advisors such as ISS have built a niche pressuring companies to change their practices with the threat of a negative ISS vote.[118] What do insurers know that these other experts do not?

[116] Edward Jay Epstein, Nicole Kidman's Knee: Or, How the Insurance Business Runs Hollywood, Slate (May 23, 2005, 7:21 PM), http://www.slate.com/id/2119328/ [https://perma.cc/78KW-BV4R].

[117] Griffith, supra note 81, at 1891 ("Moreover, D&O insurers have competitors for loss prevention and mitigation services . . . .").

[118] Elizabeth Ising, Ronald Mueller & Lori Zyskowski, ISS and Glass Lewis Issue Voting Policy Updates for 2022, Gibson Dunn (Dec. 13, 2021), https://www.gibsondunn.com/iss-and-glass-lewis-issue-voting-policy-updates-for-2022/ [https://perma.cc/62T9-KCG7] (summarizing the circumstances under which ISS will recommend "adverse" votes against directors and committee chairs); David F. Larcker, Allan L. McCall & Gaizka Ormazabal, Outsourcing Shareholder Voting to Proxy Advisory Firms, 58 J.L. Econ. 173, 178 (2015) ("Prior research clearly establishes a strong association between negative recommendations by proxy advisory firms and subsequent voting outcomes for management proposals.").

We have two good reasons to think that insurers have a structural advantage over other gatekeepers, at least some of the time, and thus could provide a complementary contribution.

First, insurers are unique among these gatekeepers in being residual claimants on the litigation risks they insure. When other gatekeepers decide whether to research and address a particular risk, they have only indirect, imperfect incentives to do so. Being an excellent risk spotter and fixer can garner prestige for an auditor, attorney, investment banker, or proxy advisor. But mischaracterizing a particular risk is often forgivable: third parties evaluating the gatekeeper's devotion and expertise cannot be sure whether the realized risk is one the gatekeeper could have addressed if suitably disposed. Likewise, bad gatekeepers face litigation risks, but there is no realistic possibility that they will pay 100% of what plaintiffs recover.[119] By contrast, insurers who shirk will realize stupefying losses. This has long been recognized as vital to the loss-controlling function insurers usually fulfill.[120] Loss-bearing can focus the mind of insurers to look for subtle gradations of risk and risk-reduction.

Second, insurers have access to non-public information not known to other gatekeepers. This is of two varieties. First, they have case-specific information by virtue of their engagement with litigation. 7.7% of securities cases settle before the complaint is filed.[121] The insurer is involved in those settlement negotiations.[122] Insurers have access to information about such a case by virtue of their involvement. This

[119] Auditors and investment bankers can be strictly liable for investors' securities losses in connection with an initial public offering ("IPO"), but the range of circumstances is quite narrow. Securities Act of 1933, Pub. L. No. 73-22, § 11, 48 Stat. 74, 82–83 (codified at 15 U.S.C. § 77k(a)(4)) (explaining that "every accountant . . . who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement" is liable under securities law if that part of the registration statement turns out to be false or misleading). No such hot wire exists for lawyers. Randolph P. Beatty & Ivo Welch, Issuer Expenses and Legal Liability in Initial Public Offerings, 39 J.L. & Econ. 545, 545, 551 (1996) (stating that, despite being involved at a later stage in the IPO process, attorneys are "held to lower legal standards" than auditors, and "law firms are typically exempt from Section 11 liability").

[120] See, e.g., Goldberg, supra note 113, at 543.

[121] Laarni T. Bulan & Laura E. Simmons, Securities Class Action Settlements: 2019 Review and Analysis, Cornerstone Research 14 (2020), https://securities.stanford.edu/research-reports/1996-2019/Securities-Class-Action-Settlements-2019-Review-and-Analysis.pdf [https://perma.cc/9EPH-D4BT].

[122] Baker & Griffith, supra note 8, at 798.

information is not publicly filed, so the insurer knows more than anyone, other than the lawyers litigating that case.

Second, insurers have important information about this firm and others arising out of the cross-section of all claims in which they are involved. Unlike outside counsel on a particular case, the insurer sees all of the litigation their client is involved in. And unlike inside counsel, the insurer sees all the litigation of all their clients. They may be able to spot warning signs and weak predictors of risk that cross many clients.

Given their distinctive incentives and information, it should be surprising if insurers are incapable of playing a role in monitoring.

To be sure, the fact that insurers currently do no monitoring bears on what monitoring they can do. If they do no monitoring today, they probably lack the resources to start doing so tomorrow morning. For example, typical D&O applications are pretty thin and yield rather little information.[123] So the application process rarely yields much more than what is gleaned through a few conversations with managers. But insurers could include more exacting questions in their applications if they wanted more risk information. As another example, insurers do not currently employ large staffs of investigators, lawyers, and accountants that are necessary to test risk control at clients.[124] But they could hire those experts if they found them useful in monitoring and wished to monitor.[125]

Present incapacity does not suggest that suitably motivated insurers cannot monitor, and the prima facie case for monitoring is strong. So, a mystery remains why insurers are nevertheless not interested in monitoring. It is to that mystery we turn in the next Section.

* * *

To summarize, the governance effect of D&O insurance includes both problem and promise. Insurance provides non-governance benefits, such as risk pooling that assures risk-averse managers that the job is worth taking at all. It is problematic in that it exacerbates moral hazard by immunizing executives against the consequences of their bad behavior and disposing them to settle (and thus encourage) even meritless lawsuits. If insurers do no monitoring and their vetting results in only the weakest pressure and most opaque price signals, it is no wonder that many

[123] AIG, PortfolioSelect Application, https://www.aig.com/content/dam/aig/america-canada/us/documents/business/management-liability/portfolio-select-application-for-public-companies-brochure.pdf [https://perma.cc/JXH8-55MK].

[124] Baker & Griffith, supra note 96, at 1835.

[125] Id. at 1836.

practitioners[126] and most scholars worry that D&O insurers may harm corporate governance.[127] While some call for radical change,[128] most of us take the bitter with the sweet. The next Part describes a recipe with different proportions.

## III. D&O HARMS GOVERNANCE BECAUSE OF HOW IT IS BOUGHT AND SOLD

The last Part identified a disappointing mystery: insurers who could plausibly take steps to address governance risks almost entirely decline to do so. This Part provides an explanation: addressing their client's risks is profitable only if clients stand ready to switch insurers when offered a better price. But if clients tend to stick with their existing insurer, whether because competing offers are rare or because the clients don't really care if a competitor offers a cheaper rate, then insurers have little reason to address client risks. To the contrary, they can profit by abandoning those costly vetting and monitoring efforts. Unfortunately, agency and transaction costs currently dampen clients' appetite for switching. Insurers accordingly lose the incentive to optimally address client risks.

This Part proceeds in four steps. First, Section A explains why insurance companies can prosper using either of two distinct strategies: a forward-looking approach that discovers, prices, and controls risk; and a backward-looking approach that simply tries to recoup past losses. Section B explains why the latter strategy tends to dominate when clients loyally retain their insurer. Section C shows that clients indeed loyally retain their insurer, and it explains why: managers prefer it this way and transaction costs run high. Section D considers and rejects alternative explanations. The takeaway is that long-term client relationships lodge business with the insurers willing to forgo socially-optimal efforts to address governance risk.

### *A. Distinguishing Active and Passive Insurance*

It is common sense that if you crash your car repeatedly, your insurance premiums will go up. But why? There are two distinct possible

[126] Evans, supra note 16, at 265 (quoting a D&O executive stating that "D&O insurance has little effect on managerial behavior").

[127] Baker & Griffith, supra note 96, at 1820–21.

[128] See Fox, supra note 21, at 288–89 (calling for an end to D&O insurance for certain securities violations).

explanations. One possibility is that the insurance company wants to charge you a premium commensurate with its future cost for insuring you, and each crash is data that collectively announces you as a costly risk. Every accident provides more information suggesting that you are the careless type.

Well, maybe not *every* accident. Sometimes accidents happen and the driver was not at fault. In fact, some accidents speak well of the driver. For example, forensic investigation of an accident might reveal that the driver had taken extreme care, the accident was a completely unavoidable fluke, and this prudent driver had in fact minimized the amount of damage due to her excellent reflexes. For an insurer trying to insure based on forward-going risk, the presence of that sort of accident should result in lower premiums, since the client has demonstrated that they are less risky than previously thought.

Yet we know that it's rare to get a premium reduction after an accident. One reason is that insurance companies may not price in a fully forward-looking manner.[129] They sometimes look backward, setting bills at a level that recoups their cost.[130] On this reasoning, the insurer concludes that it must impose higher premiums on the client in order to fill the hole that an insured's claim made in the insurer's balance sheet—even if the accident revealed nothing new about the riskiness of the insured.[131]

The former strategy, which attempts to ascertain future risk, can be called forward-looking underwriting.[132] The latter strategy, which instead derives prices based on past events (for their own sake, rather than as a proxy for the future), can be called backward-looking underwriting.[133]

[129] Another reason is that the investigation cost to distinguish good accidents from bad accidents may not be justified. And, of course, in some contexts, insurers may simply pool everyone together, without regard for their individual risk level.

[130] Donelson & Yust, supra note 100, at 692.

[131] On this approach, the insurer is basically providing a line of credit: in exchange for annual premiums, the client buys the right to receive a check at designated times with the understanding that they will pay back the money over some period of time.

[132] Underwriting means evaluating and accepting client risk in exchange for a premium. Underwriter, Black's Law Dictionary (11th ed. 2019); Jim Probasco, Underwriting: The Risk-Assessment Process Used in Everything from IPOs to Life Insurance, Insider (Nov. 17, 2021), https://www.businessinsider.com/what-is-underwriting [https://perma.cc/XE75-B996].

[133] These concepts are related to well-known insurance concepts. Forward looking is similar to "contingent" policy underwriting and backward looking is similar to "experience rated" underwriting. Ke Steven Wan, Gatekeeper Liability Versus Regulation of Wrongdoers, 34 Ohio N.U. L. Rev. 483, 493 (2008). I avoid using those terms because of the potential for conceptual confusion. Experience rating is often thought to be a rough method for pricing risk and, hence, a form of forward-looking insurance.

To see how these two strategies work, consider two simple numerical examples. Suppose that a certain director, in a given year, has a 5% chance of costing an insurer $20 million. In that case, the actuarially fair premium, the one that covers the expected costs of an insurer, is $1 million per year. An insurer who charges more than that will face aggressive competition. An insurer who charges less will become insolvent. Suppose also that a typical director is safer than this one, with only a 3% chance of making a claim. Suppose, finally, that this particular director realizes a $20 million claim, based on completely ordinary facts, in the first year of the relationship. What premiums will each insurance strategy dictate?

On the forward-looking insurance model, the insurer is likely to charge something like $1 million per year both before and after the claim. The insurer investigates enough to set an actuarially fair premium and then updates that premium only when it learns new things about the risk. Average clients can be expected to settle a big one every 20 years or so, and it is no inherent problem for it to come early on in the relationship. For every twenty new clients with that risk profile, one of them is likely to make a claim in the first year. It doesn't mean that the premium is too low on the forward-looking approach, any more than it is too high if a client celebrates a thirty-year arc with no claims.

A backward-looking insurer will charge a higher premium after a claim regardless of what the claim's cause is. The insurer may charge $600,000 in the first year, which is the actuarially fair rate for the typical director; the passive insurer cannot set a more appropriate premium because it does not vet the client to determine their individual risk level. After the accident, the insurer might charge, say, $1.02 million per year for the next 20 years afterward.[134] Then the backward-looking insurer and the forward-looking insurer will both have charged $21 million over 21 years, which is the actuarially fair rate for this director.[135] Once that cost is recouped, the backward-looking rate may drop again to $600,000.[136]

[134] Twenty years is chosen just for ease of exposition. Other periods would work just as well.

[135] $1.02 million times 20 is $20.4 million, plus the first period payment of $600,000.

[136] While the backward-looking approach would seem to predict frequent drop-offs in insurance premiums, with rates dropping close to zero when all claims are paid off, the reality may be smoother, with the insurer unable to fully raise prices in bad years and unwilling to fully lower prices once the claim is recouped. The same may be true for the forward-looking insurer who may raise prices every year but may be unable to raise them as much as they would like once new information finally arrives. See Woodruff Sawyer, Looking Ahead 2020:

These two underwriting approaches are hard to distinguish because they both end up charging risky clients more in the long run. Moreover, no real insurance company would be likely to use just one technique, nor to use it perfectly.[137] In reality, insurance companies would like to use both forward- and backward-looking pricing to obtain the highest price the market can bear. Both will raise rates when they can, even if risk or loss have not increased, and both will face competitive limits on abrupt increases they might otherwise seek to impose. But keeping the distinction in mind is useful for clarity of thought.

We have discussed discovery and pricing, but insurance can also involve risk control. And here too, distinct strategies can be imagined. One approach seeks to reduce moral hazard. For example, an insurer might require that the insured maintain its current risk profile; it might offer training to employees on risk-reduction practices; it might monitor the insured to see if it is suddenly taking risky actions. Without these actions, the customer could increase their riskiness so that an initially fair premium is now too low.

Another option is to let the insured run wild with moral hazard, increasing their risk every year, but simply chase the risky behavior with ever-increasing premiums. If an insured begins with a 5% chance of causing a $20 million problem, such that the fair premium is $1 million, the insurer could monitor in such a way as to keep the risk at 5%. Or the insurer could allow the risk to rise to 6%, 8%, or whatever—but keep a tab so that they ultimately charge the client a fair premium.

The former approach, which involves monitoring and constraining moral hazard, can be called *active* insurance. Active insurers take rational efforts to discover, price, and control risk.[138] The latter approach that does

D&O Considerations for the Next Calendar Year 8 (Priya Cherian Huskins ed., Sept. 10, 2019), https://woodruffsawyer.com/do-notebook/2020-looking-ahead-guide-do-insurance-trends [https://perma.cc/6QCN-WQF6] (reporting that 1% of insureds saw premium decreases in 2019, compared to 38% with keeping their rate—consistent with a norm of never giving back absolute premium levels). The preference for smooth, steady increases is important, but it does not apply to one pricing strategy more than the other.

[137] If the insured is in fact the risky type, both insurers could raise their rates, though the mechanism would be different. The forward-looking insurer would have to conclude that this accident proxies for a riskier-than-average client. The backward-looking insurer wouldn't make that determination, but the client's greater risk would tend to cause subsequent claims, each of which added to the implicit bill.

[138] We have not discussed disclosure, but active insurance also entails the potential for a socially-useful disclosure. If an active insurer greatly increases its premium, rational third parties should take notice. The insurer is increasing it based on something it expects about the

not seek to reduce moral hazard, only to be eventually compensated for it, can be called *passive* insurance. Passive insurers do little vetting or monitoring. Thus, the forward-looking, active insurer exemplifies the risk-addressing practices of risk discovery, pricing, and control. The backward-looking, passive insurer forgoes them. If we prefer active insurance for its tendency to address risk at client corporations, we should look for the market conditions that support it. The next Section does just that.

### *B. Switching as Necessary for Active Insurance*

Both active and passive insurance are viable business models, depending on market conditions. This Section describes the necessary market conditions for one to prevail over the other: whether clients ditch insurers who seek to charge more than the actuarially fair rate, which is to say whether the market exhibits competitive switching.

Forward-looking, active underwriting is costly to provide since the insurer must invest money to determine the client's risk profile at any given time and monitor for continued risk quality. These efforts may be well worth it if clients shop around for the best rates. In that environment, addressing risk lets the insurer avoid losses that would otherwise go unrecouped and compete for business by offering low rates to the safe clients.

For example, an insurer might expend effort determining that a given client has a 5% chance per year of making a $20 million claim, set a premium of $1 million per year, and stipulate that the client cannot change its accounting method without the insurer's permission (a signal of risky accounting hijinks) and that the insurer controls all litigation (thus reducing the highest lawyering bills and the tendency to settle meritless

present and future of the client. The premium has information content. It says that an expert with access to non-public information has become worried about this corporation and its managers. Even stronger signals can come from dropping a client or imposing conditions and exclusions. By contrast, passive insurers can send the muddiest signal to third parties. An increased rate might indicate that the client has incurred a loss, which the insurer must now recoup. This information would rarely transcend the public record. Whether this loss was the good kind, the bad kind, or just a fluke is left unstated. It is impossible for stakeholders, like investors and creditors, to make any use of such information or infer anything about present risk levels. See Griffith, supra note 5, at 1203 (arguing for mandatory disclosure of D&O policy details that would provide a signal of the firm's governance quality); Sean J. Griffith, Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' & Officers' Liability Insurance Policies, 154 U. Pa. L. Rev. 1147, 1174 (2006).

but annoying suits). The forward-looking insurer has an incentive to perform these tasks because failure to do so would expose the insurer to uncompensated losses. If the premium is set too low, there will be no opportunity recoup the losses later. That is because if the premium is ever set too high, the insurer will lose the customer to another insurer.

The contrapositive can be said of backward-looking, passive insurance. The downside of this approach is that the insurer will often be behind the curve, paying out a claim and hoping that it will have the chance to recoup the losses from the client. If the client switches insurers without paying back the loss, the backward-looking insurer has no recourse.[139] Clients whose rates go up merely because of a claim (which must be recouped), rather than because of increased risk (as proxied for by the claim), may be tempted to switch insurers if only because a forward-looking insurer will offer them a cheaper, risk-based rate.

Yet if clients do not actively switch, then backward-looking insurance is at an advantage, because it can provide insurance without including any cost for addressing risk. The backward-looking insurer has little need to engage in ex ante risk discovery and pricing. The insurer can take on nearly any client, potentially with a very low initial premium, since it is able to recoup losses from the client later. Adverse selection does not bother the insurer; if the riskiest insureds flock to it, the insurer will amortize each insured's high cost out over years of future business. At the limit, it is not worth *any* vetting expenses since the appropriate premium will be determined for free with time anyway.

Nor would the rational backward-looking insurer impose significant covenants on the client to control moral hazard. Why prohibit the corporation from taking risky actions? These risks will lead to costs for the insurer but also an offsetting of revenue as the client pays off their implicit debt over time. If a client is insensitive to price, it is desirable for insurers to sell them more coverage rather than less.[140]

[139] The insurer cannot just raise their average rate to all clients without succumbing to a death spiral of adverse selection. The higher average rates will appeal only to the worst insureds, who will make a costly claim and then switch insurers.

[140] There are other advantages to a client who becomes riskier every year. The bigger the volume of cashflows from a client (claims out, premiums in) the more options the insurer has to sell cashflows to third parties. Recall that reinsurers take much of the risk coverage from the primary insurer, and new markets for securitization of risk are born every day. See Tom Baker, Uncertainty > Risk: Lessons for Legal Thought from the Insurance Runoff Market, 61 B.C. L. Rev. 59 (2021); Lawrence A. Cunningham, Securitizing Audit Failure Risk: An Alternative to Caps on Damages, 49 Wm. & Mary L. Rev. 711 (2007). Insurers that can make

Backward-looking insurers have no need to monitor. The only thing relevant to current premiums is the list of outstanding claims the insurer is currently recouping. If the client wants to shift into riskier activities and multiply the chance of large claims, so be it. The insurer will just charge even higher recouping premiums later. A client who responds to moral hazard by doubling her level of risk-taking doubles her expected cost to the insurance company, but that is no reason for the insurance company to restrain the client—as long as the client will tolerate a doubling of premium in the years to come. The same is true of litigation decisions. So long as the insurer can recoup its losses, it will not scrutinize the bill the client's lawyers charge nor the plaintiffs who assail them.

Thus, backward-looking insurance is cheaper to underwrite, but it is threatened by opportunistic switching by insureds. If insureds frequently switch insurers in search of lower prices, then forward-looking insurance may dominate backward-looking insurance. But if insurance relationships are sticky and insureds are not very price sensitive, backward-looking insurance may dominate forward-looking, if only because of its lower cost. Thus, the relevant prevalence of forward-looking and backward-looking insurance is a function of activity costs and the competitive landscape.[141]

### *C. Agency and Switching Costs Stunt Switching*

Several factors suggest that the balance of insurance may be biased in favor of passive, backward-looking insurance, to the determinant of the public. Passive insurance tends to prevail where insureds rarely switch insurers in search of a better price.[142] Several features of the D&O market make competitive switching rare. The most important and distinctive is the prevalence of agency costs.

money reselling the risks they insure will appreciate a greater portfolio of originations, in the same way that large banks building mortgage securitizations were pleased at greater volumes of home loans (even at lower quality than average).

[141] Agency costs within the insurer could also affect the relevant prevalence. It is possible that underwriters might try to obtain lots of clients by offering low rates, or with minimal effort in vetting, in order to look like a great salesperson without much work. That would tend to urge backward-looking underwriting. But this Article does not assume any such agency costs in insurers and instead presents two strategies that can be rational from the insurer's point of view.

[142] See supra Section III.B.

Managers directly decide which insurance their corporation buys.[143] As this Section will explain, managers tend to prefer passive insurance because it offers them numerous benefits.

Passive insurance affords managers greater freedom. Passive insurers make no effort to control their losses—they know they can always recoup claims later—so they leave managers a free hand to run the business and litigation however they wish. They do not impose restrictive covenants on insurers.[144]

Passive insurers also blunt signals of managerial error and wrongdoing. If managers run the business in a way that draws frequent lawsuits—whether by gross negligence, self-dealing, or just a willingness to settle frivolous claims—it will result in higher premiums, but the timing differs crucially. Forward-looking insurers, who actively vet and monitor, will set higher premiums *now*. Backward-looking insurers will raise premiums *later*. The later rise in premium may come at a time when the managers have collected contingent pay and left the firm. A manager could tolerate inaccurate accounting, collect a bonus based on high earnings, and retire long before a settlement requires a costly payment and a restatement of earnings.

Even if the manager remains, it is less likely that the signal will place blame squarely where it is due. If a board endorses a legally problematic transaction, and this immediately results in much higher insurance premiums or a loss of the insurer altogether, there is a chance that some stakeholder will point the finger at the board.[145] That is particularly true if the rise in premiums coincides with a costly settlement. But if the settlement can be delayed a few years, and the premiums rise only after that, it may be quite unclear to casual observers who exactly has run up the company's costs.

Managers' greater freedom and lesser accountability under passive, backward-priced insurance has costs. The corporation will tend to pay higher rates, as managers pass the cost of unchecked bad governance on to future shareholders; and society may be harmed when its largest

[143] Cf. Willis Towers Watson, supra note 61, at 6 (reporting high levels of insurance mandates by directors and managers and less than 10% mandated by shareholders—of a set that includes private companies, where shareholder mandated insurance is more common).

[144] See supra Section II.C.

[145] There is no obligation to disclose the loss of an insurer or an increase in rates, but information sometimes leaks or is voluntarily disclosed. See, e.g., Tesla, Inc., Annual Report (Form 10-K/A) 30 (Apr. 28, 2020). And insurance information can appear indirectly, as when a premium impacts net earnings.

institutions are mismanaged. But managers, not stockholders or society, decide whether to shop for new insurance.[146] Managers have the power to keep the insurer they prefer, who practices passive insurance, rather than actively shopping for the cheapest and most effective active insurer.

Rational shareholders would anticipate this and hold managers accountable if they observed inexorably rising insurance premiums and no effort to shop for other providers. But shareholders do not observe anything because insurance coverage information is not subject to mandatory disclosure.[147]

Honest managers would rationally trumpet their low insurance costs.[148] They would also brag about how aggressively they shop for new insurers, foreswearing opportunities to build a cozy relationship with an existing insurer. Stakeholders could infer from silence that the non-bragging managers were engaged in self-serving insurance conduct.

Yet, such bragging does not occur. Perhaps it is because it is costly for shareholders to separate out the cheap talk.[149] Managers who obtain low rates after frequent changes of insurer may be selecting subtly less protective policies, which will fail to protect the company. Recall that the typical D&O policy bundles three types of coverage, one of which is squarely protective of the corporation.[150] Bad managers could obtain cheap insurance by hollowing out that third coverage. Nor do stakeholders necessarily draw negative inferences from rising premiums and infrequent changes in provider. Given the competitive environment as it exists, with major barriers to competitive switching, almost all firms—good and bad—will display the same behavior. Plus, honest managers' announcements of low rates and frequent changes of insurer will mean little without context; but other firms do not disclose the details of their

[146] Cf. Willis Towers Watson, supra note 61, at 6.

[147] See generally Griffith, supra note 5, at 1198 ("[T]he SEC requires only that the existence and 'general effect' of D&O insurance policies be disclosed.")

[148] Cf. Asaf Eckstein & Gideon Parchomovsky, Toward a Horizontal Fiduciary Duty in Corporate Law, 104 Cornell L. Rev. 803, 851 (2019) ("A corporate officer or director who was found liable by a court and sought payment from her insurance company for the damages she was ordered to pay will see her premium go up precipitously. This, in turn, will make her less employable relatively as the cost of hiring her would be higher relative to candidates with a clean record.").

[149] And, of course, shareholders suffer from a well-known collective action problem in informing themselves and taking action. Items like insurance premiums may be too small to organize them. See Lucian Arye Bebchuk & Jesse M. Fried, Executive Compensation as an Agency Problem, 17 J. Econ. Persp. 71, 72–74 (2003).

[150] See supra note 61 and accompanying text.

insurance practices, so shareholders will lack the benchmark to appreciate the virtue their managers have displayed.[151]

Managers benefit from passive insurers and so have an incentive to dampen the corporation's reception to competing offers. One reason managers can do this is that rare switching is overdetermined and managers can point to numerous transactional problems with competitive switching.

First, as in all insurance markets, adverse selection insulates incumbent insurers against active competition. No matter how much vetting a new competitor contemplates, the existing insurer knows things about the client already. If a corporation seeks a lower rate from a new insurer, the potential competitor must ask whether the existing rate may already reflect the risks the client poses. The competitor must spend money vetting the insurer and still faces the risk they will overlook risks that it takes years of relationship to spot. Plus, if the competitor accurately detects that a lower rate is justified, the incumbent insurer can always offer to match it. They will only decline to do so when the competitor has made a costly mistake. Knowing all this, competitors tread lightly.

Second, D&O contracts are not standardized, so it is difficult for insureds to obtain apples-to-apples competing offers.[152] One insurer's lower price may result from differing terms in her standard contract, which must then be dickered to match the insured's ideal coverage. Both sides must do a lot of commensuration to figure out whether there is a cheaper deal available elsewhere.[153]

Third, competing insurers must build a tower of reinsurers to take some risk relating to the new client. That task can be difficult. It requires the assistance of brokers,[154] who may not themselves vigorously advocate for competitive pricing. The broker's role is often to build trust between

[151] This goes to the general point that disclosure has positive externalities. One firm's earnings disclosure both tells investors about that firm and about other firms, which can now be scored comparatively. See Merritt B. Fox, Civil Liability and Mandatory Disclosure, 109 Colum. L. Rev. 237, 253–54 (2009).

[152] Baker & Griffith, supra note 26, at 506.

[153] If rotations were commonplace, parties would have incentives to conduct their affairs more modularly. Bespoke contracts are perfectly sensible in a world of long-duration insurance.

[154] Baker & Griffith, supra note 26, at 506.

parties, in ways that facilitate relational contracting,[155] rather than to aggressively push one party to shop around.

Additionally, brokers are paid as a percentage of the premiums paid.[156] This biases them against aggressive shopping, since such shopping lowers premiums and could even result in the client shopping around *for brokers*. Relatedly, the degree of concentration in D&O insurance is relatively high, with five companies dominating the market.[157] It may be hard to obtain a competitive quote in such an oligopolistic environment.[158]

Fourth, changing insurers creates difficult questions of which insurer is liable for an event. This produces consequences stretching out in time, which create transaction costs. For example, imagine that XYZ Corp's managers engage in wrongdoing while insured by Alpha, report pending litigation while insured by Beta, and then settle the case while insured by Delta. Who pays for the settlement? These questions must be settled by contract. These contracts either require the risk-bearing insurer to accept risks it does not understand (for example, if Delta agrees to pay any eventual settlements, despite not having been involved in the litigation discussions while Beta was the insurer; or Beta agrees to pay any settlement costs, despite no longer receiving premiums from client) or else the customer must fully explain the situation to the risk-bearing insurer (for example, the managers explaining to Beta that they have undisclosed sins, from before, which they plan to address with a settlement later). Either option may be undesirable and negotiating the details could be costly. In a world where no one changes insurers, these problems do not occur. In a world where only a few people change insurers, the few changing firms bear the cost of breaking ground on good hand-off procedures.[159]

[155] Cf. id. (describing the broker as "a trusted intermediary to convey information between buyer and seller").

[156] Pike, supra note 57; see also Mark Roellig & Tim Burns, Preparing for the Worst: D&O Protection and the Major Corporate Lawsuit, 2011 ACC Docket 32, 39 ("Insurance brokers are hired in connection with D&O insurance purchases, and they are paid 8-12 percent of the cost of D&O insurance – often hundreds of thousands of dollars for large corporations."); Broker and Independent Agent Compensation, supra note 57.

[157] See supra note 56.

[158] On oligopoly, see Richard A. Posner, Oligopoly and the Antitrust Laws: A Suggested Approach, 21 Stan. L. Rev. 1562, 1564 (1969). To read more on competitive pressures in insurance pricing, see Baker & Griffith, supra note 26, at 531.

[159] The typical insurance contract stipulates that the insurer pays only for expenses that are spent while with a client and regarding matters that came to the client's attention while insured. This is called a "claims-made" policy. Michael Sean Quinn & Andrea D. Levin, Directors'

For all these reasons, we should predict that D&O insurance markets involve rather little competitive switching and rather little active insurance. The evidence bears out these predictions, as the next Section indicates.

### *D. There Is Very Little Switching*

Customers dance with the one that brought them. Aon's D&O Pricing Index from 2013 through 2018 show primary policies renewal with the same carrier at rates between 93.2 to 95.7%.[160] Given the infrequency of changes to carrier-insureds' relationships, "the policy holder begins to look more like a regular customer at a local retailer."[161] The little switching that occurs does not appear to greatly benefit the switching insurer: in 2018, corporations that retained their insurer experienced a 2.9% increase in premiums, while those who switched instead experienced a 1.9% increase.[162]

Market participants on both the supply and demand side are willing to admit that the competitive environment has little impact on prices. Insurers seem not to pay their underwriters based on the profitability of the client, which is consistent with a passive insurance model.[163]

In a recent survey of D&O customers, just under one-third of respondents attributed pricing outcomes to competition (among

and Officers' Liability Insurance: Probable Directions in Texas Law, 20 Rev. Litig. 381, 457 (2001). So the hypothetical insured in this paragraph might receive coverage from Beta, if the insured told Beta about the suit before ending the insurance relationship. In the real world, there is a risk that Beta would argue that XYZ had failed to disclose a known prior claim when buying Beta insurance and so would dispute coverage. Or management might fail to disclose the nature of the litigation to Beta before migrating to Delta, which could then dispute coverage. The typical solution to arguable policy gaps is for the insured to buy from the outgoing insurer (Beta) a "tail" coverage, paying a lump sum to cover the long-term consequences of a specified legal action or category of legal action. Id. at 458. Insurers are reluctant to sell these tails because they require speculative estimations of future loss, with accordingly difficult efforts to set aside losses. Tails are also called "extended reporting periods." Id. at 468.

[160] See sources cited supra note 15.

[161] Hazel Beh & Jeffrey W. Stempel, Misclassifying the Insurance Policy: The Unforced Errors of Unilateral Contract Characterization, 32 Cardozo L. Rev. 85, 121 (2010). Note that Beh and Stempel were not discussing D&O insurance specifically.

[162] Aon, Quarterly D&O Pricing Index – Fourth Quarter and Full Year 2018, at 9 (2018), https://www.aon.com/getmedia/20bfac85-dce6-4902-91cb-c61265abcd7e/2018-Q4-DO-Pricing-Index.aspx [https://perma.cc/XP8Y-8PN7].

[163] Dobiac, supra note 93, at 502–03.

insurers).[164] Instead, customers candidly admitted that pricing often matters less than their preference for a long relationship with the insurer. Ninety-five percent of customers in a recent survey stated that "Carrier consistency/relationships" would be a top priority for them in the coming years.[165] That is a higher percentage than "Contract (contract certainty, contract readability)" and "Carrier financial ratings."[166] And it comes close behind "Carrier claim-paying reputation" and "Coverage breadth (Even if it costs more)."[167] Caring more about a longstanding relationship in which the insurer is willing to pay claims (even if the coverage costs more) is consistent with a relational contract to the mutual benefit of managers and backward-looking, passive insurers.

### *E. Explaining Why Insurers Do Not Address Governance Risk*

The argument of this Section is that the power of insurers to act as gatekeepers depends on them having a forward-looking, active business model, and such a business model requires customers who are willing to reward active insurers with their business, but that managers do not want to be subjected to active insurance and find it easy to beg off undesired suitors given obstacles in the competitive landscape. The takeaway message is that insurers lack the incentive to play gatekeeper but only because of flawed background conditions. Changing those background conditions is the subject of the next Part.

But first, there are other possible explanations for why insurers do so little to address client risk. One we have already discussed: the notion that insurers may have nothing to contribute.[168] Kevin LaCroix offers another, arguing that active insurance is hindered not by the absence of competition but by an excess of it:

> It might be possible for a D & O insurer to insist on corporate governance reforms if the insurer could offer demonstrable insurance cost savings for qualifying companies, but the reality is that the D & O insurance sector has been and remains so competitive that it is impossible to show cost savings. There is always a competitor willing to offer the same or similar coverage at the same (or better) discount,

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[164] Willis Towers Watson, supra note 61, at 10.
[165] Id. at 13.
[166] Id.
[167] Id.
[168] See supra Section II.D.

> and so companies who might otherwise accept their insurer's loss prevention requirements have little monetary incentive to do so.[169]

But this explanation is problematic. If competitive pressures cause insurers to lower their costs, they should be desperate for loss prevention techniques, whether to protect their margins or to offer still-lower prices.

At a higher level of abstraction, one might wonder whether vetting and monitoring are dampened by deeper features of the insurance environment. Canonical models of insurance recognize the possibility of pooling equilibria in which insurers make little effort to differentiate among their clients, and instead treat them all quite similarly.[170] Without purporting to show that such a model cannot possibly fit, I do think there is reason to doubt this objection. First, many such canonical models require insurers to ration coverage, either in the form of deductibles or lower caps than clients would prefer.[171] Yet such limits are unknown for Side A insurance.[172] Directors and Officers benefit from policies without any deductible and with caps that run high enough to fully cover their claims.[173] Second, the real world includes some measure of vetting by insurers, which is inconsistent with full pooling.

Perhaps other explanations are possible, but a good explanation for the low level of competitive switching and the low level of insurer monitoring is that the former causes the latter, and this is largely caused by self-protective managers to the detriment of the corporation and society.

[169] Kevin LaCroix, Why Aren't D & O Insurers Better Corporate Governance Monitors?, The D&O Diary (Dec. 3, 2006), https://www.dandodiary.com/2006/12/articles/d-o-insurance/why-arent-d-o-insurers-better-corporate-governance-monitors/ [https://perma.cc/3988-Y2JT].

[170] See, e.g., Michael Rothschild & Joseph Stiglitz, Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information, 90 Q.J. Econ. 629, 637 (1976). Note also that the Rothschild and Stiglitz model doesn't always predict pooling: it often predicts separation or no equilibrium at all. Id. at 634, 637.

[171] Id. at 629 ("In the insurance market . . . sales offers . . . do not specify a price at which customers can buy all the insurance they want, but instead consist of both a price and a quantity . . . .").

[172] See Bernard Black, Brian Cheffins & Michael Klausner, Outside Director Liability, 58 Stan. L. Rev. 1055, 1085 n.99 (2006) (explaining that almost no D&O policies include deductibles).

[173] Id. at 1059–61 (finding only 13 cases since 1980 in which directors had to pay out of pocket). Side B and C coverage often includes deductibles or retentions, but the purchasers can be assumed to be risk neutral or nearly so. And if "individuals are risk-neutral, it never pays to pool." Rothschild & Stiglitz, supra note 170, at 637.

## IV. IMPROVING GOVERNANCE THROUGH MANDATORY INSURANCE ROTATION

Insurers can operate their business in a way that creates positive or negative governance externalities. The managers of their client corporations prefer the latter. As it stands, insurers too often give them what they want. This Part describes a solution: allow insurer and insured to work together for just five years and then move on. The imposition of mandatory rotation would destabilize the relational contracting upon which the current passive insurance model relies. It would cause active insurance to rise in salience and profitability. Section A describes the basic plan and why it will work. Section B draws on analogies to other domains of law where mandatory rotation serves a similar purpose. Section C describes further details of the proposal. Section D address several objections.

### *A. The Plan of Rotation*

Where clients are retained forever, passive insurance dominates active insurance. That is because the insurer can always recoup its costs by amortizing claims across a future period. The passive insurer is assured a fair return on its capital, and it need spend nothing vetting or monitoring.

Active insurance comes in a distant second because it expends resource vetting and monitoring but gains no advantage by it. It can charge an actuarially fair price earlier on and impose risk-controlling conditions, but those steps do not actually provide a comparative advantage if clients accept supra-competitive premiums later on. And along with those costs come risks: a forward-looking underwriter can err. If they underprice risk, they never can recover the loss.

With lower cost, lower risk, and better resale options, passive insurance dominates—but only insofar as clients stick around forever.

In the real world, clients do not stick around forever. There is always the chance the client takes their business elsewhere, or goes out of business, or gets acquired. At least some insurers must use some amount of forward looking underwriting and active insurance.

At present, the proportion of forward-looking insurance is unfortunately low, because insureds engage in little switching. If switching could be increased, active insurance could be increased. One way to increase switching is to tackle the causes of stickiness: agency and transaction costs. But those interventions are hard to do—law and scholarship have been focused on lowering agency costs at big corporations for a hundred years,[174] and it is not easy to improve liquidity in as complex a market as insurance—as the proponents of the Affordable Care Act have both argued and discovered.

This section proposes cutting the Gordian knot by just requiring more switching.

Under a mandatory rotation rule, public companies and their managers could retain a given insurer for no more than five years in a row. At the end of the five years, they must part ways. This intervention will make passive insurance vastly less attractive relative to active insurance.

Consider the hypothetical passive insurer, who offers the client a $600,000 per year policy and then hopes to recoup any losses ex post, in a backward-looking fashion. Let us continue to assume that the actuarially fair premium is $1 million, since the client poses a 5% chance each year of incurring a $20 million claim. Consider the insurer's options for recouping over a number of different timelines, comparing the status quo and under the proposed regime.

At present, the insurer is free to recoup a $20 million claim over a long window—say, 20 years—resulting in a low $400,000 per year increase in premiums.[175] The cost of passive insurance will be lower to the client at many periods than the actuarially fair rate of $1 million charged by the forward-looking insurer, particularly early in the relationship, so even price sensitive clients might appreciate it.[176] In later periods, the insured will have a tab reflecting multiple claims, so it will come to cost more than forward-looking insurance, but inelastic insurance buyers may be willing to accept these later costs in service of the relational contract.[177]

With forced rotation, the insurer must recoup its loss much more quickly. For example, if the loss occurs right away, the insurer has five years to recoup its loss and must charge $4 million per year ($20 million divided by 5). Losses later in the cycle result in even steeper rises, and a

[174] See, e.g., Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 1–9 (Macmillen 1933) (arguing that the separation of power and control allowed managerial agents to act in ways that their shareholder-principals would not approve).

[175] The pre-loss premium was $600,000. Over 20 years, that amounts to $12 million. That leaves $8 million more to recoup over the 20-year period.

[176] For this discussion, I ignore the greater operating costs of passive insurance and the time value of money. Both complications are simple to add, but they do not illuminate the main issues.

[177] Indeed, it will cost much more if passive insurance leads to moral hazard. I leave that aside to illustrate the main point.

loss in the last period cannot be recouped against the client. The following table describes the premium a rational insurer would charge using forward and backward underwriting, the percentage increase in premiums a backward insurer would have to impose to recover its costs if a claim occurred at a given time, and a comparison of the adjusted cost of backward-priced underwriting relative to forward-priced insurance.

**Table 1: Comparison of Effect of Claim on Premium for Two Underwriting Models**

| Years Left | Forward Premium | Backward Premium | Increase in Backward Premium | Backward Compared to Forward |
|---|---|---|---|---|
| 20 | $1 million | $1 million | 67% | 100% |
| 5 | $1 million | $4 million | 567% | 400% |
| 4 | $1 million | $4.85 million | 708% | 485% |
| 3 | $1 million | $6.267 million | 944% | 627% |
| 2 | $1 million | $9.1 million | 1,417% | 910% |
| 1 | $1 million | $17.6 million | 2,833% | 1,760% |
| 0 | $1 million | $0.6 million | 0% | 60% |

This pricing structure makes it much more difficult for the parties to establish and maintain a relational contract, because it gives both parties ample reason to engage in defection. Consider a few of the pressure points.

First, the insured will have mounting incentives to change insurers when a large premium increase is applied. An insured who makes a claim in the second year of its relationship has four years remaining. The insurer will amortize the $20 million claim over those four years, raising the premium from $600,000 to $4.85 million—a single-year increase of 708%. At that time, her passive insurance premium will be nearly five times the prevailing rate in the active insurance market. Agency costs and transaction costs make insurance customers somewhat inelastic, but it will be tempting for customers to jump ship at those prices. Even complicit boards will find it hard to justify numbers at that scale, which may be large enough to impact net earnings. Insofar as one unspoken purpose of passive insurance is to spread the cost of settlement over a number of periods, to diffuse the effect of a single large settlement on managers' contingent pay and reputations, that purpose is almost completely thwarted by rotations. A claim right before the last renewal will be fully recouped with the final premium payment, setting a charge exactly equal to the legal expense defrayed. Mandatory rotations both put greater pressure on managers to responsibly shop for active prices and defeat managers' private benefits from passive insurance.

For both reasons, insurers must fear that their clients will enjoy low-early period premiums and then find a new insurer just after filing a claim. Fearing that clients may defect after making a claim, insurers gain their own incentive to defect by actively addressing risks. Knowing that it may not be compensated by higher-than-competitive premiums after a claim, insurers gain an incentive to detect and price expected risks now. They also can try to control the risks, reducing the number and size of claims. For example, an insurer might dispute the settlement of a frivolous lawsuit recognizing that a victory in that matter could prolong the underlying litigation but save the insurer's money.[178] The insurer might also conduct its own governance analysis to spot governance problems, or consult third-party governance monitors, and impose conditions on coverage that are intended to reduce problematic activity. The passive insurer defects by switching into active insurance—to the consternation of the constrained managers but to the benefit of the corporation and society.[179]

The insurer's incentive to defect into active insurance is even stronger after the last premium has been paid. At that point, the insurer has no hope to recoup losses from future premiums and nothing to lose by displeasing managers with aggressive oversight.[180]

[178] Since most insurers are not purely passive or active, we already observe insurers ready to resist generous settlements. Indeed, the pattern of resistance often observed is precisely what this Article could predict. Passive insurance is largely a product of agency costs, in which managers implicitly agree to reward insurers for neglecting their own self-protective instincts. Where agency costs are lower, there is no such subsidy and ordinary self-protective efforts can be expected. Settlement negotiations that have no serious shot of leading to stressful and embarrassing depositions impose no cost on managers, so managers will not predictably spend company money to shorten them.

[179] Conceivably, an insurer might even take steps to signal mounting problems to other actors, such as creditors, who could act to right the ship.

[180] An insurer that does not adopt a fully risk-adjusted price in the final period will make losses in expectation. Those losses must be recouped from other contracts—resulting in a higher average cost of administration. That $600,000 initial premium figure would grow. On this model, one out of every five clients will claim $20 million in the final period. If an insurer

Relational contracts rarely work in games with a limited number of rounds.[181] Cooperation is impossible in the final round when both parties can gain by betraying the other's goals. Anticipation of that final round defection can cause cooperation to unravel, leading to self-interested behavior in every round. In many contexts, we lament this unraveling, and we provide formal contracts to help re-establish trust and cooperation.[182] But in D&O insurance, unraveling causes a socially optimal result: insurers do their job in vetting and monitoring, and insureds respond by price-checking and improving their governance quality.

### *B. Analogies*

The core intuition of this proposal is that rotation can serve to destabilize socially undesirable relational contracts in D&O insurance. This idea is not without precedent elsewhere. In fact, mandatory rotation is used in other areas of private and public law to precisely the same end: disrupting pernicious relational contracts.

#### *1. Audit Partners*

Auditors examine the financial reporting of companies so that investors and the public can be confident that the company is operating as promised. Auditing is of great public importance because it encourages capital formation with the investments of the public and protects those investments from mishandling.[183] Auditing also contributes to corporate governance because accurate financial statements reveal problems, which shareholders and creditors can take into account in their benefaction

charged only $600,000 in the early periods ($3 million over the full five years), the insurer loses $17 million on net, which must be recouped across future contracts. Spreading a $17 million loss across twenty clients means $850,000 per client. That is the equivalent of almost a full year's actuarially fair insurance. Unless clients are very keen indeed to buy passive insurance, costs on that scale are likely to harm business.

[181] See Griffith, supra note 36, at 1239–40.

[182] See Matthew Jennejohn, Braided Agreements and New Frontiers for Relational Contract Theory, 45 J. Corp. L. 101, 104–05 (2020) (describing situations where informal and formal contracts interact to maintain effective relationships); Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine, 110 Colum. L. Rev. 1377, 1383 (2010) (coining the term "braiding" to describe this phenomenon).

[183] Ross L. Watts & Jerold L. Zimmerman, Agency Problems, Auditing, and the Theory of the Firm: Some Evidence, 26 J.L. & Econ. 613, 614 (1983) (providing evidence that auditing "is important, if not crucial, to the formation of firms").

toward managers. Yet bad auditing can have the opposite effect, by legitimating fraudulent reports and masking managerial self-dealing. And bad auditing is always a risk, since auditors who work for long periods with the same corporation may become psychologically and financially biased.

A fundamental problem for auditor complicity is that auditors may fear they will lose a profitable client if their audit results are unfavorable to the client's management.[184] In this sense, auditor complicity tracks D&O insurer complicity: both underwriters and auditors face the temptation to compromise their apparent task of honest evaluation in order to maintain a cozy forward-going relationship with managers who control the firm's willingness to pay supra-competitive rates.[185] The underwriter and auditor know that if they go easy on the client now, the client will reward them later; if they are honest and tough with the client now, the client will shop around later.[186] Indeed, the bad incentives are even stronger in D&O,

[184] See, e.g., Jaime J. Schmidt, Perceived Auditor Independence and Audit Litigation: The Role of Nonaudit Services Fees, 87 Acct. Rev. 1033, 1055 (2012) (finding evidence that plaintiffs are more likely to obtain a settlement where auditors provided non-audit services, suggesting that auditor profits lead to improper audits).

[185] While this problem is common between auditors and insurers, other problems are not. An independent reason that auditors may have blessed flawed accounting is that they had come to believe in its truth. See Robert A. Prentice, The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation, 95 Nw. U. L. Rev. 133, 148 (2000) ("[C]onfirmation and hindsight biases certainly can contribute to reckless auditing."). By working with the same client for years, the auditor may become biased to giving the client the benefit of the doubt or just blind to its failings. Insofar as auditor rotation is justified by a desire for fresh eyes, see Sarah A. Core, Only Fools Rush In: Mandatory Audit Firm Rotation and the PCAOB, 17 N.C. Banking Inst. 137, 151 (2013) (citing Comm'n on Auditors' Responsibilities, Report, Conclusions, and Recommendations 108 (1978) (discussing "[f]resh [e]yes" rationale)); see also U.S. Gen. Acct. Off., Pub. No. GAO-04-216, Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation 47 (2003) (discussing current and potential future research into whether a "fresh look" improves audit quality); Dobiac, supra note 93, at 502–03 (arguing that prospect theory may bias auditors). By contrast, there is no suggestion that insurers are lulled into believing the hype of their clients, perhaps because they have so much to lose if their assessments are wrong. See Sean M. Fitzpatrick, Fear is the Key: A Behavioral Guide to Underwriting Cycles, 10 Conn. Ins. L.J. 255, 265 (2003) (emphasizing compensation as the key driver of underwriter behavior). As Samuel Johnson wrote, "when a man knows he is to be hanged in a fortnight, it concentrates his mind wonderfully." James Boswell, Life of Samuel Johnson 309 (Herbert Vaughan Abbott ed., Scott, Foresman & Co. 1923) (1791).

[186] Gideon Mark, Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA, 39 Conn. L. Rev. 1097, 1197 (2007) ("The absence of rotation has potentially serious detrimental effects. If an auditing firm knows that it can remain employed by its client indefinitely, as long as it remains in management's good graces, it has a powerful incentive to approve the client's accounting decisions, even if that accounting is fraudulent.").

because auditors at least must fear that the jig will be up at some point. If they keep blessing a fraudulent company, somebody may reveal the truth at some point, at which point they will lose the client. There is no inevitable day of reckoning for D&O insurers.

After Arthur Anderson overlooked the accounting problems at Enron, the Sarbanes Oxley Act of 2002 imposed a form of mandatory rotation for auditors.[187] Section 203 of that law requires audit partners to rotate to new clients after five years.[188] Congress considered,[189] the PCBAOB urged,[190] and the GAO later studied[191] forcing audit *firms* to rotate as well, but that reform was never consummated.[192] However, audit firm rotation is the law in much of the European Union[193] and many other nations.[194]

### *2. Political Officeholders*

A second form of mandatory rotation concerns candidates for political office. Many states impose limits on the period of office for their legislators.[195] The U.S. Constitution imposes a term limit on the President of the United States.[196] Proposals frequently arise for term limits on federal legislators[197] and judges.[198] Term limits are a form of mandatory

[187] Sarbanes-Oxley Act of 2002, Pub. L. 107-204, § 203, 116 Stat. 745, 773 (codified at 15 U.S.C. § 78j-1(j)).
[188] Id.
[189] David S. Hilzenrath, Forensic Auditors Find What Some Companies Try to Hide, Wash. Post (Nov. 23, 2002), https://www.washingtonpost.com/archive/business/2002/11/23/forensic-auditors-find-what-some-companies-try-to-hide/b70d399a-220b-4fc9-815e-d8b91cf6f557/ [https://perma.cc/AA55-H3KQ].
[190] Zvi Singer & Jing Zhang, Auditor Tenure and the Timeliness of Misstatement Discovery, 93 Acct. Rev. 315, 317 (2018).
[191] U.S. Gov't Accountability Off., Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation, GAO-04-216 (2003). The opinion's consensus was that the costs of mandatory audit firm rotation would exceed the likely benefits. Id. at 5, 8.
[192] John C. Coates IV, The Goals and Promise of the Sarbanes-Oxley Act, 21 J. Econ. Perspectives 91, 105 (2007).
[193] U.S. Gov't Accountability Off., supra note 191, at 48, 83–90.
[194] Core, supra note 185, at 157 (noting Singapore, Brazil, India, and others).
[195] C. Daniel Chill, Political Gerrymandering: Was Elbridge Gerry Right?, 33 Touro L. Rev. 795, 821 (2017).
[196] U.S. Const. amend. XXII, § 1.
[197] E.g., Jason DeBacker, The Price of Pork: The Seniority Trap in The U.S. House, 95 J. Pub. Econ. 63, 75 (2011) (arguing that term limits should be imposed on committee memberships within the House of Representatives).
[198] See, e.g., Charles S. Collier, The Supreme Court and the Principle of Rotation in Office, 6 Geo. Wash. L. Rev. 401, 418 (1938) (proposing to amend the Constitution to impose rotation

rotation because they set a maximum period in which a provider (the politician) and a client (the government or people) may work together. After that period is up, the politician can remain a politician, but they must find a new client—they can seek another office in the government or the same office but in another government.

Term limits have been endorsed or urged for many discrete reasons, but many amount to concern for pernicious relational contracting. Many political offices seem inexorably drawn toward long incumbency: reelection rates for Members of Congress are extremely high.[199] With the possibility of long office, politicians have a temptation to make informal deals with those who can help secure re-election. Those with the power to help include (1) other politicians who can help in logrolling efforts; (2) special interest groups that can contribute manpower to reelection campaigns; (3) wealthy individuals and groups who can contribute money to reelection campaigns. When these third parties provide help to politicians they may do so in the expectation that, when re-elected, the politician will reward them in the future with favors.[200] This agreement is informal: no one can sue to enforce it. But both parties may know that their stinginess in one period will cut off support in the next. By knowing their reciprocal relationship, both sides can eke out a mutually beneficial relationship. Unfortunately, these relationships are not always in the public interest. The patron may ask the politician for assistance securing unwarranted privileges, subsidies, or immunities. Although granting these favors imposes costs on the politicians, whether emotional and ethical (if the politician cares about the public interest) or tactical (if the electorate decreases support as a result), the politician bears them to maintain the support of the patron.[201]

This mutually beneficial (but costly) relationship is disrupted in the final period. "Lame duck" politicians have limited ability to cut deals,

of Supreme Court Justices); Ryan D. Doerfler & Samuel Moyn, Democratizing the Supreme Court, 109 Calif. L. Rev. 1703, 1724–25 (2021) (describing progressive calls for term limits for Supreme Court Justices as enjoying popular support).

[199] See Reelection Rates Over the Years, OpenSecrets, https://www.opensecrets.org/overview/reelect.php [https://perma.cc/5WMY-DDKS] (last visited Jan. 16, 2022) (depicting a consistent reelection rate of at least 80% for House incumbents and an approximate average reelection rate of 80% for Senate incumbents from 1964–2018).

[200] See, e.g., Matthias Dahm & Amihai Glazer, A Carrot and Stick Approach to Agenda-Setting, 116 J. Econ. Behav. & Org. 465, 466 (2015).

[201] Amy Melissa McKay, Fundraising for Favors? Linking Lobbyist-Hosted Fundraisers to Legislative Benefits, 71 Pol. Rsch. Q. 869, 876–77 (2018).

since their influence is nearly at an end. Nor do they have the incentive to protect their future in the office, since there is none to protect. For this reason, politicians may be more willing to speak their mind and do what they think is right during the final period.[202]

In the analogy to D&O insurers, politicians can be expected to do rather little vetting of laws and policies their allies bring them, nor very much monitoring of the actual performance of those laws and policies nor signal their opinions of their quality, because the allies promise future favors in compensation.[203] Term limits are intended to bring about more frequent final periods so that politicians and their allies will less often find it rational to run the ball up the court together. And fearing the final period, the relationship may unravel even earlier.

### *3. Foreign Service Officers*

Foreign service officers are employees of the U.S. State Department. The Foreign Service was established in 1924 as a professional diplomatic corps to staff America's embassies and consulates.[204] While the chief diplomat in many offices is a political appointee with ties to the appointing president,[205] the foreign service officers who fill out the supporting roles, as well as the ambassadors appointed to more difficult assignments, are intended to operate free from political patronage.[206] They are meant to serve the United States of America rather than a particular party or politician.

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[202] Rebekah Herrick, Michael K. Moore & John R. Hibbing, Unfastening the Electoral Connection: The Behavior of U.S. Representatives When Reelection is No Longer a Factor, 56 J. Pol. 214, 221, 225 (1994) (analyzing U.S. Representatives across fourteen Congresses between 1955–1985 and finding that "in all but three of the 14 Congresses, those who were voluntarily retiring had a more focused legislative agenda," suggesting that when politicians are untethered from election cycles they are more likely to focus on legislation they actually care about).

[203] See Einer Elhauge, Are Term Limits Undemocratic?, 64 U. Chi. L. Rev. 83, 135 (1997) (arguing that term limits "mak[e] it harder to maintain the reciprocal logrolling and mutual deference needed to enact pork").

[204] Rogers Act of 1924, Pub. L. No. 68-135, 43 Stat. 140 (codified at 22 U.S.C. § 3901) (repealed 1946).

[205] Ryan M. Scoville, Unqualified Ambassadors, 69 Duke L.J. 71, 88–90 (2019) (compiling trends in the ratio of political to career ambassadors).

[206] 22 U.S.C. § 3905(b)(1); Pranshu Verma, Under Biden, Diplomacy is an Attractive Career Again, N.Y. Times (June 15, 2021), https://www.nytimes.com/2021/03/27/us/politics/biden-foreign-service-state-department.html [https://perma.cc/WYA9-B5E9].

That commitment to professionalism is threatened by the very real fact that diplomats live in foreign countries whose nationals can influence their quality of life. A foreign service officer who writes a nasty report about a local politician may face hostile retaliation in their daily life: rude phone calls, protests outside their office window, disinvitation from social engagements.[207] One who leaks intelligence to foreign governments or just liberally approves visas to travel to the United States may be rewarded.[208] There is a resulting risk that life-long postings may cause foreign service officers to favor their host country in ways detrimental to the United States.[209] This risk is known to international relations scholars and practitioners as clientism[210] or clientitis.[211]

The institutional response has been mandatory rotation.[212] Foreign service officers are permitted only three years in a host country before being lifted to another assignment.[213] With this shorter horizon in which to give and receive favors, they are more likely to identify with their professional commitments.[214]

[207] See Jonathan Bennett, Three Papers on Diplomacy, 69–70 (2017) (Ph.D. dissertation, University of Rochester) (finding that foreign service officers are "not necessarily incentivized to exert high levels of effort to assist the Office in identifying incriminating information that, if revealed, might cause or aggravate tensions between the United States and the host country"); id. at 58 ("Ambassadors — especially careerists — are particularly sensitive to the geopolitical implications that criticism of the host state in a State Department report may present; they therefore have an incentive to provide less 'ammunition' to the report writers."); Stephen B. Cohen, Conditioning U.S. Security Assistance on Human Rights Practices, 76 Am. J. Int'l L. 246, 259 (1982) (describing situations in which career bureaucrats underreported human rights violations and exaggerated improvements).

[208] Cf. Calvin Godfrey, US Consulate Officers Gone Wild, Vice (Sept. 4, 2013, 12:30 PM), https://www.vice.com/en_us/article/nnqj4g/the-corrupt-secrets-of-the-american-consulate [https://perma.cc/JPB3-YFX2] (detailing corrupt procurement of visas and other abuses).

[209] Stuart E. Eizenstat, Debating U.S. Diplomacy, Foreign Pol'y, Sept.–Oct. 2003, at 84, 84; Laurence H. Silberman, Toward Presidential Control of the State Department, 57 Foreign Affs., 872, 882 (1979).

[210] Silberman, supra note 209, at 882.

[211] Cohen, supra note 207, at 257; Barry Fulton, The Information Age: New Dimensions for U.S. Foreign Policy, Great Decisions 1999, at 9, 13; John Krizay, Clientitus, Corpulence and Cloning at State—The Symptomatology of a Sick Department, Pol'y Rev., Spring 1978, at 39.

[212] Johan Galtung & Mari Holmboe Ruge, Patterns of Diplomacy: A Study of Recruitment and Career Patterns in Norwegian Diplomacy, 2 J. Peace Rsch. 101, 112 (1965).

[213] Id.

[214] Id.

*4. Learning From the Analogies*

Auditor, politician, and diplomat rotations bear some resemblance to the proposed D&O insurance and so have some instructive value. They can inform in three ways.

First, and most simply, the existence of rotation in other domains of law should reduce any resistance that comes from unfamiliarity. D&O rotations are not an utterly untried idea such that the basic notion should arouse great suspicion. We have lived with mandatory rotation schemes in plain sight for decades.

Second, we can learn something from comparing the debates around these differing forms of rotation. For example, one possible objection to D&O rotations is that they will undermine underwriting quality by destroying relationship-specific expertise. Those who objected to audit partner rotation (and objected to full-scale audit firm rotation) argued that fresh auditors are easier to dupe than old hands.[215] The equivalent objection for politicians argues that new politicians rely even more greatly on special interest groups and elder statemen, since they lack their own knowledge and information networks.[216] And of course, foreign service officers face a steep learning curve: when they change assignments, their language skills and cultural insights are essentially lost, they must rely on and operate through advisors and translators, and they lose relationships and institutional knowledge.[217]

[215] See, e.g., Letter from the Am. Inst. of Certified Pub. Accts. to the Off. of the Sec'y of the Pub. Co. Acct. Oversight Bd. 2 (Dec. 14, 2011) (arguing that auditor partner and firm rotation hinders audit quality and is likely to result in increased fraud, and emphasizing research that shows financial reporting is more likely to occur in the first three years of the auditor-client relationship); see also Chih-Ying Chen, Chan-Jane Lin & Yu-Chen Lin, Audit Partner Tenure, Audit Firm Tenure, and Discretionary Accruals: Does Long Auditor Tenure Impair Earnings Quality?, 25 Contemp. Acct. Rsch. 415, 415 (2008) (noting that opponents of auditor rotation reason that experience is necessary to determine whether the client's accounting and reporting are proper).

[216] Steven F. Huefner, Term Limits in State Legislative Elections: Less Value for More Money?, 79 Ind. L.J. 427, 478 (2004); Nelson W. Polsby, Constitutional Mischief: What's Wrong with Term Limitations, Am. Prospect, Summer 1991, at 40, 42–43.

[217] Karen Hall, Mitigating Administrative Barriers to Successful International Rule of Law Reform, 9 Wm. & Mary Pol'y Rev. 41, 60–61 (2018); Michael K. Young, The Role of the Attorney-Adviser in the U.S. Department of State: Institutional Arrangements and Structural Imperatives, 61 L. & Contemp. Probs. 133, 143 (1998); Cohen, supra note 207, at 257–58; Richard J. Erickson, The Making of Executive Agreements by the United States Department of Defense: An Agenda for Progress, 13 B.U. Int'l L.J. 45, 88–92 (1995); Galtung & Ruge, supra note 212, at 126; Amy K. Bock, How to Restore the Airline Industry to Its Full Upright

In each case, these objections have been largely met. For political term limits, Professor Elhauge has this to say:

> [N]othing in term limits means the new candidates will lack substantive expertise. The freshman Senator may have served twelve years on a House foreign relations committee; the freshman Representative twenty years as a public policy analyst.[218]

In theory, the same politicians can shuffle from office to office, taking much of their learned skill with them. Likewise, auditors who rotate away from one company retain expertise in the industry which they can apply elsewhere.[219] The best research seems to suggest that any lost expertise is well worth it, because instances of forced rotation tend to improve audit quality even net of expertise loss.[220] Similarly, those who criticize the expertise loss in foreign service rotations mostly agree that rotations bring important benefits;[221] the most common criticism is that three years is too short a time.[222] Several of these critics consider five years—the length of this Article's proposal—to be more acceptable.[223]

More generally, the existence of empirical evidence—both anecdotal and the stuff with regression tables—from these experiments tells us a

Position: An Analysis of the National Commission to Ensure a Strong, Competitive Airline Industry Report, 59 J. Air L. & Com. 663, 694 (1994).

[218] Elhauge, supra note 203, at 123.

[219] Some studies find that auditors voluntarily let transferable expertise waste away by switching to new industries. They do this in order to keep working in the same part of the world, rather than moving to a new client far away. Brian E. Daugherty, Denise Dickins, Richard C. Hatfield & Julia L. Higgs, An Examination of Partner Perceptions of Partner Rotation: Direct and Indirect Consequences to Audit Quality, 31 Auditing 97, 98–99 (2012). The problem of geographic stickiness is less likely to affect D&O insurers. Insurance companies don't have to uproot and move their headquarters to the same location as any given client.

[220] Singer & Zhang, supra note 190, at 328 (providing evidence that "long auditor tenure impairs audit quality and highlights the benefit of a fresh look at a company's financial reports by a new auditor").

[221] Ashley S. Deeks, A (Qualified) Defense of Secret Agreements, 49 Ariz. St. L.J. 713, 780 (2017) (arguing rotations bring important diversity of perspectives); Bennett, supra note 207, at 68–72 (arguing that long-term diplomats bias their reports, without specifically addressing rotations).

[222] Hall, supra note 217, at 60–61; Young, supra note 217, at 143; Cohen, supra note 207, at 257–58.

[223] Galtung & Ruge, supra note 212, at 112; cf. Terrence K. Kelly, Ellen E. Tunstall, Thomas S. Szayna & Deanna Weber Prine, Stabilization and Reconstruction Staffing: Developing U.S. Civilian Personnel Capabilities 34–35, 39 (2008) (urging mandatory rotations for the Department of Defense, provided that the length is not too short).

little bit about what we could expect from D&O rotations. In each case, much of the research is favorable. Auditors prove more likely to discover misstatements in their final year with a client—which comes more often with rotations.[224] Political term limits reduce the influence of powerful interest groups over legislators,[225] maintain the experience level of politicians by drawing replacements from a pool of experienced candidates,[226] and lower the impact of large donors in politics.[227] Diplomats write reports less biased toward host countries to the degree their career is not bound up in the place.[228]

More important than any particular study is the finding that rotation is *workable*. America's limited experiment with audit partner, politician, and diplomat rotation minimally demonstrates that the economy can survive the disruption of rotation and that rotation is a viable government intervention. There is no voice arguing that the imposition of rotation on audit partners, politicians, or diplomats caused the wheels to fall off the car. Reasonable minds may differ on the net benefits, but no one argues that rotations ruined an otherwise viable system. That should give some comfort, raising the lower bound on what we could expect from D&O insurance.

[224] See Barbara Arel, Richard Brody & Kurt Pany, Findings on the Effects of Audit Firm Rotation on the Audit Process Under Varying Strengths of Corporate Governance, 22 Advances in Acct. 1, 2, 22 (2006) (presenting results of experiment finding greater likelihood an auditor will report a misstatement in the final period of a mandatory rotation); accord Henry Laurion, Alastair Lawrence & James P. Ryans, U.S. Audit Partner Rotations, 92 Acct. Rev. 209, 231–32 (2017) (finding that mandatory rotation increases the likelihood of restatements); see also Brandon Gipper, Luzi Hail & Christian Leuz, On the Economics of Mandatory Audit Partner Rotation and Tenure: Evidence from PCAOB Data, 96 Acct. Rev. 303, 313–16 (2021) (finding that rotation of audit partners is positively associated with the likelihood that an auditor issues an internal control weakness statement).

[225] Susan M. Miller, Jill Nicholson-Crotty & Sean Nicholson-Crotty, Reexamining the Institutional Effects of Term Limits in U.S. State Legislatures, 36 Legis. Stud. Q. 71, 86–87, 92 (2011); see also Michael Smart & Daniel M. Sturm, Term Limits and Electoral Accountability, 107 J. Pub. Econ. 93, 100 (2013) (modeling how term limits can change the incentives of politicians and encourage incumbents to engage in more "truthful" behavior when seeking re-election).

[226] Elhauge, supra note 203, at 123 n.132 (citing John Carey, Parties, Incentives, and Term Limits in Costa Rica, *in* Legislative Term Limits: Public Choice Perspectives 321, 324–25 (Bernard Grofman ed., 1996)).

[227] D.E. Apollonio & Raymond J. La Raja, Term Limits, Campaign Contributions, and the Distribution of Power in State Legislatures, 31 Legis. Stud. Q. 259, 267–75 (2006).

[228] Bennett, supra note 207, at 70–72.

### *C. Details of the Proposal*

#### *1. Optimal Rotation Length*

The optimal rotation length is not obvious. Set too long a period, and the benefits of the proposal are depleted: a fifty-year clientele period is plenty long enough to support relational contracting. But a too-short period can create problems. Right now, insurers perform moderate vetting activities. They expend effort to determine whether they want to take on a client and at what rate—these vetting activities produce *some* social value, and they are presumably rational for the insurer, who can amortize the cost of vetting over the length of the relationship.[229] Insurers who could keep a client for only an hour would have to recoup those costs over an hour, which will not be feasible. As a result, they will not do it.

This is analogous to a similar problem in the creditor-monitoring literature. It is often argued that creditors, such as bondholders and banks, are an important lever in efficient corporate operations and responsible corporate governance. Creditors will vet and monitor to protect their funds.[230] This theory was rocked during the last financial crisis by the observation that creditors did almost nothing to check the growth of risky and sometimes unsound securitization—even though securitized assets were the principal collateral securing their loans.[231] The reason for creditor inattention was their short time horizon. Creditors loaned their money overnight, with no expectation that a particular creditor would return to a particular borrower.[232] In such an environment, creditors had little incentive to do any vetting at all. They loaned blindly in good times

[229] Supra Section IV.A. There may be social costs, too, if part of the vetting is to determine whether the client is amendable to anti-social relational contracting.

[230] See George G. Triantis & Ronald J. Daniels, The Role of Debt in Interactive Corporate Governance, 83 Calif. L. Rev. 1073, 1080, 1083 (1995); see also Douglas G. Baird & Robert K. Rasmussen, Private Debt and The Missing Lever of Corporate Governance, 154 U. Pa. L. Rev. 1209, 1230 (2006) (describing how money lenders monitor a firm's progress through ongoing dealings).

[231] Adam Copeland & Antoine Martin, Repo over the Financial Crisis 12–13 (Fed. Rsrv. Bank of N.Y., Staff Reports No. 996, 2021), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr996.pdf [https://perma.cc/75TP-UMYD] (showing the content of repurchase agreement transactions during the relevant period).

[232] See Gary Gorton & Andrew Metrick, Securitized Banking and the Run on Repo, 104 J. Fin. Econ. 425, 427, 448 (2012).

and withheld credit blindly in bad times.[233] Analogously, D&O insurance renewed every night would thwart any monitoring. One wants a middle-length period, long enough to allow active insurance and short enough to encourage it.

The precise window is difficult to pinpoint, but five years seems reasonable. With renewal rates currently at about 95%, something approaching 25% of corporations might naturally change insurers over a five-year period.[234] Rotation would increase turnover by a factor of about four.

*2. Optimal Cooling-Off Period*

Insureds could strategically gut this proposal by "rotating" for only trivial periods. For example, Client could end its five-year relationship with Chubb, switching to AXA for ten minutes, and then back to Chubb. AXA would do no serious vetting and no monitoring. And Chubb could continue to regard the insurance relationship as a long-term one. Thus, any workable rotation plan must include a mandatory "cooling-off period" before a client could return to their former insurer.

On the other hand, an excessively long cooling-off period could undermine the quality and competitive status of the market. At the limit, in which insurers can never insure the same client again, insurers might provide poor service to customers, knowing that it does little to affect their clientele. Happy clients can never reward the insurer with repeat business; clients will have to select Insurer ABC someday, no matter how bad its reputation, because they will have already used up their licenses to patronize other insurers in the past. Insurers compete on dimensions other than complicity in managerial agency costs: excessively long cooling off could harm those quality parameters.

Overall, a five-year cooling-off period seems like an appropriate period. That matches the length of time the engagement is allowed to run. That symmetrical treatment is what has been endorsed in the auditor and, often, in the governmental contexts. Lead auditors can audit a client for

[233] See id. at 433, 448. This language should not be taken to criticize the lending patterns. The Gorton view is that it serves an important function in providing informationally insensitive assets. Id. at 432.

[234] See supra Section III.D; 0.95^5 = 77.38% would have retained their insurer, leaving 22.62% having reshuffled. This probably overstates turnover, since the few firms that change insurers probably differ in ways that make them more likely to switch again in the future.

five years, then they must disengage for five years.[235] In states that permit politicians to run for the same office after having left for a period, the relevant period is usually one legislative term.[236]

### *3. Identity Workarounds*

This rotations proposal will do little good if it can be evaded through the use of fig-leaf entities. For example, an insurer could insure a client for five years and then disengage, only to form a wholly-owned subsidiary which will take up the franchise. If insurers can pass clients from one pocket to another, the effect on the corporate group will be the same: an incentive to keep the client managers happy and to keep them in a long-term relationship with the group.[237]

Regulators creating rotation policy—and courts effectuating it—will need to develop look-through rules to make sure that substantive rotation is actually occurring, rather than just formal shifting. It takes sophistication to spot identity-based workarounds, and such sophistication is not equally distributed across regulators. Accordingly, the choice of regulator may be influenced by such concerns. It is to the choice of regulator that we now turn.

[235] 15 U.S.C. § 78j-1(j).

[236] Elhauge, supra note 203, at 188.

[237] A more complex workaround would have primary insurers form reinsurance subsidiaries, which would then assume most of the risk for a given client even as that client rotated its stable of primary insurers. If Insurer Alpha insures XYZ Corporation with the support of Swiss Re, and then Alpha rotates away, Swiss Re could shift to reinsuring the XYZ account for Insurer Beta. If the same reinsurer bears most of the risk and enjoys most of the benefits of a long-term relationship, the problems of the status quo could recapitulate themselves one step removed. For now, this kind of counter-rotation is not practical since the reinsurance market appears to be much more competitive. The numerous reinsurers shift their coalitions within the tower frequently and without a preordained pattern. Paula Jarzabkowski, Rebecca Bednarek & Paul Spee, Making a Market for Acts of God: The Practice of Risk-Trading in the Global Reinsurance Industry 11, 127, 152–53 (2015). Presumably, that fragmentation would make concerted counter-rotation unstable. Individual reinsurers would be tempted to join towers that had engaged in slightly more vetting, withholding their capital from insureds at the stages of the relationship where the premium is underpriced. It would take a great deal of work to build the reputational infrastructure for insureds to punish such defectors. Moreover, the current industry uses excess insurers, who are in privity with the client corporation, rather than reinsurers, who are in privity with the primary insurer. Squire, supra note 66, at 12–13. Excess insurers would be subject to the same rotation requirements as primary insurers. But changing the industry to a reinsurance structure would involve a fundamental change of the business—no small moat in the way of the workaround.

*4. Choice of Regulator*

The best way to effectuate mandatory insurance rotations is for the federal government to amend the Securities Exchange Act of 1934 to permit and require the SEC to require rotation of D&O insurance firms. The SEC's involvement is optimal because it will require a sophisticated regulator to craft detailed rules specifying the terms of rotation, such as the parameters for disallowing identity-based workarounds. The SEC's involvement is appropriate because the problems of D&O insurance are localized on public companies, they implicate shareholder litigation, and the costs ultimately befall public company shareholders. Congressional action is required because there is currently no colorable basis for the SEC to impose such a requirement on public companies.[238] This is the path by which auditor rotations were established: Congress created a mandate for rotation but then entrusted the auditor-specific regulator (the PCAOB) to define and enforce it.[239]

A second strategy is also promising and not mutually exclusive, though it is far less complete. Courts should take seriously the dangers of relational D&O contracting when shareholders demand information and litigate claims.

One place this can be expressed is at motions to dismiss a complaint for failure to state a claim. Federal securities claims generally require plaintiffs to plead facts with particularity that support their allegations.[240] State corporate law, likewise, requires plaintiffs to plead facts that raise a reasonable doubt that the defendant managers cannot exercise their business judgment in considering a litigation demand.[241] These are deemed to be difficult curbs to cross, in part because plaintiffs have no access to discovery at the stage of such motions. Plaintiffs often piece

[238] The SEC, however, does have the authority to mandate disclosure of insurance premiums and coverage, as Griffith and Baker note. Sean J. Griffith, Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies, 154 U. Pa. L. Rev. 1147, 1150–51 (2006). It should do so.

[239] Gipper et al., supra note 224, at 307–09.

[240] 15 U.S.C. § 78u-4(b)(1) (requiring complaint to identify "each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed"); Fed. R. Civ. P. 9(b) ("In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake.").

[241] Del. Ch. R. 23.1(a) (requiring particularized allegations concerning plaintiffs' failure to make a demand on the board); United Food & Com. Workers Union v. Zuckerberg, 262 A.3d 1034, 1057–58 (Del. 2021) (adopting new standard for content of the pleading).

things together from the public record and from confidential witnesses.[242] Courts should recognize the red flag raised by a long-lasting relationship with a D&O insurer. If plaintiffs are able to learn of such a relationship, courts should take it into account as supportive of plaintiff's claims. Specifically, a long-tenure with a single D&O insurer should help the plaintiff's case even if the defendant accurately responds that long-tenure is commonplace. Right now, the opposite is likely. Courts are likely to regard details such as how to shop for insurance as a matter of business judgment, particularly when the choice places the managers squarely in the norm. Courts should recognize that the normal pattern is problematic and give plaintiffs some credit for spotting the issue—just as if the plaintiff spotted that the board owned shares in a company that they asked the company to acquire; such transactions can be innocent, but they should sow seeds of doubt. If courts penalize defendants who fail to rotate, it will be an encouragement to rotate.[243]

Of course, plaintiffs will have no easy time leveraging allegations of relational D&O contracting if they cannot find evidence of it. Corporations are under no obligation to tell shareholders about their coverage, rates, or shopping patterns.[244] As a matter of state corporate law, courts should now appreciate the value of this information to shareholders. A shareholder could reasonably use insurance information to investigate her corporation for wrongdoing, weigh the value of her shares, or test the quality of her managers. Accordingly, there are abundant proper purposes for a shareholder to request information about (1) premiums, (2) coverage, (3) duration of coverage with the current and recent insurers, and (4) management's approach to shopping for new insurance. When shareholders request this insurance information in a books and records action, courts should vindicate their information rights.[245] Again, sunlight may discourage bad practices or arm

[242] John C. Coffee, Jr. & Alexandra D. Lahav, Class Actions in the Era of Trump: Trends and Developments in Class Certification and Related Issues 15–19 (2017) (describing use of confidential witnesses), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3037564 [https://perma.cc/9LTP-X4GC].

[243] The opposite is equally true. Managers who disclose frequent rotations and low insurance rates may be able to prove their bona fides more easily.

[244] Griffith, supra note 238, at 1150–51.

[245] See Del. Code Ann. tit. 8, § 220(b)–(c) (2019). See generally George S. Geis, Information Litigation in Corporate Law, 71 Ala. L. Rev. 407, 440–50 (2019) (explaining the importance of shareholder information rights).

shareholders with better tools to litigate managerial wrongdoing claims, which also encourages rotation.

We have discussed two avenues to impose rotation—a top-down strategy led by Congress and the SEC, and a bottom-up strategy led by courts in individual cases. Other avenues are available but face limitations.

Congress could, in principle, act to regulate not the insured corporations but the insurers, but insurance is typically regulated at the state level.[246] McCarran-Ferguson explicitly delegated the power to regulate insurance to the states in 1944.[247] While Congress occasionally does intervene despite this compromise,[248] it is reluctant to do so.[249]

Given that states are vested with insurance regulation, they could be change agents to impose mandatory rotation. Each state licenses insurers to operate in their state,[250] so each could require those insurers to restrain their long-term ties and focus on only five-year engagements. Coordination among many regulators could be possible through a model rule promulgated by the National Association of Insurance Commissioners ("NAIC"), "a voluntary association of the insurance commissioners of the 50 states, the District of Columbia, and the U.S.

[246] John S. Pruitt, Insurance and Reinsurance in the United States: Overview, Westlaw Practical Law Country Q&A 9-501-3187 (last updated June 1, 2021); see also Miriam Hechler Baer, Insuring Corporate Crime, 83 Ind. L.J. 1035, 1085 (2008) (explaining that insurance has been explicitly delegated to the states by McCarran-Ferguson, despite the federal government's power to regulate insurance under the Commerce Clause); John Patrick Hunt, Rating Dependent Regulation of Insurance, 17 Conn. Ins. L.J. 101, 107–08 (2010) ("Insurance in the United States historically has been and currently is regulated at the state level. Generally, state insurance regulators are given authority over insurers' ability to incorporate or conduct business in the state in question, and are charged with enforcing requirements created by state statutes, which typically include minimum capital levels.").

[247] The Act provides, "Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States." 15 U.S.C. § 1011.

[248] There is even a Federal Insurance Office. Elizabeth F. Brown, Will the Federal Insurance Office Improve Insurance Regulation?, 81 U. Cin. L. Rev. 551, 579–80 (2012).

[249] For example, Congress stipulated in creating the Federal Insurance Office that "nothing in the provisions establishing and granting authority to the Office 'shall be construed to establish or provide the Office or the Department of the Treasury with general supervisory or regulatory authority over the business of insurance.'" Hunt, supra note 246, at 108 (quoting 31 U.S.C. § 313(k)).

[250] Brown, supra note 248, at 557–58.

territories."[251] The NAIC sets standards for insurance companies and oversees insurers' operations,[252] and it could urge rotation as required. NAIC and state insurance regulators certainly possess sufficient expertise to draft, evaluate, and enforce these rules.

However, state-level insurance regulation is an unlikely avenue for reform because this project runs counter to some conception of the goals of insurance regulation. A plausible story of what insurance regulators try to do is to protect the solvency of insurance companies while protecting customers from abusive products.[253] At least superficially, those two goals are undermined by this Article's proposal. Rotations make insurance companies unstable, since forward-looking insurers can go out of business if they grossly underestimate premiums; backward-looking insurers are safer because they can always recoup their losses. Rotations also take away a product that delights all of its buyers: long-term relationships with a familiar partner. Insurance regulators do not think themselves in the business of improving corporate governance of non-insurance companies.[254]

[251] Hunt, supra note 246, at 109 (citing Susan Randall, Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners, 26 Fla. St. U. L. Rev. 625, 629 (1999)).

[252] Id. at 110.

[253] Robert W. Klein, Principles for Insurance Regulation: An Evaluation of Current Practices and Potential Reforms, 37 Geneva Papers 175, 179 (2012). Other plausible stories are even worse for would-be reformers. Perhaps insurance regulators are captured by their regulated industry. Eric R. Hansen, Nicholas Carnes & Virginia Gray, What Happens When Insurers Make Insurance Laws? State Legislative Agendas and the Occupational Makeup of Government, 19 State Pol. & Pol'y Q. 155, 172 (2019). In that case, regulators will take few steps that upset incumbent players in a market. The incumbent players show no displeasure with the status quo and would likely chafe at the new business practices required in a world of rotations and active insurance.

[254] Perhaps they should consider that part of their mandate. After all, it is a longstanding feature of insurance regulation that insurance must not be permitted that contravenes public policy. 16 Williston on Contracts § 49:12 (4th ed. 2021). We ban the Godfather taking out a fire insurance policy on his enemy's house, even if the Godfather and the insurance company are delighted at the arrangement, because it tends to encourage and reward arson. Insurance regulators could take a similar view of insurance that functionally encourages hubristic management and frivolous litigation. Relatedly, consumer protection could urge this intervention. An insurance policy may be inappropriate, even if popular, if it generally works to harm its customer in ways the customer does not appreciate—such as a policy with hard-to-evaluate exclusions. Likewise, the client of D&O insurance is the corporation, not the management, and the corporation may not appreciate that it is buying a self-destructive product. But regulators, often willingly, sacrifice values that are not in their core mandate. See, e.g., Andrew Verstein, Insider Trading in Commodities Markets, 102 Va. L. Rev. 447,

State corporate law could also supply a solution.[255] Corporation statutes contain provisions authorizing the purchase of D&O insurance.[256] But such provisions are unlikely. The public companies in focus are mostly Delaware incorporated. Delaware corporate law is scarce on mandatory terms. It is rarely altered in ways that bother and constrain managers.[257] And the code does not tend to contain the kinds of detailed rules that would be required to effectuate this policy.

### *D. Objections*

Any reform proposal faces objections, and this one is no exception. While some of these objections have been implicitly addressed in early parts of this Article, this Section explicitly raises and addresses concerns that may linger on some readers' minds.

#### *1. Rotation Will Not Work*

It may be thought that this proposal will only shift relational contracts to reputation markets.[258] Insurers that act as though there were no rotation, imposing few risk-controls even in the final period, will gain a reputation as accommodating of managers. Managers will then select these insurers despite their higher prices. One can easily imagine an insured going back and forth between two insurers, each of whom know that the customer's tab will be loyally recouped, albeit after a five-year delay in some cases. If true, this objection would render this proposal less effective because the same passive insurers will be hired to provide the same passive insurance, just with the extra work of rearranging deck chairs every five years.

478–79 (2016) (discussing how bank regulators blessed "insider trading" by investment banks).

[255] Federal corporate law could likewise perform this function if such charters are someday available. Proposals to create such charters are occasionally considered. See Accountable Capitalism Act, S. 3348, 115th Cong. (2018) (permitting federal chartering of corporations).

[256] E.g., Del. Code Ann. tit. 8, § 145(g).

[257] Lynn M. LoPucki, Corporate Charter Competition, 102 Minn. L. Rev. 2101, 2166–67 (2018).

[258] There are other ways in which rotation might not "work." For example, the high degree of concentration in the D&O market may allow insurers to exercise market power. To the degree that they can do so, they will be able to do so after rotation as well. This proposal does not solve problems emergent from oligopoly, but it probably does not make those problems any worse.

Even if relational contracts merely shifted to reputation contracts, that would still mark an improvement over the status quo.

Managers' ability to select over-priced (but pro-management) insurance depends in part on obscurity.[259] At present, managers have the practical ability to renew their current insurer without shopping around for the lowest price, and the evidence suggests that they use this freedom to pay supra-competitive rates to their long-term partner.[260] By contrast, when managers do seek quotes, in a realistic attempt to change insurers, prices actually seem relevant. Insurers do a measure of vetting, presumably because they recognize that a lower price matters at least a little bit to securing a client.[261] Passive insurers can prevail in winning price-sensitive new clients because their supra-competitive premiums will come in later periods as a consequence of inelastic renewals.[262]

Even if reputation proves a strong substitute for relationship, the rotation system creates more moments in which insurers must bid for clients, and during which managers may feel some pressure to pick an insurer whose costs are in the ballpark of an active insurer. Forcing more corporations to buy in this less pathological context would mark a real improvement.

Moreover, it is quite difficult to design and maintain a pricing strategy for a reputation-based backward-looking insurance model amid rotation. Consider an insurer whose client XYZ incurs a $20 million claim in the final year and so who would like to recoup the $20 million from XYZ in five years. To amortize that over five years requires a premium of $4 million per year. But it is difficult to offer a $4 million initial bid in the first period, so the insurer could instead charge $0.6 million, which is the actuarially fair rate for a typical director, and amortize the missing premiums over the remaining periods so that the next four years instead costs $4.85 million. But what will it look like if insurance premiums increase by more than 700% despite no change in the underlying risk and no claims events? Even complicit managers may feel pressure to address a change large enough to impact earnings. To put this in perspective, a *mere* 360% increase in premiums following the controversial *Smith v. Van*

[259] Supra note 147 and accompanying text.
[260] Baker & Griffith, supra note 26, at 531.
[261] Supra text accompanying note 90.
[262] Supra Section III.B.

*Gorkom* decision was visible enough to lead to a prompt legislative rescue.[263]

Insurers could opt for an even smoother curve, charging $1 million plus overhead in the first period,[264] then raising the premium by 73% per period. Then the payments become $1 million, $1.73 million, $3 million, $5.21 million, and $9.04 million. This totals to $20 million without any abrupt jumps. But, again, a 73% increase every year without any change in risk or claim may raise eyebrows—particularly since these increases only arise when doing business with an insurer with a debt to settle. A 73% increase is almost exactly what rates increased by at the very largest companies in 2004, when post-Enron lawsuits ran hot and new Sarbanes-Oxley rules created entirely new categories of liability.[265] That was an exceptional period with 2/3 of the rise being attributed to risks attendant to Sarbanes-Oxley,[266] the largest federal intervention into corporate governance in at least 75 years. It would be strange for an insurer to count on such rate increases every year when managers are being offered much lower active rates.

The rapidly rising rates of rotating passive insurers will look aberrant not just in contrast to active insurers, but also other passive insurers. When the corporation rotates out, it will switch to another insurer that may not have any past-focused claims to recoup and so will charge much lower annual premiums with much lower annual rate increases. Managers may feel strange switching from an insurer with a low rate of annual increase to one that is sure to have a high rate, and back again, every few years.

If any of these stresses cause a previously complicit board to balk, the corporation will abandon the relationship and switch to an active insurer. That defection leaves the insurer with an uncompensated cost which it

[263] Quinn & Levin, supra note 159, at 398 (citing James J. Hanks, Jr., Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification, 43 Bus. Law. 1207, 1209 (1988)); see also Sarath Sanga, Network Effects in Corporate Governance, 63 J.L. & Econ. 1, 3–4 (2020) (documenting link between *Van Gorkom* decision and enactment of Del. Code Ann. Tit. 8, § 102(b)(7), which permits director exculpation).

[264] In this example, I make the charitable assumption that the passive insurer can learn the actuarially fair rate for this higher risk director, despite doing no vetting or monitoring.

[265] Nancy R. Mansfield, Joan T. A. Gabel, Kathleen A. McCullough & Stephen Fier, The Shocking Impact of Corporate Scandal on Directors' and Officers' Liability, 20 U. Mia. Bus. L. Rev. 211, 230–32 (2012).

[266] Id. at 232

must try to cover from other customers. Its average costs go up, making periods with "reasonable" prices increasingly untenable.

Therefore, it is not enough that some insurers might be able to make deals with some corporations based on reputation. The reputation approach unravels if the insurer cannot tell with terrific accuracy which managers will defect at some point, which seems quite plausible.

*2. Rotation Imposes Costs*

Rotation increases transaction costs. Insurers must (a) fill out a bunch of paperwork, (b) address transition-liability issues, (c) market to new clients, (d) vet them from scratch, and (e) develop from scratch the company-specific monitoring expertise.

Forcing rotation undoubtably increases scrivener costs, (a), though it is hard to imagine that cost as prohibitive if it stood alone and if rotation otherwise brought benefits.

A more serious question is whether rotation would lead to complex and litigation-prone controversies about which insurer is liable for what claim, (b). For example, Alpha may be the insurer when an allegedly reckless act is taken, Beta may be the insurer when a plaintiff sues for the act, and Delta may be the insurer when the settlement takes place. Who pays? The parties will need to negotiate transition issues. Right now, it is customary for Beta to sell the customer optional coverage for the eventual settlement and for Alpha and Delta to disclaim coverage. A rarer, but conceptually possible solution is for the customer to disclose the litigation to Delta and pay for it in the coverage. In the market as it exists, transitions are rare, so negotiating cross-policy risk can be problematic: insurers are naturally suspicious of taking on risks and costs from a period when they are not receiving premiums, and clients are reluctant to disclose brewing problems. But new standard practices may emerge once rotation becomes commonplace. Likely, the most efficient practice is for insurers to cover all expenses incurred during coverage but exclude items the client knew about but did not disclose in the policy application. Forthright clients would always enjoy coverage, and insurers could use this forthrightness to craft appropriate premiums and risk-mitigation techniques. While addressing transition issues is non-trivial, it does not seem insurmountable.

It is far from obvious that (c) marketing costs would rise. True, brokers would have to hustle more often to sell policies and clients would have to consider pitches more often. But each pitch would likely be less work.

Right now, brokers who make a sale are capturing many years of profits for themselves and their affiliated insurer; clients are likewise picking a partner who may be with them for years. The stakes are lower when engagements last no more than five years. Both sides may not overinvest in getting the perfect partner.

As for whether (d) vetting and monitoring costs rise, they certainly will if the proposal is successful. Forcing greater investment in vetting and monitoring is precisely the goal of mandatory rotation. Those investments are unjustified if we already have the optimal level of vetting and monitoring. But someone who thought vetting and monitoring were already correctly calibrated doubts the benefits of the proposal; it hardly makes sense to repeat that discussion under the guise of cost. The point is that these costs are real but entirely justified if the increased insurer gatekeeping would outweigh those costs.

Vetting and monitoring costs only rise if the program is successful. Right now, vetting costs are low and monitoring costs are about zero. Under a purely passive model, both are precisely zero. If a passive insurer remains passive after a rotation, it will incur no new vetting and monitoring costs. A consoling fact is that if we try mandatory rotations and they are unsuccessful in forcing more active insurance, we can take comfort that the costs will be low as well.

### *3. There Are Other Proposals*

If we wish to disrupt chummy links between insurer and insured, mandatory rotations are not the only possible proposal. Some alternative proposals are perfectly consistent with rotations, so there is no need to spar with them.[267] For example, Baker and Griffith's notion that D&O premium information ought to be publicly disclosed in no way competes with this Article.[268]

[267] In the auditor context, Kahn and Lawson propose that auditors rotate through random assignment: the auditor and corporation do not get to pick one another. David B. Kahn & Gary S. Lawson, Who's the Boss?: Controlling Auditor Incentives Through Random Selection, 53 Emory L.J. 391, 413 (2004). Such a proposal is compatible with D&O rotations, though I would not personally favor it. It seems reasonable that some insureds and clients would be better matches than others, and that competitive pressure to be the sort of business the other wants to work with is sometimes salutary.

[268] Griffith, supra note 238, at 1182–85. This proposal is valuable even if, per Baker and Griffith, premiums were publicly disclosed. First, D&O insurance contracts are not standardized, making firm-by-firm comparison difficult. Andy Moss & Carolyn Rosenberg, D&O Insurance Basics (Part 2), The Policyholder Perspective (Aug. 11, 2020),

Other proposals would be mutually exclusive with mandatory rotation. For example, why mandatory rotations rather than auctions of D&O insurance rights? That idea can be extracted from a paper on bank regulation, where Todd Henderson and Frederick Tung identify similar capture problems to the ones in the D&O context, but propose regulator auctions as the solution.[269] Bank examiners are currently tied to a particular bank based on the bank's charter, but Henderson and Tung would allow price-based auctions where examiners would bid for the right to examine (i.e., regulate) a particular bank.[270] Bank examination resembles D&O insurance in that a gatekeeper is charged with investigating a firm that can take its patronage elsewhere if it dislikes its treatment.[271] Henderson and Tung consider fixed rotation instead but argue, "[T]here are downsides to a fixed-rotation system: knowing when one's stake in a particular institution will end may provide opportunities to hide costs in future periods."[272] For example, they cite the perverse incentives of governors in China, who are subject to mandatory rotation to avoid building up personal political machines, and assert the officials therefore are not bound to "the consequences of [their] shoddy construction."[273]

Whatever the merits of this worry for bank examination and Chinese real estate, there is not a great risk of increasing antisocial behavior in the last period of rotating D&O insurance. The client is unlikely to redouble

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https://www.policyholderperspective.com/2020/08/articles/do-eo-professional-liability/do-insurance-basics-part-2/ [https://perma.cc/V5UC-4UJQ]. Second, managers could obtain superficially lower rates by bundling D&O insurance with other products, for which they accept higher prices or worse terms. For example, firms already may bundle D&O insurance with property & casualty ("P&C") insurance (say, for ordinary slip & fall cases). Lucy Lazarony, Directors and Officers Insurance Explained, Forbes Advisor (Aug. 6, 2021), https://www.forbes.com/advisor/business-insurance/directors-and-officers-insurance/ [https://perma.cc/KDM3-R47X]. Insurers already have an incentive to provide extra-generous D&O coverage in the hopes of extra-costly P&C coverage. That incentive would grow if disclosure were public, but it would largely fall away if rotations were also imposed.

[269] M. Todd Henderson & Frederick Tung, Reverse Regulatory Arbitrage: An Auction Approach to Regulatory Assignments, 98 Iowa L. Rev. 1895, 1899–900 (2013).

[270] Id.

[271] Bank examiners want patronage both institutionally, since they are often funded directly or indirectly by the body of firms they examine, and individually, since they may have exit options if their expertise pertains to important firms. Id.

[272] Id. at 1897–98.

[273] Id. at 1898 n.2 (quoting Amity Shlaes, China's Katrina Shows Post-Communism No Big Easy, Bloomberg (May 21, 2008), http://www.amityshlaes.com/articles/2008/2008-05-21.php).

its risks in the last period because the maturing claims might come too late, then thus arise as early claims under the next policy relationship (and, thus, they would have to pay for them). They are also going to be under a monitoring regime intended to constrain moral hazard; insurers will understand the insureds' risk and try to take risk-controlling steps. In parallel, insurers have only limited ability to engage in bad behavior in year five. Insurance law constrains their ability to suddenly become stingy with legitimate claims.[274] And poor customer service is unlikely to save much money, in part because insurance law already furnishes doctrines to force excessively litigious and stingy insurers to be fair.[275]

There are also just problems with auctions in this market. First, active insurers can only bid if they invest in discovering and pricing risk. The number of bidders is unlikely to be large because it isn't rational for insurers to invest large sums to bid for clients that they will almost certainly not get. Second, clients have to share non-public information with insurers to help with vetting. Clients will understandably chafe at sharing sensitive information far and wide and will de facto convert the auction into a race with only a few horses. Both of these factors will tend to protect incumbent insurers, who do not have to invest or ask permission to learn quite as much about the insurer. They can consequently outbid any outsider if so inclined. In fact, outsider bidders should know that the only time that they have outbid the incumbent insurer, it is because the incumbent knew something adverse about the client that cautioned them against a cheaper bid. Bidding is, therefore, subject to asymmetric information and adverse selection. The result will be tepid bidding that only reduces relational contracting in its most extreme forms.

## CONCLUSION

It has been theorized that the Great Wall of China was built not to keep pillagers *out*, but to keep them *in*. Loaded down with treasure, it would be difficult for them to quickly traverse the wall without the garrison's help. As a historical fact, the Mongol invaders had little trouble entering China but they largely remained, along with the treasure, inside the wall. They established themselves as the new Yuan emperors—to whom the garrison swore fealty. Gatekeepers are protectors, but who do they protect? All gatekeepers know to bar entry to ravenous outsiders, but

[274] See, e.g., Squire, supra note 66, at 18–22.
[275] See id.

loyalties are revealed only when insiders approach the wall with cartloads of jade and silver.

This Article took up the case of a compromised gatekeeper and offers a path of reform and restoration. D&O insurers should play an important role in corporate governance by detecting, preventing, and announcing problems. If insurers were active gatekeepers, managers might take fewer liberties with the care they exercise, the power they wield, and the funds they expend. Corporations would be somewhat better run and courts would have fewer disputes—meritorious and frivolous—to address.

This Article identified relational contracting as a major obstacle to good insurance. With insurers as life-long partners to corporations and the managers that govern them, the insurer has little incentive to make painful but helpful demands. Far better to go along and get along. However much their dereliction costs, its perpetrators are long-lived and will reward them. Far better for the insurer to know that its tour of duty will end and that it will be impossible to recoup deep losses in the fullness of time. Forced to internalize the cost of moral hazard, the insurer will take steps to control it.

Loyal gatekeepers must be steadfast in their post, watchful and solitary. But after a time, they must go away. They must tender the keys to their replacement. It is good to rest, reflect, and then serve again.