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BOOK REVIEW

SOME THOUGHTS ON THE POROUS BOUNDARY BETWEEN ORDINARY AND EXTRAORDINARY CORPORATE FRAUD

ENSURING CORPORATE MISCONDUCT,

BY TOM BAKER AND SEAN J. GRIFFITH, 2010

Miriam H. Baer*

INTRODUCTION

In the wake of a massive financial meltdown that has triggered a protracted crisis and recession, one might argue that the time has come for commentators to reduce their emphasis on intentional wrongdoing within corporations, insofar as this last go-around of failures seemed to be caused by factors beyond simple, intentional fraud.¹ Nevertheless, our appetite for

* Associate Professor, Brooklyn Law School. This book review stems from comments that were delivered at an Author Meets Reader panel at the Law and Society Association's Annual Meeting in San Francisco, 2011, which was organized by Tanina Rostain. The author thanks Tom Baker and Sean Griffith for encouraging the writing of this review and their generous feedback in response to an earlier draft. The author also gratefully thanks Professor Rostain for her invitation to sit on the Law and Society panel, as well as Dana Brakman-Reiser, James Fanto, Roberta Karmel, and James Park for comments on earlier drafts, and Dean Michael Gerber and President Joan Wexler of Brooklyn Law School, whose summer research stipend supported the writing of this Review.

1. Commentators have attributed the meltdown to numerous factors, although there appears to be a consensus that "excessive risk-taking by major financial institutions was an important cause [of the crisis] . . . and consequently, that there were significant failures of risk management systems at such firms." Robert T. Miller, *Oversight Liability for Risk-Management Failures at Financial Firms*, 84 S. CAL. L. REV. 47, 50 (2010); RICHARD POSNER, *A FAILURE OF CAPITALISM* (2009) (blaming the financial crisis on poor regulatory response to risk-taking); Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309 (2011) (identifying moral hazard and excessive risk-taking within financial firms as cause of crisis); see also Brian Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 BUS. LAW. 1, 3-4 (2009) (concluding from an empirical study that corporate governance

the subject—and the various mechanisms that seem best poised to fight it—remains as strong as ever. Perhaps this is because economic crises—intentional or otherwise—deftly highlight the extent to which corporate chieftains exercise a vast amount of power and influence over our economy and political system.² It is hardly surprising, then, that commentators worry both about the ways in which corporate chieftains abuse the shareholding public's trust, and whether existing legal tools are best designed to deter such abuses.

Professors Tom Baker and Sean Griffith have enhanced this highly charged debate with their nuanced and fine-grained account of how corporations procure insurance for their directors and officers (so-called “D&O insurance”).³ Baker and Griffith skillfully educate their audience on what this type of insurance is, how it is sold and marketed, and how it affects corporate officers and directors and the possibility of misconduct within corporate firms. Although the discussion is balanced and thorough, the title itself will lead most readers to conclude the worst, which is that D&O insurance “ensures” the continued existence of corporate misconduct by shielding directors and officers from personal monetary liability and legal accountability.⁴ Although the authors do not contend that D&O

functioned fairly well outside of the financial sector).

2. “Corporations dominate the business world, accounting for an overwhelming majority of commercial revenues and serving as the nearly exclusive organizational form for large-scale enterprise.” Erik Luna, *The Curious Case of Corporate Criminality*, 46 AM. CRIM. L. REV. 1507, 1507 (2009).

3. TOM BAKER & SEAN J. GRIFFITH, *ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION* (2010). Earlier discussions of these issues appeared in other works by Baker and Griffith. See Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' and Officers' Liability Insurer*, 95 GEO. L.J. 1795 (2007); Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' and Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487 (2007); Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755 (2009).

4. The concern that directors and officers have escaped the consequences of their own malfeasance has been well explored in both the business press and academic literature. See, e.g., Steven Davidoff, *Ex-Directors of Failed Firms Have Little to Fear*, DealBook (Aug. 2, 2011, 8:56 PM), <http://dealbook.nytimes.com/2011/08/02/ex-directors-of-failed-firms-have-little-to-fear/>; see also John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1534 (2006); Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105 (2006); Donald C. Langevoort, *On Leaving Corporate Executives “Naked, Homeless and Without Wheels”*: *Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627 (2007) [hereinafter *Wheels*]; see also Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006) (finding close to no risk for outside directors for inattentiveness or insufficient oversight).

insurance *causes* fraud, they nevertheless argue that its presence vastly undermines the private litigation system erected to *deter* fraud. Accordingly, Baker and Griffith focus private litigation's critics on a new target, the D&O insurance product that so well serves corporate directors and officers.

Through excerpts of multiple conversations with key players in the insurance world,⁵ Baker and Griffith paint a picture that is not particularly pretty: insurance prevents managers from paying for the costs of securities litigation stemming from corporate misconduct, but the insurance insufficiently reflects the corporation's individual governance risks.⁶ During the life of the insurance policy, insurance carriers fail to monitor the insureds adequately (if at all).⁷ Finally, when litigation arises, D&O insurers (unlike other types of carriers) allow corporate managers substantial latitude to negotiate settlements with insurers' money.⁸ In sum, insurance carriers fail to monitor corporate managers robustly before, during, and after an incident of corporate misconduct surfaces.

One might reply that, whatever its drawbacks, D&O insurance at least spreads a single corporation's litigation risk to a broader pool, which in turn indirectly benefits shareholders. But even here, Baker and Griffith see little value. Insurance carriers charge fees in exchange for performing their risk-spreading function; corporations, and effectively their shareholders, pay these fees. Shareholders, however, could just as easily avoid the fees by skipping the insurance and diversifying their stock portfolios.⁹

Nor do Baker and Griffith find much of an information-pooling benefit from D&O insurance, through which firms might discover the techniques or structures that result in less serious or frequent wrongdoing.¹⁰ Unlike other types of insurance (casualty insurance, for example), D&O

5. BAKER & GRIFFITH, *supra* note 3, at 13–17 (describing research methodology and listing categories of interview subjects).

6. *Id.* at 103–04 (concluding that although carriers “attempt to price corporate governance risk” their efforts may be compromised by market forces and “defects of either the underwriting system or the liability system”).

7. *Id.* at 109 (“D&O insurers do almost nothing to monitor the public corporations they insure.”).

8. “D&O insurance policies provide the insurance company with the right to ‘associate’ in the defense of the claim, meaning that the insurer is entitled to receive information about the defense of the claim and to provide input to the defense lawyers, but the clear understanding and practice are that the policy holder, not the insurance company, controls the defense of the claim.” *Id.* at 130 (identifying key differences between D&O insurance defense and other forms of liability insurance).

9. *Id.* at 57–58.

10. See generally Omri Ben-Shahar & Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard* (Univ. of Chi. Inst. for Law & Econ., Working Paper No. 593, 2012), available at <http://ssrn.com/abstract=2038105> (discussing insurance pooling).

insurance does not produce industry-wide data leading to better compliance outcomes.¹¹ Since D&O insurance does not produce better outcomes, it simply protects managers from payouts and introduces moral hazard.¹² Corporate officers become less, not more, accountable for corporate wrongdoing, and shareholders foot the bill.¹³

This is a deeply troubling critique, likely to invoke concern and discomfort among jurists, policymakers and academics. Some may conclude from Baker and Griffith's findings that we should discontinue or radically curtail the availability of D&O insurance, even though the authors themselves avoid embracing such a drastic response. Others may see Baker and Griffith's account as additional support for the view that public enforcement by the SEC, as opposed to private enforcement via shareholder litigation, is the optimal vehicle for restraining corporate misconduct.¹⁴

Like *Ensuring Corporate Misconduct*, this Book Review also adopts a pragmatic approach, albeit one that is more skeptical of the notion that corporate managers can commit fraud without worry. As I argue below, the state of the world becomes a bit murkier when one reflects upon the porous boundary between ordinary and extraordinary corporate misconduct. It is along this boundary that the limited, spontaneous embezzlement scheme imperceptibly bleeds into a multi-year, multi-division *Ponzi* scheme. Whereas the former may be solely the focus of private litigation, the latter is very much the focus of public enforcement and sanctions. Although the authors acknowledge that corporate misconduct can support "a multiplicity of state and federal causes of action,"¹⁵ their critique downplays the effect of public enforcement

11. Instead, D&O insurance "mutes the deterrence effect of shareholder litigation." BAKER & GRIFFITH, *supra* note 3, at 201.

12. "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." *Id.* at 3. For a useful recent discussion of moral hazard and insurance, see Dustin E. Buehler & Steve P. Calandrillo, *Baseball's Moral Hazard: Law, Economics, and the Designated Hitter Rule*, 90 B.U. L. REV. 2083, 2097-99 (2010).

13. "[V]irtually all U.S. public corporations purchase D&O insurance, and shareholder litigation is largely funded by insurance proceeds. What this ultimately means, to both plaintiffs and corporate defendants alike, is that their settlements are funded by other people's money." BAKER & GRIFFITH, *supra* note 3, at 202.

14. For examples of recent calls for a reduced emphasis on or narrowing of private shareholder litigation for securities fraud, see William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69 (2011) (arguing for substantial narrowing of private fraud-on-the-market claims); and Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301 (2008) (suggesting prescreening role for SEC).

15. BAKER & GRIFFITH, *supra* note 3, at 40.

responses on corporate managers, in part because they appear to believe that much of private litigation is directed at “ordinary” fraud, and that public enforcers reserve their limited resources for extraordinary “super-frauds.”¹⁶ If the line between ordinary and extraordinary fraud is weak, however, then a robust public deterrence effort for the latter may make up for a weak private deterrence system for the former. No doubt, the permeability of this boundary does not undermine Baker and Griffith’s key claim that shareholders have been paying for a product that produces relatively few returns. Still, it provides important insights on the authors’ policy suggestions for improving the current state of affairs. These proposals (for a “coinsurance” system, disclosure of insurance contracts, and a lottery system designed to reduce settlements),¹⁷ may be less necessary, and in some instances, redundant, when we consider the broader enforcement landscape in which corporate managers reside.¹⁸

The remainder of this Review proceeds in three parts. First, I summarize the authors’ analysis of the D&O insurance market and its alleged effect on corporate management. In Part II, I analyze Baker and Griffith’s accountability critique by exploring at length the porous boundary between “ordinary” and “extraordinary” frauds.¹⁹ Since no level of insurance protects corporate chieftains from the wrath of criminal prosecutors, state attorneys general, and the Securities and Exchange Commission (“SEC”) Enforcement Division, D&O insurance’s potential for causing moral hazard in *private* litigation therefore must be considered alongside the deterrence effects of *public* enforcement.²⁰ With this broader

16. *Id.* at 60–61 (suggesting that nonmonetary losses such as criminal penalties and loss of reputation “do not follow from most acts that give rise to a D&O claim”).

17. See discussion *infra* pp. 124–27 (laying out proposals in greater detail).

18. This is not to deny that private and public corporate enforcement mechanisms have collectively demonstrated serious shortcomings. See Urska Velikonja, *Leverage, Sanctions, and Deterrence of Accounting Fraud*, 44 U.C. DAVIS L. REV. 1281, 1297–1313 (2011) (providing a recent overview of the literature documenting flaws in entity-liability as a deterrent of corporate accounting fraud).

19. I focus on fraud because it is the primary target of Baker and Griffith’s critique. See BAKER & GRIFFITH, *supra* note 3, at 21 (“Much of our discussion therefore focuses on shareholder class actions under the federal securities laws, particularly 10b-5 class actions.”).

20. Several scholars have recognized and addressed the fact that multiple private and public enforcers address corporate wrongdoing. See, e.g., James D. Cox & Randall Thomas with the assistance of Dana Kiku, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 738 (2003) (observing that “[a] public private partnership for the enforcement of the securities laws is now entering its eighth decade”). Cf. Geraldine Szott Moohr, *The Balance Among Corporate Criminal Liability, Private Civil Suits, and Regulatory Enforcement*, 46 AM. CRIM. L. REV. 1459, 1470 (2009) (noting that “private civil actions involving securities laws may be viewed as ‘essential supplements’ to public enforcement or as abusive demands on law-abiding companies”).

enforcement picture in mind, I assess in Part III several of Baker and Griffith's policy proposals.

I. THE DEPRESSING STORY OF D&O LIABILITY INSURANCE

Baker and Griffith begin their analysis with a brief exploration of the justifications for corporate shareholder litigation.²¹ The authors agree with the scholarly consensus that the compensation rationale for shareholder litigation is neither accurate nor desirable.²² Shareholders receive a mere fraction of their losses once attorneys' fees and costs of litigation are taken into account.²³ Moreover, it is far from clear that shareholders are entitled to *any* payout, given securities litigation's circularity.²⁴ That is, when the company agrees to a settlement for securities fraud (or in rare cases, pays a post-trial judgment), its current shareholders effectively pay those shareholders who purchased and sold securities during the fraud period for the misconduct that was committed by directors and officers. Assuming shareholders are diversified, they are simply paying themselves, less transaction costs, for the very wrongs they suffered.²⁵

With compensation out of the way, deterrence remains the only real justification for shareholder litigation. The authors rightfully question whether the system for procuring D&O liability protection enhances,

21. BAKER & GRIFFITH, *supra* note 3, at 5–10.

22. *See id.* at 6 (observing that “an emerging consensus among most corporate and securities law scholars rejects compensation as a justification for shareholder litigation”).

23. *See* Coffee, *supra* note 4, at 1545–47 (striking down the compensation rationale); Langevoort, *supra* note 4, at 635 & n.35 (“[Private litigation] delivers at best only five to ten cents per dollar of alleged losses (often less), compensates far too many investors who do not have the same claim to compensation, and comes at a very high price tag that eats up fifteen to thirty percent of the claims in plaintiffs’ legal fees and costs plus arguably even more in indirect costs (particularly defendants’ legal fees and costs).”).

24. Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 252 (2009) (contending that “the primary social benefit from a higher level of disclosure by established issuers is not the protection of investors from unfair prices or risk”).

25. This is the famous pocket-shifting or “circularity” argument that has long been a source of discussion among corporate academics. *See, e.g.*, Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 694–95 (1992) (describing how private securities litigation simultaneously imposes costs and benefits on innocent shareholders); Coffee, *supra* note 4, at 1562–63 (2006) (noting that private securities litigation, victims of fraudulent behavior and shareholders are largely the same class); Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 345–47 (explaining why the circularity problem exists only when diversified investors are assumed). *But see* James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323, 328–33 (2009) (questioning existence of circularity problem by comparing settlement payment to the corporate dividend).

undermines, or has no effect on litigation's deterrent effect. Based on their interviews with, among others, risk managers and D&O brokers and carriers, Baker and Griffith soberly conclude that insurance undermines the deterrent effect of shareholder litigation.

The key to understanding this critique is Baker and Griffith's succinct description of the standard D&O insurance product. Each insurance policy has three components, which are called "sides" by the industry participants.²⁶ Side A coverage directly covers directors and officers for claims for which the company cannot practically or legally pay.²⁷ The second and third "sides" of the standard D&O policy, Sides B and C, are the stronger targets of Baker and Griffith's critique, as these provisions compensate *the company* for the indemnification it pays directors and officers (Side B), and for any liability the company bears separately on its own (Side C).²⁸ As the authors explain, Side C seems to have arisen to keep the insurance carriers from arguing with insureds over how a particular settlement ought to be allocated when "the company" and its officers and directors are deemed equally responsible for a given course of conduct.²⁹

Although the authors are willing to accept the standard argument for A-side protection, which is that it serves as a form of protection for otherwise risk-averse officers and directors,³⁰ Baker and Griffith are far more critical of Sides B and C, which also happen to be the sources of the "vast majority"³¹ of D&O insurance payments.

26. See generally BAKER & GRIFFITH, *supra* note 3, at 46–48 (discussing Sides A, B, and C).

27. The company's inability to indemnify the corporate manager may result from its bankruptcy or stem from the fact that Delaware law permits corporations to insure corporate managers for certain claims while simultaneously forbidding the same corporations from directly indemnifying them. *Id.* at 64 (observing that "one of the main functions of side A coverage is to protect the directors' and officers' assets in the event of bankruptcy"). So, for example, the corporation may not indemnify managers for claims successfully pursued in derivative litigation against the corporation's managers, but it can purchase insurance to cover the same managers for that contingency. *Id.* at 43–44.

28. *Id.* at 47 ("Payments under Side B coverage are thus triggered when the corporation incurs an obligation to indemnify its officers or directors, which most policies deem to be required in every case in which a corporation is legally permitted to do so.").

29. *Id.* at 47–48.

30. See, e.g., Fox, *supra* note 24, at 288 ("The normal justification for having the issuer purchase directors and officers (D&O) insurance is that it is necessary to attract qualified people to do these other tasks. The risk of a large judgment being imposed erroneously, the argument goes, would make such a person unwilling to serve without insurance."). Fox favors the dissolution of D&O liability insurance, and in its place, a cap on damages. *Id.*

31. Baker & Griffith, *supra* note 3, at 48. This analytical move poses somewhat of a puzzle. If, as Baker and Griffith claim, private shareholders' litigation is inadequately deterring managerial misconduct, then why do they so easily let Side A insurance off the

Having laid out the various components of the D&O insurance policy, Baker and Griffith then consider whether D&O insurance maintains or reduces shareholder litigation's deterrent effect. An insurance policy that completely insulates a director or officer from monetary payment, regardless of how poorly that director or officer has behaved, is undesirable because it creates moral hazard. Accordingly, throughout much of the book, Baker and Griffith inquire of their research subjects whether D&O insurance carriers adequately prevent the moral hazard problem through the pricing of insurance policies, increased monitoring of insureds, and adequate control of litigation defense costs and strategy.

For the most part, Baker and Griffith's research demonstrates that D&O insurance carriers either fail to engage in the activities necessary to prevent moral hazard, or, at the very least, fail to do them as well as they should. Through a collection of extensive interviews, which they excerpt throughout the book, Baker and Griffith demonstrate that D&O policies do not result in increased monitoring during the life of a policy;³² or a robust, experienced-based pricing of policies;³³ or in the proliferation of loss prevention services.³⁴ Nor do they result in sufficient monitoring once a lawsuit is actually brought.³⁵ To the contrary, insurers allow corporate defendants to shape the litigation strategy and settlement terms, and place far less oversight over corporate defense counsel than the purveyors of other types of insurance.³⁶

Even worse, the insurance appears to forge an unholy alliance between defense and plaintiffs' attorneys. Because the insurance policies include explicit coverage exclusions for fraud and intentional misconduct,³⁷ plaintiffs' attorneys, who obtain the policies through discovery and are keenly aware of their limits and exceptions, intentionally alter their pleadings and negotiation stances in order to access the amounts set forth in

hook? More importantly, why are they so dismissive of Side B insurance, assuming managers might feel more comfortable signing a contract with a company that had bonded itself for insurance with a third party?

32. BAKER & GRIFFITH, *supra* note 3, at 109.

33. Baker and Griffith worry that although carriers attempt to price "governance risk" into the insured's D&O policy, they do so ineffectively: "[T]he actuaries we interviewed doubted that underwriters have a consistent system of evaluation that applies the same factors in the same way over time." *Id.* at 98.

34. *Id.* at 109.

35. *Id.* at 130.

36. On claims management, *see id.* at 134 (concluding that "D&O insurers have relatively little control over who conducts the defense" and "over how the defense is conducted").

37. *Id.* at 48–51. "[O]nce a claim is moving toward settlement at or near the limits of the D&O policy, the plaintiffs and the defense have common adversaries—namely, the D&O insurers." *Id.* at 143.

the D&O policies.³⁸ Accordingly, D&O insurance not only increases moral hazard within corporate firms, but it also reduces transparency generally, since neither shareholders nor the public learn what has transpired.

Baker and Griffith go into much further detail than is possible to convey in this Review, including an overview of the D&O market, excerpts of conversations with multiple players who describe everything from the pricing of insurance to the factors that drive settlements, and an analysis (and rejection) of the various reasons, other than agency costs, that might explain the purchase of D&O liability insurance.³⁹ For the purpose of this discussion, it is sufficient to summarize their conclusions as follows: entity-side insurance plays the important role of capping liability artificially, reducing truth in claims, and creating moral hazard. Directors and officers who are covered by state-of-the art D&O insurance policies can rest easy in the knowledge that they likely will never pay out a dime on a shareholder suit, and their company will pay little more than the amount previously negotiated by the company's designated risk manager.⁴⁰ Shareholders, meanwhile, fail to enjoy the deterrent effect of shareholder litigation. The game is rigged, the amount is capped, and shareholders lose. Were one to stop here, one rightfully would be quite concerned.

II. INTRODUCING THE POROUS BOUNDARY BETWEEN ORDINARY AND EXTRAORDINARY FRAUD

Although Baker and Griffith mount a powerful critique of D&O insurance, there are, fortunately, some good reasons to doubt that D&O insurance "ensures" corporate misconduct. Because it is beyond the scope of their project, the authors do not consider at length how managers may be affected by the broader enforcement landscape, which includes public regulators, state attorneys general, and criminal prosecutors. If public enforcement is strong, then D&O insurance's effect on managerial behavior may be of less consequence than Baker and Griffith suspect.⁴¹

38. *Id.* at 49, 147, 187 (reporting evidence that plaintiffs' and defense counsel explicitly collude to convince D&O carriers to settle). Baker and Griffith further observe that plaintiffs' lawyers "plead strategically in order to avoid handing the insurer a valid coverage defense." *Id.* at 187.

39. *Id.* at 51-56, 57-76.

40. In some cases, the company itself may be forced to contribute to the settlement, but that contribution will be relatively small compared to its insurance coverage. *Id.* at 10 (reporting, from review of Stanford Class Action Clearinghouse website, that "the amount of the corporation's contribution was substantially less than the amount paid by the corporation's D&O insurers, and in some cases, the payment may have been part of satisfying an insurance deductible").

41. I do not mean to suggest here that public enforcement in fact operates at optimal levels.

Moreover, even if public enforcement is weak or uneven, there may be a good argument for fine-tuning or strengthening it rather than directing attention toward private litigation.⁴² Private litigation-as-enforcement, after all, includes a number of agency costs. Plaintiffs' lawyers, insurance carriers, and even defense attorneys all have their own interests, which may or may not align with those of shareholders. Public enforcement, at least in theory, can avoid some of these problems.⁴³

More importantly, the authors seem to assume that much of private litigation involves "ordinary fraud" that is beyond the pale of most public enforcement efforts.⁴⁴ It is this assumption that this Review challenges. Consider the following: let us assume that all shareholder losses stem from one of three causes. The first is incompetence and bad decision-making. Officers and directors make numerous mistakes, some of which are masked by luck and some of which cause companies to lose money and fail. The second source of loss is a type of misconduct that I will refer to for now as "ordinary fraud." Some commentators may refer to it as "garden variety" fraud. Ordinary fraud results from agency costs that often reduce the value of the company. Although vexatious, it is neither so harmful nor so complicated as to draw the ire of public enforcement authorities. Finally, the third category is what I refer to as "extraordinary" fraud. Extraordinary frauds involve more severe losses, threaten many more victims, and therefore trigger criminal and civil investigations by public authorities.

I fully admit that for purposes of this analysis, the difference between ordinary and extraordinary fraud is purely result-driven: a fraud becomes extraordinary when public authorities decide to treat it as such. I do not attempt to distinguish these categories by what corporate managers actually *do* because the law itself does not draw such a bright line.⁴⁵ One of the great problems—and opportunities—for social planners is that putative defendants often do not know in advance whether an ordinary fraud is

42. Indeed, several scholars have recently argued for increasing public securities enforcement with an eye toward reducing or eliminating certain types of private securities litigation. *See, e.g.*, Bratton & Wachter, *supra* note 14 (arguing for substantial narrowing of private fraud-on-market claims); Rose, *supra* note 14, at 1306 (proposing a public oversight approach whereby the SEC would prescreen private 10b-5 lawsuits).

43. Rose, *supra* note 14, at 1305.

44. BAKER & GRIFFITH, *supra* note 3, at 61.

45. For example, the ordinary frauds that lay at the heart of the corporate accounting scandals in the early 2000's morphed into super frauds simply because of their size. *See* Jayne W. Barnard, *Rule 10b-5 and the "Unfitness" Question*, 47 ARIZ. L. REV. 9, 36 n.179 (2005) (explaining that, "the fraud in WorldCom—the recharacterization of ordinary business expenses as capitalized items—might easily be described as a 'garden variety' fraud, but its magnitude—eleven billion dollars—puts it into an entirely different category").

likely to turn into a super fraud.⁴⁶ Once upon a time, perhaps twenty years ago, Bernard Madoff's investment sleight of hand may have seemed like an ordinary fraud. By the time he turned himself in to the authorities in December 2009, however, his scam had grown into one of the largest *Ponzi* schemes of all time.⁴⁷

With this taxonomy of corporate loss in mind, we can better assess Baker and Griffith's critique by asking the question: how does D&O liability insurance affect the three types of shareholder loss described above?

a. Losses from bad decision-making and bad luck:

Return, for a moment, to the first category of losses, which are caused by incompetence and bad decision-making. It is impossible to denigrate D&O liability insurance for either causing or exacerbating these losses because shareholder litigation is not intended to deter or compensate these ills. To the contrary, state and federal legislators and jurists have largely decided that incompetence and bad decision-making ought not to be the subject of shareholder litigation, much less class actions brought under Rule 10b-5.⁴⁸ Markets and shareholder democracy take care of these problems, along with social norms and signaling.⁴⁹ Accordingly, the proper

46. More importantly, managers themselves may be unable to predict those instances in which ordinary fraud will morph into extraordinary fraud. See Michael Guttentag, *Stumbling into Crime: Stochastic Process Models of Accounting Fraud*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CRIMINAL LAW 74 (A. Harel et al. eds., 2011) (citing research supporting the proposition that "accounting fraud is the unforeseen consequence of a sequence of minor and seemingly innocuous transgressions"); Sung Hui Kim, *The Banality of Fraud: Re-Situating the Inside Counsel as Gatekeeper*, 74 *FORDHAM L. REV.* 983, 997 (2005) (arguing that "the behavioral origins of lawyer acquiescence in corporate fraud are found in commonplace interaction in organizational settings").

47. See, e.g., Diana B. Henriques, *Madoff is Sentenced to 150 Years for Ponzi Scheme*, *N.Y. TIMES*, June 29, 2009 (describing the scheme and sentencing).

48. For example, Delaware General Corporation Law permits corporations to include a provision in their charters immunizing directors from monetary damages for losses stemming from good faith, but negligent, decisions. Del. Code Ann. tit. 8, § 102 (b)(7) (2012). Similarly, the well-known business judgment rule shields managers from judicial second-guessing of substantive decisions. See, e.g., *Gagliardi v. Trifood Int'l*, 683 A.2d 1049, 1052-53 (Del. Ch. 1996). For a general discussion of the business judgment rule, see Martin Petrin, *Assessing Delaware's Oversight Jurisprudence: A Policy and Theory Perspective*, 5 *VA. L. & BUS. REV.* 433, 458-59 (2011) (footnote omitted). For arguments that Rule 10b-5 was not intended to apply to garden variety violations of fiduciary duty, see *Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977) (rejecting Rule 10b-5 liability for "a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure").

49. See, e.g., JONATHAN R. MACEY, *CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN* 46 (2008) (discussing various mechanisms, including markets and social

use of shareholder litigation is to deter fraud and intentional wrongdoing, and not mistakes or generalized nonfraud losses.⁵⁰

If, despite the above policies, private litigants can successfully dress up undeserving claims as “fraud”, then D&O insurance may provide a valuable second-best capping and shielding function for shareholders. Even where the merits are weak, private litigants and their attorneys may file fraud suits because the defendant has deep pockets, the public suspects fraud, or because attorneys are overly optimistic regarding their ability to file a pleading that withstands a motion to dismiss.⁵¹ Pleading requirements, including the stricter pleading rules ushered in by the Private Securities Litigation Reform Act of 1995⁵² (as well as the demand rules for shareholder derivative suits) may be insufficient to screen out meritless claims.⁵³ Accordingly, for this residual group, D&O insurance offers an adequate second-best mechanism for capping non-fraud liability and reducing the transaction costs of otherwise unproductive behavior. Although it does not completely insulate shareholders from these costs, D&O insurance keeps them in check and sets a useful frame around which litigants can bargain.

This second-best hypothesis also explains Side A insurance, which Baker and Griffith more or less concede. If shareholder litigation includes unproductive plaintiff-side behavior, then Side A insurance permits corporations to recruit talented officers and directors who also happen to have particularly deep pockets (since those with deep pockets would be afraid to attract individual suits), and reduces costly and inefficient risk aversion among corporate managers.⁵⁴

norms, that govern corporate managers).

50. One of Macey’s arguments is that political forces have combined to undermine the market forces that are best poised to deal with a number of corporate governance problems. *Id.* at 46–47.

51. See generally Donald C. Langevoort, *Basic At Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 155–56 (2009) (explaining that amount of recovery and uncertainty over causes of fraud can exacerbate lawsuits). On the uncertainty inherent in corporate law, see Ehud Kamar, *Shareholder Litigation Under Indeterminate Corporate Law*, 66 U. CHI. L. REV. 887, 888 (1999).

52. The Private Securities Litigation Reform Act requires plaintiffs to plead specific facts giving rise to a “strong inference” of the defendant’s scienter. 15 U.S.C. §§ 78u-4(b)(1), (b)(2). See generally ARTHUR PINTO & DOUGLAS BRANSON, UNDERSTANDING CORPORATE LAW 512–15 (3rd ed. 2009) (summarizing the Private Securities Litigation Reform Act).

53. With regard to the Private Securities Litigation Reform Act, Baker and Griffith observe, “Our respondents seemed to confirm . . . that the motion to dismiss is not a perfect filter for separating good liability cases from bad liability cases.” BAKER & GRIFFITH, *supra* note 3, at 170.

54. As Ehud Kamar has observed, insurance is additionally valuable because it converts a volatile, one-time payment into a series of predictable, annual (premium)

b. *Losses from fraud and intentional misconduct:*

Of course, most commentators would disagree with the proposition that all corporate shareholder litigation lacks merit, and quite a bit of research suggests that these commentators are indeed correct.⁵⁵ So let us stipulate that among the many corporate losses experienced by shareholders, some number is caused by fraud or bad faith behavior. From that perspective, shareholder litigation may be independently valuable insofar as it increases the cost of wrongdoing (either fraud or intentional dereliction of fiduciary duty) to directors and officers. This is the point where Baker and Griffith's critique becomes important. If D&O insurance *reduces* management's liability for misconduct, it also reduces the value of shareholder litigation by creating an accountability vacuum. That vacuum, in turn, becomes much worse when liability insurance carriers fail to fill it with adequate monitoring, experience-based pricing, and control of ensuing shareholder litigation.

Fortunately, private litigation is not the end of the story, because public enforcement impacts corporate management's behavior as well. Although Baker and Griffith discuss public enforcers in passing, they do not give them full attention.⁵⁶ This is in part because the authors assume some stable distinction between "ordinary" fraud and the types of frauds that trigger public enforcement responses.⁵⁷ I focus on fraud here because the much of the book's focus is on the securities fraud class action.

It has long been recognized that the legal line between "ordinary" securities fraud and the so-called "sexier" version that lands one in jail is

payments: "Insofar as fiduciaries are risk averse, their disutility from high and infrequent monetary sanctions exceeds their disutility from low and frequent sanctions, despite the fact that the expected sanction is the same." Kamar, *supra* note 51, at 889. Note also that a small, frequent sanction is less likely to spur costly efforts to avoid detection such as cover-ups and obstruction of justice. Accordingly, frequent, low-level sanctions offer society benefits in the form of reduced detection avoidance, and, consequently, reduced policing costs. For more on how higher sanctions can trigger additional wrongdoing, see Jacob Nussim & Avraham D. Tabbach, *Deterrence and Avoidance*, 29 INT'L REV. L. & ECON. 314 (2009); Chris William Sanchirico, *Detection Avoidance*, 81 N.Y.U. L. REV. 1331 (2006).

55. See Langevoort, *supra* note 51, at 155 nn.15–16 (citing relevant research).

56. Baker and Griffith concede that D&O insurance cannot shield corporate managers from criminal penalties and reputational harm, but presume that "these consequences do not follow from most acts that give rise to a D&O claim." BAKER & GRIFFITH, *supra* note 3 at 60.

57. "Our sense is that the truly massive settlements occur in cases in which the managers violated ordinary, business-as-usual norms by a very substantial margin, and thus the fear of residual corporate liability, or criminal liability, most likely does not deter managers who engage in more *ordinary* financial misreporting. But this would be a worthy subject for more research." *Id.* at 61 (emphasis added).

quite faint.⁵⁸ The federal law that triggers private civil liability for fraud and misrepresentation—Rule 10b-5—is the same rule that triggers both SEC enforcement authority and criminal prosecutions.⁵⁹ Section 10(b) of the Securities Exchange Act and Rule 10b-5 provide securities enforcers with a remarkable amount of enforcement flexibility.⁶⁰ So long as the conduct is “willful”⁶¹ (and the much of the misconduct that concern Baker and Griffith could credibly meet this definition), the same conduct likely satisfies the requirements for criminal liability, provided the government has collected evidence sufficient to satisfy the “beyond a reasonable doubt” standard.⁶² Accordingly, the legal boundary that separates purely private enforcement of securities law on the one hand, and public enforcement ranging from administrative proceedings to criminal prosecutions on the other, is factually and legally porous.

Ordinarily, one might question the fairness and efficiency of a legal

58. Baker and Griffith’s interview subjects refer to those instances of wrongdoing that trigger public enforcement as the “sexier” frauds. *Id.* at 157. “Cases with sex appeal, our respondents emphasized, are cases with scandalous or otherwise vivid facts.” *Id.*

59. 17 C.F.R. § 240.10b-5 (2009). Rule 10b-5 was promulgated pursuant to Section 10(b) of the 1934 Securities Exchange Act, 15 U.S.C. § 78j(b). The Exchange Act provides for criminal penalties for “willful” violations. 15 U.S.C. § 78ff(a). *See also* United States v. O’Hagan, 521 U.S. 642, 677 n.23 (1997) (reiterating that criminal penalties must be premised on a finding that the defendant intentionally violated the law). For discussions regarding the implications of dual-remedy statutes, see Margaret V. Sachs, *Harmonizing Civil and Criminal Enforcement of Federal Regulatory Statutes: The Case of The Securities Exchange Act of 1934*, 2001 U. ILL. L. REV. 1025 (2001) (arguing for a single interpretive approach to dual remedy statutes); Lawrence M. Solan, *Statutory Inflation and Institutional Choice*, 44 WM. & MARY L. REV. 2209 (2003) (speculating how presence of dual remedies influences statutory interpretation in both civil and criminal cases).

60. Among claims brought by shareholders alleging misconduct by officers and directors, “securities class actions represent, by far, the largest potential source of liability.” BAKER & GRIFFITH, *supra* note 3, at 3.

61. *See, e.g.*, 15 U.S.C. § 78ff(a) (providing punishments for willful misconduct). The United States Courts of Appeal for the Second and Eighth Circuits require a showing of intentional misconduct to meet the criminal willfulness standard. *United States v. O’Hagan*, 139 F.3d 641, 647 (8th Cir. 1998); *Trane Co. v. O’Conner Sec.*, 718 F.2d 26, 29 n.4 (2d Cir. 1983). The Ninth and Sixth Circuits permit a showing of recklessness for both criminal and civil suits. *United States v. Tarallo*, 380 F.3d 1174, 1189 (9th Cir. 2004); *United States v. DeSantis*, 238 F.3d 424 (6th Cir. 2000). For a recently filed petition for certiorari discussing this circuit split, see *Petition for Writ of Certiorari, McCall v. United States*, No. 11-882, 2012 WL 151756 (9th Cir. Jan. 18, 2012).

62. Indeed, as a growing number of scholars have observed (and criticized), it may be easier to prosecute a criminal violation than impose civil liability in the securities context. Richard Booth, *What Is a Business Crime?*, 3 J. BUS. & TECH. L. 127, 142 (2008) (“The bottom line is that the standard of pleading and proof in a criminal proceeding is lower than in a civil proceeding. Clearly, something is awry.”); Christine Hurt, *The Undercivilization of Corporate Law*, 33 J. CORP. L. 361 (2008); Geraldine Szott Moohr, *The Balance Among Corporate Criminal Liability, Private Civil Suits, and Regulatory Enforcement*, 46 AM. CRIM. L. REV. 1459, 1474 (2009).

system that blurs the legal treatment of fraudulent conduct. But here, the uncertain treatment of fraud may do some good, or at the very least, quell some of the concerns one might have regarding D&O liability insurance. If corporate fraud can credibly trigger administrative proceedings, civil penalties, and criminal investigations of intentional wrongdoing, then even the state of the art insurance policy has significant limitations. After all, as Baker and Griffith demonstrate, D&O insurance policies contain coverage exclusions against fines, penalties, and payments for adjudicated violations of the law.⁶³ If a public enforcer so desires, she can extract admissions of intentional wrongdoing, seek fines and penalties that are explicitly excluded by the policy, and impose structural reforms that are costly to the company and its managers and yet beyond the reach of any D&O policy.⁶⁴ In the worst of cases, a public enforcer may seek corporate prosecutions and entity-level indictments, all of which will do massive damage to the company's reputation and future prospects.

Public enforcement is bad enough for the company, but it can be far worse for the specific individuals the government targets, particularly when the company decides to cooperate in the government's prosecution of corporate managers. Indeed, even when (or particularly when) the government treats a corporate entity relatively leniently, it may focus keenly on one or more corporate managers responsible for intentional violations of law.⁶⁵ D&O insurance offers little assurance to the targets of such investigations. It does not prevent or compensate the public stigma attached to civil and criminal enforcement proceedings; the loss of one's job; suspension or exclusion from participating in one or more regulated industries; or, most dramatically, the imposition of a sentence of imprisonment.

In sum, disastrous consequences can flow from a public enforcer's investigation of fraud.⁶⁶ Although private enforcers possess a number of

63. BAKER & GRIFFITH, *supra* note 3, at 186.

64. As Baker and Griffith point out, coverage exclusions for fraud often do not apply unless "adjudicated," which may not even be the case in public enforcement proceedings, where defendants often settle without admitting wrongdoing. *Id.* at 187–88. However, the D&O policy still may exclude payments that are designated "fines" or "penalties" or disgorgement for ill-gotten gains. *See, e.g.,* STEVEN PLITT & JORDAN R. PLITT, 2 PRACTICAL TOOLS FOR HANDLING INSURANCE CASES § 14.14 (2011) (observing that the "typical D&O policy" excludes coverage for "criminal or civil fines or penalties imposed by law").

65. *See* William S. Laufer, *Corporate Prosecution, Cooperation, and the Trading of Favors*, 87 IOWA L. REV. 643, 657–660 (2002) (describing the practice of "reverse whistleblowing" whereby corporations identify culpable employees in exchange for entity-level leniency from government).

66. *See* Jonathan Karpoff, D. Scott Lee & Gerald S. Martin, *The Consequences to Managers for Financial Misrepresentation*, 88 J. FIN. ECON. 195, 201 (2008) (describing the punishments endured by corporate managers who were caught "cooking the books"). For

good reasons to downplay misconduct in order to avoid an insurance exclusion,⁶⁷ public enforcers possess fewer incentives to hold their fire, assuming there exists robust evidence of intentional misrepresentations and schemes to defraud. Moreover, if public enforcers are in fact abdicating their roles by declining cases or unnecessarily abandoning the requirement that corporate managers admit wrongdoing as a condition of civil settlements, then perhaps the easiest way to deter corporate misconduct is to demand changes in public enforcement, assuming such demands are warranted.⁶⁸

Now it would be one thing if, despite the weak *legal* boundary between private and public enforcement, corporate wrongdoers could still predict with relative certainty the practical amount of wrongdoing that would trigger public enforcement.⁶⁹ It would be cause for great concern if managers could calibrate, with precision, the amount of fraud likely to trigger weak or strong public enforcement responses. This, however, would require managers to (a) identify the public enforcement trigger, *ex ante*, and (b) ensure that the extent of their fraud remained below that trigger. Under these conditions, managers would be able to do a fair amount of damage to the corporation's shareholders and capital markets in general. Directors and officers would take the modicum of care to avoid public enforcement inquiries while simultaneously stealing (albeit slowly

more on corporate losses following public enforcement proceedings, see Jonathan Karpoff, D. Scott Lee & Gerald S. Martin, *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581, 581–611 (2008). For more on the drawbacks of a corporate-wide criminal indictment, see *United States v. Stein*, 435 F. Supp. 2d 330, 381 (S.D.N.Y. 2006) (referring to entity-wide indictment as the equivalent of a death sentence); Miriam H. Baer, *Insuring Corporate Crime*, 83 IND. L.J. 1035, 1090–92 (2008) (describing the consequences of indictment).

67. BAKER & GRIFFITH, *supra* note 3 at 186–88.

68. See *SEC v. Citigroup Global Mkts.*, 827 F. Supp. 2d 328 (S.D.N.Y. 2011) (rejecting proposed settlement with Citigroup for alleged misrepresentation in sales of mortgage-backed securities). Judge Rakoff's opinion in the case pointedly took the SEC to task for failing to extract any admission of wrongdoing from Citigroup: "Here, the SEC's long-standing policy—hallowed by history, but not by reason—of allowing defendants to enter into Consent Judgments without admitting or denying the underlying allegations, deprives the Court of even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact." *Id.* slip op. at 9. The Second Circuit, however, rejected the district court's authority to impose such demands on the SEC. *SEC v. Citigroup Global Mkts.*, 673 F.3d 158, 163 (2d. Cir. 2012) (criticizing the district court for interfering with the agency's "judgment on wholly discretionary matters of policy").

69. For example, drivers can safely ignore a highway sign that specifies a speed limit of fifty-five miles per hour if they know, from experience, that the police only arrest speeders traveling above seventy-two miles per hour. Notice, in this instance, the drivers can safely drive above fifty-five miles per hour because (a) they are certain that the police arrest only those drivers whose speeds exceed seventy-two miles per hour, and (b) they have the absolute ability to drive at speeds below the unofficial speed limit.

and moderately) from the company's shareholders. The ordinary fraud would be left to private litigation and paid for by insurance (effectively, the shareholders who were themselves victims), and the extraordinary fraud would remain the province of federal prosecutors, state attorneys general, and SEC enforcement attorneys. Machiavellian corporate managers who knew how to maintain frauds at so-called "ordinary" levels could enrich themselves at the expense of hapless shareholders, while their overly greedy colleagues fell prey to periodic show-trials. Although Baker and Griffith do not portray this scenario outright, they seem to presume it when they concede only that public enforcement "may still operate to deter the worst corporate misconduct."⁷⁰

Assuming we could test for the presence of these conditions (a stable, transparent enforcement trigger, and sufficient managerial control to keep fraud below that trigger), it is unlikely that we would find either of them. Public enforcement priorities are neither stable nor transparent.⁷¹ To begin with, public enforcement itself is hardly a monolith. State attorneys general, who are funded by state funds and supported and elected by state taxpayers (including shareholders) may be more aggressive and potentially less predictable than the SEC officials who balance a constant need for public approval, congressional funding, and corporate cooperation.⁷² The SEC, despite its reputation for being weak, can also become more aggressive in response to enforcement competition by state prosecutors.⁷³ Federal prosecutors, meanwhile, may decide to enter the fray when the frauds in question trigger the institutional interests of their respective United States Attorney Offices. Finally, public opinion, which ebbs and flows in response to economic cycles and salient scandals, also influences enforcement priorities.⁷⁴ Accordingly, predicting public enforcement priorities is likely to be a risky and error-laden game.

Moreover, corporate managers may not find it so easy to predict in

70. BAKER & GRIFFITH, *supra* note 3, at 21.

71. See Tom Baker et. al., *The Virtues of Uncertainty in Law: An Experimental Approach*, 89 IOWA L. REV. 443 (2004) (using empirical experiment to demonstrate the potential deterrence benefits that flow from uncertainty).

72. See generally Margaret H. Lemos, *State Enforcement of Federal Law*, 86 N.Y.U. L. REV. 698, 701 (2011) (exploring how state enforcement of federal law provides states with a "unique" form of power).

73. See Coffee *supra* note 4, at 779 (2007) (arguing that "competition among enforcers is healthy and has filled gaps in securities enforcement").

74. *Id.* at 781 (discussing how state attorneys general are "adept" at marshaling public opinion in their favor); see also Stephen Choi, et. al., *Scandal Enforcement at the SEC: Salience and the Arc of the Option Backdating Investigation* (N.Y.U. Law & Econ. Res., Working Paper No. 11-20, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1876725 (providing empirical evidence that state attorneys general are in fact adept at marshaling public opinion in their favor).

advance how far or deep an apparent “ordinary” fraud will extend. Like the public enforcement world, the corporate world itself is complex and difficult to predict. A single decision to cook the books in one quarter may commit a manager to cooking the books in all subsequent quarters, lest he alert observers that prior reports were wrong.⁷⁵ By the same token, a manager who thinks he has uncovered mere “ordinary fraud” may later find out that he has uncovered not simply a single instance of fraud, but in fact the tip of a “super fraud” iceberg.

So if we assume that the practical, as well as legal boundaries between white lies and disastrous deception are easily crossed, then it is not at all clear that D&O insurance’s marginal effect on deterrence is as negative as the authors’ account suggests. Corporations—particularly large, publicly held ones that are continuously in the public eye—should have good reason to fear public regulators and prosecutors, assuming those regulators and prosecutors are competent and motivated. This is true even if the number of cases prosecuted criminally is low relative to the number of class action claims filed civilly, or if the amount of fines collected civilly far outstrips the dollar value of fines collected through criminal and SEC enforcement proceedings.⁷⁶ What matters is that officers and directors perceive a real, credible threat that the fraud they promulgate or cover up will grow into the kind of scandal that triggers protracted investigations, unpleasant government oversight, and significant reputational costs to their company and to them personally.

Even more so than its managers, the corporation’s in-house attorneys are likely to be keenly aware of the potential for frauds to blow up into high-profile scandals.⁷⁷ Public enforcement has, through a number of different mechanisms, imposed obligations on all publicly held companies to improve their overall compliance with the law, all of which increases internal monitoring and external reporting by corporations. Accordingly, corporate in-house attorneys and their external legal advisers are quite aware of the compliance requirements embedded in the Sarbanes-Oxley

75. Miriam H. Baer, *Linkage and the Deterrence of Corporate Fraud*, 94 VA. L. REV. 1295 (2008).

76. See Coffee, *supra* note 4, at 1542–1551 (2006) (comparing the incidence and intensity of private and public proceedings and penalties); see also Cox & Thomas, *supra* note 20, at 777 (finding a “modest overlap” of fifteen percent between SEC enforcement proceedings and private securities fraud proceedings filed between 1997 and 2002). For more on regulatory intensity and enforcement, see generally John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 258 (2007); Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REG. 253, 271–80 (2007).

77. Indeed, this fear of fraud may cause corporate attorneys to overlook more pernicious threats to the corporation’s health, such as excess risk.

Act, the United States Sentencing Guidelines, and the charging memoranda and enforcement guidelines maintained respectively by the Department of Justice and the SEC.⁷⁸ Regardless of whether they are actually cost-effective, it is not a far cry to assume that these programs have increased officers and directors' awareness of the potential for public enforcement's tangible and intangible costs.⁷⁹

This richer account of corporate fraud enforcement and compliance yields several conclusions. First, for the clear-eyed, rational manager ("Rational Manager"), the decision to engage in fraud is fraught with dangerous consequences. Ordinary fraud can turn into extraordinary fraud, and extraordinary fraud, when it comes to light, triggers public enforcement and uniformly negative consequences for the company and its individual managers. Similarly, the decision to ignore or concur in *someone else's* ordinary fraud (the usual claim lobbed at directors and willfully blind managers) is equally senseless. The ordinary fraud that the Rational Manager chooses to ignore might well mask extraordinary fraud, or transform itself relatively quickly. The risks, even discounted and long-term as they may be, outweigh the benefits.

For the myopic manager ("Myopic Manager"), the calculation is admittedly different. Myopic Manager cares most about "making his numbers" and maintaining his job and receiving his next bonus. Alternately, if he is innocent of his own wrongdoing but becomes aware of someone else's, Myopic Manager is intent on "not making waves" again because he is worried about maintaining his position and receiving his next bonus. In both cases, Myopic Manager vastly discounts the likelihood that his (or someone else's) minor fraud will turn into extraordinary fraud; accordingly, Myopic Manager is not deterred by potential criminal penalties or the substantial enforcement sanctions that attach to his decision not to report someone else's fraud. But notice, Myopic Manager probably would not be deterred by the loss of insurance coverage either. This is so because Myopic Manager vastly discounts the likelihood that *anyone* will

78. See generally Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 958–75 (2009) (describing legal developments that fueled rise of compliance industry) and Harry First, *Branch Office of the Prosecutor: The New Role of the Corporation in Business Crime Prosecutions*, 89 N.C. L. REV. 23 (2010) (providing an overview of different compliance requirements and enforcement guidelines).

79. See, e.g., Richard H. McAdams, *Beyond the Prisoners' Dilemma: Coordination, Game Theory, and Law*, 82 S. CAL. L. REV. 209, 233–35 (2009) (explaining how legal expression can create "focal points" that make certain outcomes more likely, even when enforcement is relatively unlikely); Richard H. McAdams & Janice Nadler, *Coordinating in the Shadow of the Law: Two Contextualized Tests of the Focal Point Theory of Compliance*, 42 LAW & SOC'Y REV. 865 (2008) (using experimental evidence to show how focal points form in response to legal developments).

catch him or his colleagues. The solution for curing the manager of his myopia is not to remove his employer's Side B and C insurance protection, but rather to increase, in a credible manner, the likelihood of the fraud's detection, and to decrease the types of structural weaknesses that encourage fraud in the first place.⁸⁰

Currently, D&O carriers perform neither of these tasks. They do not monitor insureds so closely as to increase the likelihood of fraud detection, and they do not offer the types of structural loss prevention services that would reduce the incidence of overoptimistic performance promises.⁸¹ Baker and Griffith attribute this failure to managerial agency costs. But it may also be that the services are particularly difficult to design and sell.⁸²

More importantly, the carriers' reticence also may stem from the fact that *public* enforcers maintain considerable prerogative to define what constitutes adequate oversight. For example, public enforcement agencies already require corporations to maintain "effective" compliance programs, whose effectiveness are measured not in terms of aggregate data, but rather by the gestalt conclusions of enforcement agents and prosecutors.⁸³ The same public enforcers offer corporations leniency in exchange for monitoring and reporting of wrongdoing.⁸⁴

If public enforcers maintain ultimate discretion to decide what constitutes "effective" corporate compliance and reporting, then it is not surprising that insurance carriers have largely avoided the corporate monitoring and loss prevention businesses. Carriers cannot easily advise

80. See, e.g., Raymond Paternoster, *How Much Do We Really Know about Criminal Deterrence?*, 100 J. CRIM. L. & CRIMINOLOGY 765, 817–18 (2010) (providing empirical and theoretical evidence that deterrence is better achieved by increasing the likelihood of detection, rather than increasing the severity of sanctions).

81. BAKER & GRIFFITH, *supra* note 3, at 105.

82. Compliance services are arguably experience or credence goods. "Experience goods" are ones that can be judged only after the purchaser has enjoyed personal experience using the good. "Credence goods" are goods whose intrinsic values are difficult to discern and therefore require the purchaser to place much credence in the sellers' claims. See generally Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 SMU L. REV. 299, 317–18 (2009) (explaining how corporate governance reforms can be credence goods); Omari Scott Simmons, *Corporate Reform as a Credence Service*, 5 J. BUS. & TECH. L. 113, 119 (2010) (elaborating on the "credence characteristics of corporate governance reform").

83. See, e.g., Baer, *supra* note 78, at 977-78 (criticizing the Department of Justice for failing to systematically gather data on compliance, or rely on such data in making individual decisions).

84. *Id.* at 972. For an overview of corporate criminal liability and an economic analysis of how offers of leniency can improve deterrence, see Jennifer Arlen, *Corporate Criminal Liability: Theory and Evidence*, in RESEARCH HANDBOOK ON CRIMINAL LAW (Hylton et al. eds., forthcoming), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1890733.

their corporate customers how public enforcers will respond to a particular oversight or monitoring problem.⁸⁵ That job falls to the corporation's in-house and outside counsel, who not only have sufficient expertise to judge what public prosecutors and regulators (often attorneys) *may* do, but also have the ability to influence what those same enforcers *will* do. Insurance carriers can make bets on which compliance failures trigger liability; lawyers, by contrast, can persuade the public officials responsible for deciding whether and how much liability the corporation will incur. To put it in the insurance vernacular: corporate attorneys do not simply predict the risk of fires; in some circumstances, they actually extinguish them too.⁸⁶

Given the foregoing, it is hardly surprising that corporate attorneys (internal or external) advise the corporation on the content and structure of the corporate compliance program, as well as whether and when to report wrongdoing, and the likely penalties that will befall the corporation in the event of a compliance breakdown.⁸⁷ Even if D&O insurance carriers could perform these functions more effectively than attorneys, corporations currently have far greater incentive to place these functions with corporate counsel so long as public enforcers remain in the mix.⁸⁸

Moreover, even if public enforcement agencies were to relinquish their monopoly on the definition of "effective" internal compliance, the

85. As Baker and Griffith observe, carriers do in fact attempt to price governance risk into the D&O policy, even though they fail to monitor the corporation during the life of the policy and fail to offer incentives for companies to reduce governance risk. Moreover, carriers have hired forensic accountants to evaluate the corporation's internal controls. BAKER & GRIFFITH, *supra* note 3, at 92.

86. One might imagine a world in which carriers employed attorneys to predict public enforcement response, much the same way carriers employ forensic accountants. Even here, it seems unlikely that the corporation would forego the opportunity to seek advice from attorneys directly since that advice would be protected by the attorney-client privilege, and because the attorney would be better positioned to interpose herself between the company and public enforcement agency.

87. See Sung Hui Kim, *Gatekeepers Inside Out*, 21 GEO J. LEGAL ETHICS 411, 450 (2008) (exploring the expansion of in-house counsel's duties to include monitoring of corporate compliance); Omari Scott Simmons & James D. Dinnage, *Innkeepers: A Unifying Theory of the In-House Counsel Role*, 41 SETON HALL L. REV. 77 (2011) (discussing the importance of in-house counsel in guarding against corporate fraud and opportunism).

88. There is currently debate on whether the corporation's compliance program ought to be kept separate from the General Counsel's department. See Michele DeStefano, *The Government's Unofficial Stance on Compliance Departments: To Comply or Not To Comply* 21-35 (Dec. 23, 2011) (unpublished article) (on file with author) (reporting on interviews with general counsel and compliance officers). This debate, however, does not alter the fact that corporations are much more likely to rely on lawyers than insurance carriers to design corporate compliance systems, insofar as lawyers can better deduce public enforcement's reaction to a given compliance failure. Indeed, DeStefano's research revealed that many compliance departments continue to employ attorneys, despite the fact that the department exists outside of the general counsel's office. *Id.* at 10.

carriers' collective ability to set compliance obligations at optimal levels still would not be a forgone conclusion. Baker and Griffith contend that insurance carriers are best positioned to reduce the risk of corporate fraud because their money is on the line.⁸⁹ But Baker and Griffith's interviews with the insurance carriers' employees ironically do not inspire much confidence. Some of the guidelines that influence the carriers' pricing (albeit moderately), for example, are little more than bromides: "To me, my style in terms of underwriting has been to look for the way people deal with certain issues and how they view their goals and how they are going to achieve them."⁹⁰

There is hardly anything objectionable about the above statement. Nor is there anything particularly objectionable about seeking information on internal structure, information flows, or CEO perquisites, all of which seem to matter to the D&O insurance agents who price governance risk.⁹¹ But much of this information is already sought by multiple parties, most notably institutional shareholders and their advisory services.⁹² Why are we so sure that insurance carriers are seeking better information, or are better positioned to evaluate the information they receive?⁹³

Despite the foregoing, Baker and Griffith have raised an important point. To the extent we employ a "multienforcer" approach to various types of corporate fraud, at least one of those "enforcers"—private shareholder litigation—may be weaker than we realize, thanks to D&O insurance. This, in turn, places greater reliance on public enforcers. Were all public enforcers deeply captured and enforcement actions by state and federal officials unsuccessful or nonexistent, Baker and Griffith's findings would be cause for real concern. And indeed, for some types of wrongdoing, concerns about diffident public enforcers may be well-

89. BAKER & GRIFFITH, *supra* note 3, at 221.

90. *Id.* at 89.

91. *Id.* at 88–92.

92. For an overview and critique of such advisory services, see Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887 (2007) (arguing that conflicts of interest reduce credibility of proxy advisors' governance advice). Rose has also argued that the link between "good corporate governance" (as defined by proxy advisory services) and corporate performance is uneven: "[T]his is primarily due to the fact that 'good' corporate governance is firm-specific and often based on qualities, such as corporate culture, that are not readily quantifiable and so are difficult or impossible to reduce to a set of metrics." Paul Rose, *Regulating Risk by "Strengthening Corporate Governance,"* 17 CONN. INS. L. J. 1, 11 (2010) (questioning the Dodd-Frank Act's emphasis on "strengthening corporate governance" by focusing on executive compensation and shareholder proxy access).

93. According to Baker and Griffith, "[m]ost insurers are not rigidly quantitative in their adjustments to price." BAKER & GRIFFITH, *supra* note 3, at 96. The quantitative models that do exist are not necessarily well-designed or rigorous. *Id.*

founded.⁹⁴

For example, nothing in recent memory has triggered so much criticism of the SEC as its abject failure to identify and shut down Bernard Madoff's *Ponzi* scheme.⁹⁵ The SEC not only failed to act on detailed allegations provided by an external financial analyst, but its agents arguably did not even comprehend basic finance concepts.⁹⁶ These were hardly the building blocks of effective enforcement. But even here, the SEC is not usually the sole source of public enforcement. Where SEC enforcement agents fail, public prosecutors and state attorneys general may take up the slack, with varying results.⁹⁷ Even when public enforcement withers, the public policy answer may not be strengthening private litigation, but rather, focusing on ways to improve and reinvigorate public enforcement, or channel public enforcement towards different targets.⁹⁸

The foregoing account is not intended to suggest that no one in corporate America commits fraud. Nor is it to say that the current public enforcement system is the one we would choose were we starting over from scratch. Nevertheless, despite well-documented weaknesses in portions of our public enforcement apparatus, those who commit corporate wrongdoing operate in a world in which drastic sanctions can apply depending on the fraud's scope and the public's animus. As a result, corporate managers have good reason to avoid wrongdoing. At the same time—and this is one of the recurring ironies of strong enforcement regimes—those who *do* engage in wrongdoing have very good reason to take substantial steps to *hide* their misconduct. This is hardly a problem that Side A, B or C insurance has caused. Nor is it a problem that ordinary insurance carriers can easily solve. Indeed, the fact that managers hide

94. See, e.g., Cox & Thomas, *supra* note 20, at 751 (observing that overall SEC enforcement volume is relatively modest).

95. See Donald C. Langevoort, *The SEC and the Madoff Scandal: Three Narratives in Search of a Story*, 2009 MICH. ST. L. REV. 899 (2009) (assessing bureaucratic and institutional failures that contributed to the SEC's failure to detect Madoff).

96. See Robert J. Rhee, *The Madoff Scandal, Market Regulatory Failure and the Business Education of Lawyers*, 35 J. CORP. L. 363 (2009) (providing further overview of various factors that contributed to the SEC's failure to detect Madoff).

97. John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 763–65 (2009).

98. See Mark Klock, *Lessons Learned from Bernard Madoff: Why We Should Partially Privatize the Barney Fifes at the SEC*, 42 ARIZ. ST. L. J. 783, 784 (2010) (contending that “the SEC is simply not capable of providing adequate protection for the integrity of our public financial markets without assistance from private attorneys general”). Alternate approaches might be to encourage the SEC to focus more intently on corporate executives instead of corporations and their shareholders. “[I]t has not always been so clear that executives are the primary focus of securities enforcement in financial misreporting cases, even when they are its main architects. Their companies often seem to be the real targets.” Langevoort, *supra* note 4, at 627–28.

their frauds demonstrates an even deeper problem, which is that stronger sanction systems may lead managers to invest more strongly in detection avoidance, rather than simply desisting from fraud.⁹⁹

To sum up: if we assume that it is difficult to distinguish between ordinary and extraordinary frauds, and we accept the fact that extraordinary frauds *do* elicit substantial public sanctions, and that those sanctions *do* alter managerial conduct, then fraud's porous nature fills some of the vacuum left by D&O insurance. Insurance may be overly costly, but it may not impose as much additional hazard as Baker and Griffith fear. The corporate world poses plenty of hazards for shareholders, but those hazards stem from the fact that corporate managers exercise tremendous discretion over other people's money.¹⁰⁰

III. POLICY PROPOSALS: ENSURING D&O DISCLOSURE

With this broader enforcement framework in mind, we can better understand and evaluate Baker and Griffith's policy proposals. To their credit, Baker and Griffith do not call for the elimination of D&O insurance, or for a rollback of the Private Securities Litigation Reform Act, which set the high procedural thresholds that screen out the more fanciful plaintiffs claims, or for any of the dramatic reforms that critics periodically tout. Instead, Baker and Griffith focus on three policy adjustments that appear more moderate in tone and incremental in effect.

Most relevant to this Review's focus, Baker and Griffith propose a type of "coinsurance" whereby companies retain a portion of risk for wrongdoing.¹⁰¹ Through such coinsurance, companies would maintain some mandatory portion of risk for losses caused by managerial misconduct.¹⁰² According to the authors, this deliberate provision of residual risk would alter how managers behave before and after misconduct

99. On detection avoidance, see generally Jacob Nussim & Avraham D. Tabbach, *Controlling Avoidance: Ex-Ante Regulation Versus Ex-Post Punishment*, 4 REV. L. & ECON. 1 (2008); Sanchirico, *supra* note 54; Avraham D. Tabbach, *The Social Desirability of Punishment Avoidance*, 26 J. L. ECON. & ORG. 265 (2010).

100. This point was brought home long ago by Louis Brandeis' famous tome, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* (1914). For a discussion of Brandeis' critique in the corporate governance context, see Edward Janger, *Brandeis, Business Ethics, and Enron*, in *ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS* (Nancy B. Rapoport & Bala G. Dharan, eds., 2004).

101. BAKER & GRIFFITH, *supra* note 3, at 222–25.

102. The authors purposely leave open for future discussion the details of how much residual risk corporations would bear. *Id.* at 223 (conceding that “[s]etting the optimal level of coinsurance would be a complicated corporate finance exercise that we will not attempt here”).

arises.¹⁰³

Putting aside the authors' concerns about how corporations settle fraud cases, it is far from obvious that corporations with entity-level coverage do not already enjoy a fair amount of residual risk. As the public enforcement discussion in Part II demonstrates, most publicly held companies already retain substantial risks related to the costs of preventing and responding to inquiries by public enforcers. Nothing in a D&O insurance policy shields the corporation from the effects of an investigation by the SEC, the DOJ or any of the fifty state attorneys general. A number of studies have documented the numerous ways in which public investigations and prosecutions harm both their corporate targets and the officers who are employed by them.¹⁰⁴ Concededly, coinsurance would shore up deterrence in those instances where public enforcement is overly lax, and where managers can reliably prevent ordinary fraud from triggering public inquiries. It is unclear, however, how much Baker and Griffith's proposal would introduce expensive redundancies rather than close true gaps.

Coinsurance is not Baker & Griffith's central policy proposal. Rather, their argument is that the SEC should mandate the disclosure of corporate D&O insurance policies. Without question, this is their strongest and most elegant policy suggestion. Their proposal for mandatory insurance disclosure would yield information currently unavailable to many shareholders, such as the policy's limits, premiums and any exceptions.¹⁰⁵

To the extent information improves shareholder oversight through voting and exit,¹⁰⁶ mandatory disclosure ought to be valuable.¹⁰⁷ Assuming market failure has thus far failed to produce such information, Baker and Griffith's proposal is quite useful. That being said, the utility of the proposal would likely come down to the details of its execution. As Baker and Griffith report, a number of aspects of the D&O policy have little to do with the carrier's assessment of likelihood of wrongdoing, but rather with

103. *Id.* at 224-25.

104. See *The Cost to Firms*, *supra* note 66; and *The Consequences to Managers for Financial Misrepresentation*, *supra* note 66, at 209, 212 (2008).

105. BAKER & GRIFFITH, *supra* note 3, at 205-07 (observing that Delaware does not mandate disclosure of insurance policies, and that most states follow Delaware's lead, with the notable exception of New York).

106. Shareholders can exert pressure on directors and officers by voting for different directors (voice), selling their shares (exit), or bringing lawsuits (liability).

107. On the efficiency benefits of publicly mandated disclosure, see Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 *Colum. L. Rev.* 237, 254-55 (2009) (explaining how mandatory disclosure improves corporate governance) (citing John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 *Va. L. Rev.* 717, 751 (1984)).

the risk of financial loss.¹⁰⁸ Indeed, one of the authors' criticisms is that carriers currently fail to price governance risk accurately.¹⁰⁹ If carriers price governance risk sub-optimally, then shareholders are not likely to learn how strongly their investment is at risk for fraud or intentional misconduct. Perhaps mandatory disclosure itself would improve carriers' pricing of governance risk, but this happy symbiosis is far from certain.¹¹⁰

One can imagine other objections. For example, depending on the uniqueness of policies, comparison of terms might be difficult. The information conveyed by the policies also might be redundant, assuming analysts and sophisticated persons already enjoy access to much of the same information that insurance carriers consider.¹¹¹ Moreover, an already overburdened public enforcer might experience difficulty ensuring that insurance disclosures were accurate. At the other end of the spectrum, we might see the emergence of frivolous lawsuits for supposedly misleading D&O insurance disclosures.

Despite these objections, the authors' proposal is quite alluring. Surely, some of the information reflected in the corporation's D&O policy would be quite useful. Over time, sophisticated and institutional shareholders would be able to develop a sense of what terms certain policies ought or ought not to contain. A corporation's change in policy might trigger fruitful inquiries from shareholders or media analysts, as might a corporation's failure to secure a policy similar to that of its peers. In sum, mandatory reporting may not be a panacea for the ills the authors describe, but it offers enough benefits to merit serious consideration.

By contrast, a third proposal, which the authors explicitly label as a thought experiment, seems least tenable: legislatures would impose a lottery system whereby five to ten percent of all shareholder class actions that survived a motion to dismiss would be selected for mandatory adjudication.¹¹² The litigants bringing such cases would be forbidden from settling their cases prior to trial.¹¹³ The benefit Baker and Griffith hypothesize from this imaginary lottery is additional adjudication. Were more cases to go to trial, courts would be forced to address more liability claims, sift through competing damage models, and impose penalty

108. BAKER & GRIFFITH, *supra* note 3, at 87 (explaining that "underwriters now focus their financial risk assessment on such factors as the prospective insured's industry and maturity, market capitalization, volatility, and other various accounting ratios").

109. *Id.* at 103-04.

110. *Id.* at 219 (suggesting that "side benefit" of mandatory disclosure would be improvement of "product market efficiency" for D&O insurance).

111. *Id.* at 217-18 (noting and responding to objections that sophisticated investors "already have at least as much access to corporate managers as D&O underwriters").

112. *Id.* at 229.

113. *Id.*

decisions such that “the world of securities litigation . . . could begin to resemble the model of civil litigation propounded by legal academics.”¹¹⁴

Leaving aside the proposal’s low political feasibility, which Baker and Griffith duly acknowledge,¹¹⁵ as well as the constitutional questions it is likely to generate (one can imagine some version of a due process challenge), the proposal ultimately reminds the reader why public enforcement is so important. True, shareholder plaintiffs’ premature settlements may cause society to lose out on the informational benefits of adjudication on the merits. Insurance carriers may well exacerbate this problem. But the answer to this problem is not forced private adjudication, so much as it is the maintenance of robust public enforcement. Where private parties seek quick settlements, public enforcers can pursue results that are more aligned with the public’s interest.

CONCLUSION

Corporate fraud is difficult to prevent. To reduce agency costs caused by shirking and other bad behavior, shareholders demand objective evidence of performance from officers and directors, who receive compensation, power and prestige in return. When officers and employees meet or exceed the market’s performance expectations, all parties benefit. When employees and officers fall short of performance levels, however, they cast about for substitutes. At least in the short term, fraud functions quite nicely as a substitute for performance.¹¹⁶ In the long run, however, its consequences are often disastrous.

Given the negative consequences of fraud on society, Baker and Griffith rightly focus on the D&O insurance market and its effect on shareholder litigation and corporate governance. Moreover, they do readers a tremendous service by meticulously describing the contours of the D&O industry and the manner by which D&O policies are marketed, sold and employed. Their analysis of D&O insurance and its effect on private shareholder litigation, however, must be considered against a backdrop of overlapping and periodically strong instances of public enforcement and regulation. If we believe that corporate officers and directors respond to the threat of criminal and civil enforcement and that public securities enforcement is even moderately credible, then the

114. *Id.* at 228.

115. *Id.* at 229 (recognizing that moral objections to use of a lottery to allocate legal rights would likely prevail).

116. See Bratton & Wachter, *supra* note 14, at 106 (“The temptations [to commit fraud] are built into corporate capitalism, whether through concealment of bad news or overblown projection of future success.”).

situation is not quite as dire as one might conclude from reading *Ensuring Corporate Misconduct*. So long as our public regulators and enforcers are informed, well incentivized, and competent, officers and directors have plenty to fear.¹¹⁷

On the other hand, Baker and Griffith's account ought to make us even more concerned when it appears that our public enforcers *are not* operating very well, or when we conclude that the costs of improving public enforcement are so great that we would rather focus on improving alternatives such as private litigation.¹¹⁸ If private litigation fills the gaps where public enforcement falls short; spurs public enforcement to do a better job; and aids public enforcement by directing regulators and prosecutors towards nascent scandals, then we might be concerned that D&O insurance undermines private litigation's dual functions as a backstop and complement.¹¹⁹ Until we have a better handle on just how weak public enforcement is (and more importantly, whether and how corporate actors perceive these weaknesses), it is difficult to conclude how much D&O insurance "ensures" corporate misconduct.

Hopefully, this is only the beginning and not the end of inquiries regarding the practical implications of liability insurance for corporate governance policy. By providing information about an institution that operates primarily in the shadow of the law, Baker and Griffith have opened the door for additional research, albeit of a different kind. For example, experimental research might demonstrate the extent to which managerial behavior is affected by changes in public versus private enforcement, as well as the difference between direct protection (Side A insurance) and indirect, entity-level protection (Sides B and C insurance).

More importantly, those who study the field of D&O insurance would do well to separate out the product's effect on independent directors (outsiders who bear the bulk of oversight duties), and its effect on inside directors and officers (often the primary architects of intentional misconduct). It may be that the presence of D&O insurance reduces or weakens oversight intensity, but has relatively little effect on existing intentions to commit wrongdoing.

Finally, as we increase our knowledge of how D&O insurance affects officers and directors, we ought to take into account the likelihood of

117. Indeed, in some instances, corporate managers may be over-deterred. See Baer, *supra* note 66, at 1061, 1063–66.

118. For a recent critique of the SEC's Enforcement Division, see Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 VA. L. REV. 785, 813–15 (2009).

119. See, e.g., Renee M. Jones, *Legitimacy and Corporate Law: The Case For Regulatory Redundancy*, 86 WASH. U. L. REV. 1273 (2009). For evidence that public and private litigation overlap more than they complement each other, see Jessica M. Erickson, *Overlitigating Corporate Fraud: An Empirical Examination*, 97 IOWA L. REV. 49 (2011).

inconsistent enforcement by public actors. For example, if public enforcers prefer to bring fraud enforcement actions against officers, but shy away from claims that are based more on oversight and lack of appropriate action by directors, then D&O insurance may affect management unevenly. By the same token, highly regulated corporations may respond less poorly to D&O's liability shield, whereas privately held corporations that fly under the public enforcer's radar may be more prone to the moral hazards that Baker and Griffith understandably fear.

If death and taxes are constants in American life, then so too are corporate frauds and the outrage that accompanies them. For those reasons, it is beyond debate that public *and* private litigation responses will continue to thrive in the wake of corporate meltdowns and scandals. The most successful policy prescriptions in this arena should be the ones that are backed by strong research and go beyond analysis of formal statutes and regulations. To that end, Baker and Griffith are exactly where they should be. They have made a number of sensible proposals backed by their knowledge of how D&O insurance actually works. The authors have done us a great service by shining a light on the insurance world, a world that is murky and divorced from the written statutes and regulations that lawyers and judges know so well. The challenge for researchers like Baker and Griffith—and indeed for all corporate governance policymakers—is to figure out how those sensible policy proposals fare as part of a broader enforcement landscape.

