

## HOW COLLECTIVE SETTLEMENTS CAMOUFLAGE THE COSTS OF SHAREHOLDER LAWSUITS

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### ABSTRACT

*Corporations insure against liability in shareholder lawsuits by buying tiered coverage from multiple insurers who each cover a distinct segment of the potential damages range. Rather than negotiating to settle individually with the plaintiff, the insurers seek to reach a single, collectively binding settlement agreement. This combination of segmented coverage and collective settlements produces a conflict of interests: the corporation's managers and some insurers are better off if the case settles pre-trial for the expected damages, while other insurers are better off going to trial. To force reluctant insurers to settle, courts have created a duty that can require an insurer to pay its policy amount when the plaintiff makes a settlement demand that exceeds that amount and another insurer or the corporation is willing to pay the rest. This "duty to contribute" biases negotiations toward settlements that overcompensate plaintiffs, thereby encouraging lawsuits of doubtful merit. The conflict of interests in settlement negotiations could be eliminated by allowing defense-side parties (defendants and their liability insurers) to settle separately their respective segments of the damages range. But this "segmented" approach to settlements is contrary to the private interests of managers because it eliminates the justification for the*

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*duty to contribute. That duty forces insurers to pay for settlements that they think are excessive or contractually uninsurable, thereby shielding corporate earnings reports—and managers’ incentive-based pay—from the costs of shareholder lawsuits resulting from the managers’ conduct.*

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## INTRODUCTION

Liability insurance makes defendants overeager to settle risky lawsuits. If a lawsuit goes to trial, the damages award could be greater than the coverage limit on the defendant's liability policy, forcing the defendant to pay the excess. But the plaintiff will usually be willing to settle before trial for a discounted amount that factors in the possibility of a verdict for the defendant. Settling pre-trial thus compresses the liability burden, increasing the proportion that falls within the insurance policy limit and hence is borne by the insurer. This opportunity to concentrate liability on the insurer can make the defendant better off settling before trial even when the plaintiff's settlement demand exceeds the expected (that is, risk-discounted) damages. And the insurer has the opposite bias: it often is better off going to trial, even when the plaintiff is willing to settle for *less* than the expected damages.

The same dynamic arises in the more complex situation in which the defendant has multiple liability insurers, as is typical in shareholder lawsuits against corporate managers for securities fraud and breaches of fiduciary duties. To cover the costs of such suits, most public corporations purchase not just one directors-and-officers (D&O) liability insurance policy, but rather a stack of them, forming a so-called insurance "tower." The tower's ground floor is occupied by a "primary" insurer that bears the initial liability in a lawsuit up to its policy limit. Upper floors are occupied by a series of "excess" insurers, each of whose liability begins at the limit of the policy immediately below it in the tower. As liability mounts, the policies are exhausted in succession. When a lawsuit's trial outcome is uncertain, the primary insurer is biased toward trial, the insured defendants are biased toward settling before trial, and the excess insurers divide in their biases based on where the expected damages fall within the tower.

To encourage settlements by insurers that are structurally biased toward trial, courts have read two duties into liability insurance contracts. The first duty requires an insurer to settle before trial when it can do so for a reasonable amount within its policy limit. This "duty to settle" has been thoroughly analyzed by academic commentators. The second duty requires an insurer to contribute its policy amount to a settlement when the plaintiff's settlement demand is *above* the insurer's policy limit but another defense-side party—that is, another insurer or the defendant—is willing to pay the above-limit portion.

This second duty has been ignored by commentators, and indeed there is no conventional name for it: this Article calls it the “duty to contribute.” This duty distorts negotiations by permitting “cramdown” settlements in which a party on an upper floor of an insurance tower settles with the plaintiff and then shifts most of the liability to the insurers below. Because cramdown settlements concentrate liability on non-consenting third parties, they will tend to overcompensate plaintiffs, the predictable consequence of a judge-made duty that favors the parties in settlement negotiations who are overeager to settle.

A more efficient way to resolve the conflict of interests in settlement negotiations would be to eliminate the conflict at its source. Courts and commentators have treated the conflict as an inevitable byproduct of insurance policy limits. But the conflict is not inevitable; rather, it arises only when a settlement takes the form of a collective resolution that binds all defense-side parties. The presumption that settlements must be collective is so widespread that it has gone essentially unnoticed. Yet the presumption is worth questioning, as it is the reason that settlement causes some defense-side parties to pay more, and others to pay less, than their expected liability at trial. This divergence between trial burdens and settlement burdens encourages strategic behavior, as it enables defense-side parties to shift liability onto each other when deciding whether to accept or reject a settlement offer.

This conflict of interests in settlement negotiations would be eliminated if each defense-side party were allowed to settle separately its respective slice of the damages range. Under this “segmented” approach to settlements, trial would occur unless all slices settled, and the plaintiff would collect at trial only those awarded damages (if any) that fell within the unsettled slices. Segmenting settlements in this way would eliminate the mismatch between trial liability and settlement liability that encourages strategic behavior. Unlike the judge-made duties to settle and contribute, this segmented approach would address both sides of the conflict: lower-level insurers would no longer be biased against settling, and upper-level insurers and defendants would no longer be biased in favor of settling. With these biases eliminated, the duties to settle and contribute could be abandoned as obsolete. And because the duty to contribute produces cramdown settlements, its elimination would remove the plaintiff-overcompensation hazard.

If segmented settlements really would be more efficient, why have they not been adopted already? Outside the context of shareholder litigation, the most likely obstacle to the segmented approach is liability insurers' traditional "duty to defend." For example, automobile and homeowners liability policies state that the insurer, in addition to covering the policyholder's liability in a lawsuit, will defend the policyholder through trial. Courts might deem an insurer to have breached its duty to defend if it settled out of a lawsuit without obtaining a complete release for the policyholder as well.

D&O policies, by contrast, cover corporate managers who typically disclaim the insurer's duty to defend and insist on controlling their own defenses. Therefore, in shareholder lawsuits the most likely explanation for the persistence of collective settlements is not the duty to defend, but rather the managers' private interests. Managers benefit from the collective approach because it provides a justification for the duty to contribute, which can be used to overcome insurer resistance to settlement. Yet structural bias caused by the collective settlements approach is not the only reason that insurers might resist settling. They also might resist because they think that the plaintiff is demanding more than the lawsuit is worth, or that coverage is likely to be excused at trial by a finding that the defendants deliberately engaged in misconduct. There is no public-policy reason to force insurers to settle when their resistance is based on these alternative grounds. But the duty to contribute does not discriminate, as it forces insurers to settle regardless of their reasons for rejecting a plaintiff's settlement demand.

Under the segmented approach to settlements, there would be no mechanism to force settlements by insurers that believe that the plaintiff is overreaching or that a coverage exclusion is likely. For this reason, the segmented approach would cause the proportion of settlements paid by D&O insurers to fall. The additional liability would be borne not by the managers who defend such suits, but rather by their corporations, which invariably agree to indemnify managers for liability that they incur on the job. But managers would still be averse to the change, because insurance coverage prevents a large settlement payment from causing a drop in the corporation's reported earnings that could draw unfavorable investor attention and reduce managers' performance-based pay. In this way, insurance shields managers who are sued by reducing the volatility of their corporation's reported earnings.

Although insurance coverage for settlements benefits corporate managers, it imposes a host of costs on shareholders. First, by camouflaging the costs of shareholder lawsuits, insurance reduces the usefulness of a firm's reported earnings as a measure of the contribution of that firm's managers to diversified shareholder wealth. Second, by encouraging plaintiff overcompensation, the duty to contribute gives plaintiffs' attorneys an incentive to file lawsuits of doubtful merit. Third, both the duty to contribute and the duty to settle require potentially expensive follow-up lawsuits over whether the duties have been breached. Fourth, cramdown settlements discourage insurer specialization by concentrating liability for both low-risk and high-risk lawsuits on primary insurers. And fifth, collective settlements lead to overspending on defense attorneys, as D&O policies combine coverage for litigation expenses with coverage for liability to discourage insurers from rejecting reasonable settlement offers. Each of the last four costs drives up D&O insurance premiums, which shareholders ultimately pay.

Courts seem unaware that reading a duty to contribute into D&O policies advances managers' interests at the expense of shareholders. Judicial opinions cite the bias of primary insurers against settling but do not mention the countervailing bias that makes defendants and some excess insurers overeager to settle. Courts could increase social wealth by being much leazier of the duty to contribute in shareholder lawsuits. Given that defendants in such cases are sophisticated enough to insist on running their own defenses and negotiating directly with plaintiffs to settle, the justification for the duty to contribute does not apply. And without this mechanism for camouflaging the costs of shareholder lawsuits, managers would be less reluctant to adopt an alternative settlements approach that would increase shareholder profits.

The rest of this Article has four parts. Part I explains the conflict of interests that occurs in settlement negotiations when settlements are collective, and it describes the various legal devices—including the duty to contribute—that have been developed to overcome it. Part II describes the social costs of these various conflict-control devices. Part III explains how the defense-side conflict of interests that courts and commentators attribute to policy limits would disappear if settlements were segmented rather than collective. Part IV describes why, despite the efficiencies of the segmented approach, corporate managers probably prefer the status quo. A brief conclusion and an appendix follow.

## I. STRUCTURAL CONFLICT WHEN SETTLEMENTS ARE COLLECTIVE

The conflict of interests among liability insurers and defendants in settlement negotiations is caused by the interaction of two factors: policy limits, which serve valuable economic functions, and the collective approach to settlements, which often does not. Several legal devices have been developed to manage this conflict, but these presuppose—and indeed tend to reinforce—the collective approach, thereby failing to correct the problem at its source.

The conflict of interests is perhaps most conspicuous in the context of D&O insurance, which protects public corporations and their managers against the most significant source of civil liability they face: shareholder litigation. For this reason, this Part begins by describing the structure of D&O coverage purchased by public firms. Many of the qualitative observations about D&O insurance are, however, also true of other important types of commercial liability coverage.

### A. *Liability and Insurance in Shareholder Litigation*

As Professors Thomas Baker and Sean Griffith describe in an important recent book on shareholder litigation, the most important source of civil liability for American public corporations is the shareholder class action alleging fraud on the securities markets.<sup>1</sup> These lawsuits, the majority of which are brought under Rule 10b-5<sup>2</sup> of the Securities Exchange Act of 1934,<sup>3</sup> can be highly lucrative for plaintiffs and their attorneys.<sup>4</sup> Between 2003 and 2008, the average settlement payout in 10b-5 class actions was \$45 million.<sup>5</sup> And a handful of cases are worth much more: a case against McKesson HBOC settled in 2008 for \$1.1 billion.<sup>6</sup> By comparison, the average profits of a Fortune 500 company between 2003 and 2008 were \$256

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1. TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION 21 (2010).

2. Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2012).

3. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78pp (2006 & Supp. IV 2011).

4. Sixty-six percent of securities class actions brought in 2010 alleged violations of Rule 10b-5. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2010 YEAR IN REVIEW 31 (2011), available at <http://www.cornerstone.com/securities-filings-2010-year-in-review>.

5. BAKER & GRIFFITH, *supra* note 1, at 22.

6. *Id.* at 23.

million per quarter.<sup>7</sup> Thus, the average settlement in this period would have reduced the average Fortune 500 corporation's earnings by 18 percent in the quarter in which it was reported—that is, if the settlement were not covered by insurance.<sup>8</sup>

Because of the role that managers play in preparing and reviewing corporate financial reports, virtually all 10b-5 actions name at least one corporate manager as a defendant.<sup>9</sup> As a practical matter, however, the managers rarely bear personal liability in securities class actions.<sup>10</sup> One important reason for the managers' de facto immunity is that almost all public corporations agree to indemnify their managers for liability that they incur on the job.<sup>11</sup> To be sure, general incorporation statutes forbid indemnification when the corporate agent is shown to have acted in bad faith or with wrongful intent.<sup>12</sup> But these indemnification disqualifiers are almost never established, as essentially all 10b-5 claims are either dismissed or settled before trial,<sup>13</sup> and the plaintiffs' attorneys have no financial incentive to insist that the defendants admit wrongdoing in the settlement agreement. Indeed, the incentives go the other way: the corporation usually has much deeper pockets than its managers, giving the managers and the

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7. Earnings figures for the five hundred largest U.S. corporations by revenues (the "Fortune 500") are published by *Fortune* and are available at *Fortune 500*, CNNMONEY, [http://money.cnn.com/magazines/fortune/fortune500\\_archive/full](http://money.cnn.com/magazines/fortune/fortune500_archive/full) (last visited Sept. 14, 2012).

8. This figure actually understates the percentage because the settlement amount is for all securities actions while the earnings figure is only for Fortune 500 companies, which due to their size will tend to have higher average liability.

9. See Michael Klausner & Jason Hegland, *How Protective Is D&O Insurance in Securities Class Actions?—Part I*, PROF. LIABILITY UNDERWRITING SOC'Y J. REPRINT, Feb. 2010, at 1, 2 (finding that 99 percent of securities class-action complaints name the company's CEO, and 80 percent name the CFO).

10. See *id.* at 3 (reporting that corporate officers pay into less than 5 percent of securities class action settlements and that outside directors pay into less than 1 percent).

11. See *id.* ("[T]he combination of D&O insurance, indemnification, and the ability of the corporation to pay whatever portion of the settlement the insurer does not pay, provides substantial protection for officers and directors."); see also David B. Schulz, *Indemnification of Directors and Officers Against Liabilities Imposed Under Federal Securities Laws*, 78 MARQ. L. REV. 1043, 1045 (1995) ("[I]ndemnification [of directors and officers] is generally provided for in a corporation's bylaws or through separate indemnity agreements between the corporation and its managers.").

12. *E.g.*, DEL. CODE ANN. tit. 8, § 145(a) (2012); MODEL BUS. CORP. ACT § 8.51(a)(1) (1984 & Supp. 1988/89); see also *Stockman v. Heartland Indus. Partners, L.P.*, No. 4227-VCS, 2009 WL 2096213, at \*10 (Del. Ch. July 14, 2009) (discussing the function of the indemnification exclusions under the Delaware General Corporation Law, DEL. CODE ANN. tit 8, ch. 1 (2012)); *VonFeldt v. Stifel Fin. Corp.*, No. Civ.A. 15688, 1999 WL 413393, at \*2 (Del. Ch. June 11, 1999) (same).

13. BAKER & GRIFFITH, *supra* note 1, at 22.



plaintiffs' attorneys a common interest in ensuring that indemnification by the corporation remains available.<sup>14</sup>

To cover the costs of securities actions, virtually all public corporations purchase D&O insurance.<sup>15</sup> Besides covering the managers for their personal liability, the typical D&O policy covers the corporation itself, both for its indemnification obligations to its agents and for any vicarious liability it incurs under the doctrine of respondeat superior.<sup>16</sup> And, in addition to providing *liability* coverage—that is, coverage for amounts paid to plaintiffs in settlements or judgments—D&O policies provide *defense* coverage—that is, coverage for defense attorneys and for other litigation expenses.<sup>17</sup>

D&O insurance is expensive in nominal terms. In 2008, public companies with market capitalizations of at least \$10 billion paid an average of \$2.2 million in D&O insurance premiums.<sup>18</sup> In relative terms, however, this was a small expense—less than 1 percent of these companies' average annual profits.<sup>19</sup> And the companies seem to have gotten a good deal of coverage for their money. A recent study of securities class-action settlements found that D&O insurers paid for the full settlement in 53 percent of cases, and they paid a portion—usually a large portion—of the settlement in 35 percent more.<sup>20</sup> Because directors and officers themselves rarely pay anything in such cases, the amounts not covered by the insurers were paid almost entirely by the corporations directly.

Besides covering liability in securities actions, D&O insurance covers the costs of a second type of shareholder lawsuit: the derivative suit.<sup>21</sup> Like securities class actions, most derivative suits are

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14. See Klausner & Hegland, *supra* note 9, at 3 (“Because securities class actions are settled with defendants denying all wrongdoing, there is no way to know whether actual misconduct occurred.”).

15. BAKER & GRIFFITH, *supra* note 1, at 44.

16. In the language of D&O insurance, insurance for the corporation's indemnification obligations is “Side B” coverage, and insurance for the corporation's direct litigation liability is “Side C” coverage. “Side A” coverage is for the managers' personal liability. *Id.* at 46–48.

17. *Id.* at 45.

18. TOWERS WATSON, DIRECTORS AND OFFICERS LIABILITY: 2008 SURVEY OF INSURANCE PURCHASING TRENDS 29 fig.47 (2010), available at <http://www.towerswatson.com/assets/pdf/2791/2791.pdf>.

19. In 2008, the average annual earnings for all Fortune 500 companies, many of which had market capitalizations of less than \$10 billion, was \$1.3 billion. *Fortune 500*, *supra* note 7.

20. Klausner & Hegland, *supra* note 9, at 1.

21. *Id.*

brought by shareholders against corporate managers. The main difference is that a derivative suit is brought on behalf of the corporation, meaning that the corporation rather than its shareholders recovers any judgment or settlement payment.<sup>22</sup> General incorporation statutes prohibit corporations from indemnifying managers for personal liability in derivative suits, which makes sense given that otherwise the money flow would be circular, with the corporation paying for its own recovery.<sup>23</sup> But corporations can—and almost always do—buy D&O insurance for their managers that covers their personal liability in derivative litigation.<sup>24</sup> In this way, corporations fund their own derivative-suit recoveries *ex ante* (through D&O insurance premiums) even though they are prohibited from doing so *ex post* (by reimbursing the defendants for the judgment or settlement).<sup>25</sup>

D&O policies always specify that coverage is unavailable if the defendants are found to have engaged in deliberate fraud or to have enriched themselves at the expense of the corporation.<sup>26</sup> Like the statutory indemnification disqualifiers, these coverage exclusions encourage managers to settle before trial to avoid an adverse finding by a judge or jury that could leave them responsible for their own legal bills.

Even though most D&O policies cover defense costs, the corporate managers rather than the insurers control the defenses of shareholder lawsuits.<sup>27</sup> In this way, D&O policies are different from,

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22. WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTS AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 364 (3d ed. 2009).

23. In derivative litigation, corporations can indemnify their managers for legal expenses such as attorneys' fees, but not for judgments or amounts paid in settlement. *Compare* DEL. CODE ANN. tit. 8, § 145(a) (2012) (permitting indemnification in direct suits against corporate agents for "expenses (including attorneys' fees), judgments, fines, and amounts paid in settlement"), *and* MODEL BUS. CORP. ACT § 8.51(a) (1985 & Supp. 1988/99) (permitting indemnification of directors against "liability incurred in the proceeding[s]"), *with* DEL. tit. 8, § 145(b) (permitting indemnification in derivative suits only for "expenses (including attorneys' fees)"), *and* MODEL BUS. CORP. ACT § 8.51(d)(1) (prohibiting indemnification in derivative suits except for "reasonable expenses").

24. *See, e.g.*, DEL. CODE ANN. tit. 8, § 145(g) (authorizing D&O insurance); MODEL BUS. CORP. ACT § 8.57 (1985 & Supp. 2000/01/02) (same); BAKER & GRIFFITH, *supra* note 1, at 57 (noting that the "vast majority" of public corporations buy both individual coverage for directors and officers and entity-level coverage for the corporation).

25. In addition, the plaintiffs' attorneys in a derivative suit can recover their fees directly from the corporation. *E.g.*, *Fletcher v. A.J. Indus., Inc.*, 72 Cal. Rptr. 146, 149–54 (Ct. App. 1968).

26. BAKER & GRIFFITH, *supra* note 1, at 49.

27. *Id.* at 130.

for example, automobile and homeowners liability policies, which assign the insurer both the right and the duty to run the defense.<sup>28</sup> One potential reason for this difference is that insurers may be more likely to assert coverage defenses for intentional misconduct in the D&O context, creating a conflict of interests if the insurers were also running the defenses of the lawsuits. Other reasons that corporate managers would rather run their own defenses in shareholder lawsuits are that the managers typically have their own preferred lawyers, and that a public trial could impose reputational costs that, unlike monetary liability, cannot be shifted to the insurer.

The managers' right to run their own defenses entails a right to negotiate directly with plaintiffs to settle. D&O policies provide, however, that the insurer must consent to a settlement agreement to be bound by it.<sup>29</sup> Such provisions are strictly enforced, with courts holding that policyholders forfeit coverage if they settle without first seeking the insurer's permission.<sup>30</sup> This does not mean, however, that the insurer has an absolute veto right, as the insurer can be held liable for rejecting a settlement offer that a court later decides was reasonable.<sup>31</sup>

As with other types of liability insurance, D&O policies always come with coverage caps, known as policy amounts or limits.<sup>32</sup> Policy limits make liability insurance marketable, as a policyholder with finite wealth will be unwilling or unable to buy infinite wealth protection.<sup>33</sup> And policy limits also protect insurers against losses they cannot bear in a cost-effective manner. Thus, insurance creates economic value by enabling the risk-averse policyholder to incur a certain cost (the insurance premium) in exchange for protection

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28. *Id.* at 132.

29. *Id.*

30. *E.g.*, *Fed. Ins. Co. v. Arthur Andersen LLP*, 522 F.3d 740, 744 (7th Cir. 2008) ("By cutting Federal Insurance out of the process, Arthur Andersen gave up any claim to indemnity . . ."); *Vigilant Ins. Co. v. Bear Stearns Cos.*, 884 N.E.2d 1044, 1047–48 (N.Y. 2008) (describing how Bear Stearns waived an indemnification clause by settling with the SEC without Vigilant's permission).

31. *See infra* Part I.C.

32. *BAKER & GRIFFITH*, *supra* note 1, at 79.

33. Wealthy people will tend to buy more insurance coverage both because they can afford more and because they have more to lose from an adverse verdict. *See* Alan O. Sykes, *Judicial Limitations on the Discretion of Liability Insurers To Settle or Litigate: An Economic Critique*, 72 *TEX. L. REV.* 1345, 1361 (1994) (noting that liability policies have limits because "most insureds have assets considerably less than the largest possible liability judgment they might incur").

against the risk of a much larger, uncertain loss. The insurer, in turn, pools this risk with uncorrelated risks from other policies that it sells, thereby building a diversified portfolio of contingent liabilities whose overall performance is predictable.<sup>34</sup> But an insurer may be unable to diversify against the risk of an especially large loss on a particular policy and hence may use a policy limit to exclude the risk from its liability portfolio.

A characteristic feature of the D&O insurance market is that most public corporations do not buy all of their coverage from a single insurer. Rather, they buy tiered coverage from several insurers, constructing what is called an insurance “tower.”<sup>35</sup> The tower’s ground floor is occupied by the primary insurer, which bears the initial costs of a lawsuit up to the primary policy limit. Above the primary insurer is a first-layer excess insurer, which provides coverage for losses greater than a specified amount, known as the “attachment” point.<sup>36</sup> The attachment point typically equals the policy limit of the primary policy, making coverage continuous.<sup>37</sup> Additional layers of excess insurance can be stacked atop the first, creating a column of policies that are exhausted in succession as the costs of a lawsuit mount. Sitting atop the tower are the defendants themselves, who bear any residual liability after all policies have been exhausted.<sup>38</sup> Towers with numerous stories are the norm: in 2008, public companies with market capitalizations of at least \$10 billion owned an average of seven full layers of D&O coverage.<sup>39</sup>

Why do corporations erect multi-insurer towers when they seemingly could save on transaction costs by consolidating coverage in a single policy? One commonly cited explanation for D&O towers is that corporate managers want more liability coverage than any

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34. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 131 (8th ed. 2011).

35. BAKER & GRIFFITH, *supra* note 1, at 53.

36. *Id.* at 79.

37. *See, e.g.*, *Great Am. Ins. Co. v. Bally Total Fitness Holding Corp.*, No. 06C4554, 2010 WL 2542191, at \*2 (N.D. Ill. June 22, 2010) (describing a five-policy tower in which each excess policy’s attachment point was the limit of the subsituated policy in the tower).

38. The defendants also have windows of exposure on lower levels if the policies have deductibles.

39. According to survey data from Towers Watson, a risk-management consultancy, large-cap companies had an average of 5.7 full excess policies, or 6.7 full policies when the primary policy is included. Interestingly, the survey also found that 80 percent of those companies had an additional, Side A-only policy that attached at the top of the stack of full policies. *See TOWERS WATSON, supra* note 18, at 16 fig.21, 18 fig.22. As noted *supra*, note 16, Side A policies cover directors and officers directly for any personal liability they incur.

individual insurer is willing to sell.<sup>40</sup> Thus, by covering only a portion of a company's potential liability, an insurer avoids the risk of a large loss that the insurer cannot easily hedge through diversification. In this way, towers are a substitute for reinsurance, an arrangement in which an insurer sells a policyholder the desired amount of coverage but then purchases from a "reinsurer" its own coverage for some or all of its liability on the primary policy.<sup>41</sup> The reinsurer is comparable to an excess insurer, as it accepts the risk of losses beyond those that the primary insurer is willing to bear. The converse explanation for insurance towers is that the policyholders want to diversify their coverage to protect themselves against the risk that an insurer will fail. Evidence for this explanation is the fact that corporate managers who are responsible for choosing their companies' D&O insurers rank "financial strength" among their most important selection criteria.<sup>42</sup>

Starting in Part II, this Article advances two additional explanations for D&O towers—one benign, the other worrisome. The benign explanation is that towers permit insurers to specialize by focusing their coverage on discrete aspects of litigation risk. Specialization in this form could create social wealth by enabling insurers to reduce their operating costs, a benefit that would translate into lower premiums.

The second, and more troublesome, explanation for insurance towers this Article proposes is that towers create settlement conflicts among insurers that serve the interests of corporate managers. Due to the settlement obligations that courts place on liability insurers, these conflicts increase the likelihood that the settlement of a shareholder lawsuit will be paid by the defendant corporation's D&O insurers rather than by the corporation itself. Shifting liability for settlements to insurers reduces the earnings volatility of those corporations whose managers are sued. In this way, insurance towers camouflage the costs of shareholder lawsuits resulting from managers' conduct in office, costs that shareholders ultimately bear. While this result is good for

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40. *E.g.*, BAKER & GRIFFITH, *supra* note 1, at 53.

41. *See* ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES § 1.3(b)(2) (1988) ("Reinsurance allows an insurer to secure adequate risk distribution by transferring part of the risk to another insurer or group of insurers.").

42. TOWERS WATSON, DIRECTORS AND OFFICERS LIABILITY SURVEY: 2010 SUMMARY OF RESULTS 26 fig.46 (2011), available at [http://www.towerswatson.com/assets/pdf/3790/DandO-Survey\\_2011.pdf](http://www.towerswatson.com/assets/pdf/3790/DandO-Survey_2011.pdf).

the corporation's managers, it harms diversified shareholders by diminishing the value of a firm's reported earnings as an indicator of the amount of shareholder wealth created by that firm's management team. The next section lays a foundation for the discussion of these additional functions of insurance towers by describing how conflicts of interests among defense-side parties arise when settlements are collective.

### *B. The Settlement-Trial Liability Gap*

It is widely recognized among courts and commentators that policy limits introduce a conflict of interests in settlement negotiations.<sup>43</sup> What these observers have not recognized is that policy limits alone are not sufficient to produce this conflict. The other necessary element is a presumption that any settlement will be a collective resolution that binds all defense-side parties. When the trial outcome is uncertain, the collective approach to settlements drives a gap between the distribution of the settlement burden and the distribution of the expected trial liability, biasing some defense-side parties in favor of settling and others against it.

The collective approach to settlements creates a conflict of interests whenever the trial outcome is uncertain and the potential damages—that is, the damages the plaintiff will win if he prevails at trial—exceed the limit of the defendant's primary liability policy. As an illustration, consider a hypothetical lawsuit against an insured

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43. See, e.g., *Merritt v. Reserve Ins. Co.*, 110 Cal. Rptr. 511, 518–19 (Ct. App. 1973) (describing how a policy limit can cause the interests of the “assured and carrier” to diverge); see also *Schwartz v. Liberty Mut. Ins. Co.*, 539 F.3d 135, 142 (2d Cir. 2008) (citing *Merritt*, 110 Cal. Rptr. at 518–19); Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1138 (1954) (observing in the context of insurance with policy limits that the “company and insured often have conflicting interests as to whether settlement should be made”); Michael J. Meurer, *The Gains from Faith in an Unfaithful Agent: Settlement Conflicts Between Defendants and Liability Insurers*, 8 J.L. ECON. & ORG. 502, 503 (1992) (“The essence of the conflict between the insurer and the insured inheres in the limits on indemnity provided by typical liability policies.”); Kathryn E. Spier, *Litigation*, in 1 HANDBOOK OF LAW AND ECONOMICS 259, 331 (A. Mitchell Polinsky & Steven Shavell eds., 2007) (showing how policy limits introduce conflict between insurers and policyholders); Alan O. Sykes, “*Bad Faith*” *Refusal To Settle by Liability Insurers: Some Implications of the Judgment-Proof Problem*, 23 J. LEGAL STUD. 77, 77 (1994) (“[P]olicy limits create conflicts of interest between the insured and the insurer in the conduct of litigation.”); Sykes, *supra* note 33, at 1346 (“Disputes over the rejection of settlement offers by insurers would not arise absent provisions in insurance contracts setting policy limits . . . .”); Kent D. Syverud, *The Duty To Settle*, 76 VA. L. REV. 1113, 1127 (1990) (describing how policy limits encourage insurers to reject reasonable settlement offers and policyholders to accept unreasonable offers).

defendant with a single, \$2M liability policy.<sup>44</sup> Assume that the plaintiff has a 50 percent chance of winning \$3M at trial and a 50 percent chance of winning nothing. Assume further that the defendant has enough wealth to pay any above-limit damages.<sup>45</sup> On these assumptions, the actuarially fair settlement amount, meaning the amount of the expected damages, is \$1.5M.<sup>46</sup> And settling for \$1.5M rather than going to trial would minimize the combined costs to the defendant and the insurer,<sup>47</sup> as trial would entail \$1.5M in expected damages plus additional litigation expenses that settlement avoids.

Consider what would happen, however, if the plaintiff offered to settle the case pre-trial for the actuarially fair amount.

*Table 1. Liability When Expected Damages Within Primary Limit*

	Expected Trial Liability	Share of Collective Settlement	Benefit (Cost) of Collective Settlement
(Primary) Insurer, \$2M limit	\$1.0M	\$1.5M	(\$0.5M)
Defendant/Excess Insurer	\$0.5M	\$0M	\$0.5M
Total	\$1.5M	\$1.5M	—

The defendant would be happy if this case settled for \$1.5M, which is within the policy limit and hence would be paid entirely by the insurer. If the case instead went to trial, there would be a 50 percent chance of a \$3M verdict, \$1M of which would exceed the policy limit and thus be the defendant's responsibility. The defendant's expected trial liability therefore is \$0.5M—that is, the expected damages above the policy limit—plus the additional attorneys' fees and other

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44. A generalized model of insurer-policyholder conflict over settlements is provided in the Appendix.

45. If personal assets are limited, the defendant's exposure is the lesser of her net worth and the above-limit damages. For a general analysis of settlement negotiations with a judgment-proof defendant, see Sykes, *supra* note 43.

46.  $(50\% \times \$3M) + (50\% \times \$0) = \$1.5M$ .

47. Two implicit assumptions, which are not important to the points being illustrated, are that the time-value of money is zero and that the insurer and defendant are risk-neutral. As in all hypotheticals in the Article, this one also assumes a dichotomous set of trial outcomes, meaning that the plaintiff is awarded either the potential damages or nothing.

litigation expenses associated with trial. By contrast, her liability is zero if the case settles for the actuarially fair amount. Thus, as Table 1 indicates, the benefit to the defendant of an actuarially fair settlement *relative* to trial, in terms of liability only (that is, excluding defense costs), is \$0.5M.

To the insurer, on the other hand, trial is the cheaper option in expected value terms. Although settlement would cost the insurer \$1.5M, trial presents expected liability of only \$1M, equal to the policy amount of \$2M multiplied by the 50 percent chance of a verdict for the plaintiff. Thus, the cost to the insurer of a fair settlement relative to trial is \$0.5M. Put another way, settling pre-trial for the expected damages instead of going to trial shifts \$0.5M in liability from the defendant to the insurer, a shift the insurer will naturally resist.

If the insurance policy covers not just liability to the plaintiff but also defense costs such as attorneys' fees, then the insurer will be more inclined to settle pre-trial, as it will bear the defense's trial expenses.<sup>48</sup> Unless, however, those expenses would be at least \$1M, the insurer will still be better off vetoing the actuarially fair settlement offer.<sup>49</sup> In this way, bundling defense coverage with liability coverage only partly corrects the insurer's underincentive to settle.

The same structural conflict that makes the insurer too reluctant to settle makes the defendant overeager to do so. To see why, assume that the defense's trial costs in the same hypothetical lawsuit would be \$0.4M and that the plaintiff demands a settlement payment of \$2M rather than the actuarially fair \$1.5M. Now it is in the combined

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48. If the case is a securities action, the insurer probably would not cover the fees of the plaintiff's attorneys, as federal securities laws lack fee-shifting provisions. In theory, a plaintiff's attorney could demand that a settlement include an amount for his fees and expenses. But because these are sunk costs, it is not rational for him to insist upon their reimbursement as a condition of settlement. On the other hand, derivative-suit settlements may include a provision for attorneys' fees if, as is typical, the relief granted is injunctive rather than monetary. See Jessica M. Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749, 1798 (2010) (finding that only about 10 percent of derivative-suit settlements over the one-year period from July 2005 to June 2006 included a cash payment to the corporation).

49. If the verdict is for the plaintiff, then the damages will exceed the policy limit, making the defense costs the responsibility of the defendant. Therefore, in this hypothetical lawsuit the insurer bears those costs only if the defendant wins at trial. If the defense's trial expenses would be \$1M, then the insurer's overall expected trial liability is  $(0.5 \times \$2M) + (0.5 \times \$1M) = \$1.5M$ . This analysis assumes that, as is standard in D&O policies, litigation expenses count toward the policy limit. BAKER & GRIFFITH, *supra* note 1, at 136.



interest of the defense-side parties to reject the settlement demand, which exceeds the expected damages plus the defense's trial expenses. Yet the defendant individually remains better off accepting the plaintiff's demand instead of going to trial,<sup>50</sup> as the \$2M settlement would be fully covered by the insurer and would avoid the risk of an above-limit damages award.<sup>51</sup> If the defendant and plaintiff could agree to enter into a settlement that bound the insurer, they might do so for an amount that overcompensates the plaintiff relative to the expected damages.

If the defendant were a public corporation, it probably would have one or more excess insurance policies in addition to its \$2M primary policy.<sup>52</sup> To reflect this possibility, the hypothetical could be changed to assume that the defendant has a \$3M excess policy to supplement its \$2M primary policy. The consequence of this change would be that the excess insurer would step into the shoes of the defendant as summarized in Table 1, facing the same potential liability and thus being similarly biased toward pre-trial settlement.<sup>53</sup> Stated in general terms, defense-side parties on upper floors of an insurance tower tend to be biased in favor of settling before trial, and parties on lower floors tend to be biased against it.<sup>54</sup>

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50. See Syverud, *supra* note 43, at 1130 (“Regardless of the strength of Plaintiff’s claim of liability, a rational Defendant might want to accept any proposed settlement that falls within the [insurance] company’s share of the potential liability.”).

51. In this example, the defendant’s total expected trial liability is \$0.9M if the insurance policy provides liability coverage only. If the policy also provides defense coverage, then the defendant bears the \$0.4M in trial litigation costs only when the plaintiff prevails and hence the total liability exceeds the policy limit. In such a case, the defendant’s total expected trial liability is \$0.7M.

52. See TOWERS WATSON, *supra* note 18, at 18 fig.22 (finding that corporations which buy D&O insurance have an average of three full excess policies in addition to their primary policy).

53. See Syverud, *supra* note 43, at 1202 (observing how the excess insurer-primary insurer conflict parallels the insurer-policyholder conflict when a settlement offer is within the primary policy limit).

54. An analogy can be drawn to the conflict of interests between corporate creditors, who prefer that the corporation pursue safe (low-variance) projects, and corporate shareholders, who prefer risky (high-variance) projects. See Michael Simkovic & Benjamin S. Kaminetzky, *Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias, and the Credit Default Swap Solution*, 2011 COLUM. BUS. L. REV. 118, 215–18 (describing the creditor-shareholder conflict over risk preferences). Defense-side parties toward the bottom of a tower are analogues to corporate shareholders, as they prefer the high variance of outcomes offered by trial; defense-side parties toward the top of a tower are like corporate creditors, as they prefer the safety of settlement.

C. *The Conflict-Control Devices Now in Use*

At least three legal devices have been developed to address the defense-side conflict of interests over settlements. One device has already been mentioned: the bundling of defense coverage with liability coverage.<sup>55</sup> That device is only partially effective because, as was illustrated by the hypothetical lawsuit summarized in Table 1, even when the insurer bears defense costs there will be cases in which the insurer's expected trial liability is less than its share of a pre-trial settlement for the expected damages.

The other two conflict-control devices are a pair of quasi-contractual duties that are placed on liability insurers. Both duties require insurers to accept certain settlement offers even when doing so is contrary to their private interests. One of these, known as the "duty to settle," arises when a plaintiff would be willing to settle within or at the insurer's policy limit. This duty is straightforward in its implications and has been well analyzed in the academic literature.<sup>56</sup> Much less famous—yet more problematic—is the second duty, which arises when the plaintiff makes a settlement demand above the insurer's policy limit and the defendant or an excess insurer is willing to pay the above-limit portion. The question in such cases is not, strictly speaking, whether the insurer has a duty to settle, but rather whether it must "tender"—that is, contribute—its policy amount in support of a settlement negotiated and partly funded by another defense-side party. Courts have held that the answer often is yes, thereby creating the duty that is termed here the "duty to contribute."

1. *Settlement Demands Within the Policy Limit: The Duty To Settle.* The standard statement of the duty to settle is that a liability insurer must agree to settle a case if it can do so for a reasonable

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55. See *supra* text accompanying note 48.

56. E.g., Seth J. Chandler, *Reconsidering the Duty To Settle*, 42 DRAKE L. REV. 741 (1993); David A. Hyman, Bernard Black & Charles Silver, *Settlement at Policy Limits and the Duty To Settle: Evidence from Texas*, 8 J. EMPIRICAL LEGAL STUD. 48, 49–52 (2011); Keeton, *supra* note 43, at 1137–48; Meurer, *supra* note 43, at 503–15; Charles Silver, Commentary, *A Missed Misalignment of Interests: A Comment on Syverud*, The Duty to Settle, 77 VA. L. REV. 1585 (1991); Spier, *supra* note 43, at 331; Sykes, *supra* note 43, at 88–99; Sykes, *supra* note 33, at 1349–53; Syverud, *supra* note 43, at 1163–72.

amount within its policy limit.<sup>57</sup> The penalty for breach is forfeiture of the limit, leaving the insurer responsible for the full damages award at trial plus any other consequential damages.<sup>58</sup> The duty has a contractual basis: while liability policies typically require the policyholder to seek the insurer's consent before settling, they provide that consent will not be "unreasonably withheld."<sup>59</sup> Courts, however, impose the duty to settle even on those insurers that do not assume it explicitly, most often by holding that the duty is an aspect of the covenant of good faith and fair dealing implied in every contract.<sup>60</sup>

To determine whether an insurer breached the duty to settle, courts ask whether "a prudent insurer without policy limits would have accepted the settlement offer."<sup>61</sup> As a matter of theory this approach has some appeal. Recall the earlier hypothetical lawsuit (summarized in Table 1) in which the actuarially fair settlement amount was \$1.5M. Settling for that figure was in the combined interests of the defendant and the insurer, as trial entailed that amount in expected damages plus additional litigation expenses. Yet if the insurer were to consider its financial interests alone, it might reject a \$1.5M settlement demand, as its policy limit causes its expected trial liability to be only \$1.0M. On the other hand, if its policy lacked a limit, the insurer's expected trial liability would be \$1.5M, making the insurer better off accepting a settlement demand for that amount to avoid the expenses of trial.<sup>62</sup> Thus, assuming that a court would deem the \$1.5M settlement demand reasonable, applying the duty to settle would overcome the insurer's structural disincentive

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57. The courts of all but two states have explicitly recognized a duty to settle along these lines. JEFFREY W. STEMPEL, 1 STEMPEL ON INSURANCE CONTRACTS 9-146 & n.363 (3d ed. 2006 & Supp. 2010).

58. *Id.* at 9-147; *see, e.g.*, *Birth Ctr. v. St. Paul Cos.*, 787 A.2d 376, 389 (Pa. 2001).

59. BAKER & GRIFFITH, *supra* note 1, at 140 (quoting a common policy form) (internal quotation mark omitted).

60. *See, e.g.*, *PPG Indus., Inc. v. Transamerica Ins. Co.*, 975 P.2d 652, 659 (Cal. 1999) ("Pursuant to the covenant of good faith and fair dealing, which is implied by law in every liability insurance policy, the insurer has a duty to make reasonable efforts to settle a claim against its insured by the insured's victim—which accords with the public policy favoring settlements." (citations omitted)); *see also* *Ganaway v. Shelter Mut. Ins. Co.*, 795 S.W.2d 554, 556 (Mo. Ct. App. 1990) (holding that the duty to settle "sounds in tort, not in contract").

61. *Crisci v. Sec. Ins. Co.*, 426 P.2d 173, 176 (Cal. 1967); *see also* *Wierck v. Grinnell Mut. Reinsurance Co.*, 456 N.W.2d 191, 195 (Iowa 1990) ("If, but for the policy limits, the insurer would settle for an offered amount, it is obliged to do so . . .").

62. *See* *Spier*, *supra* note 43, at 331 (showing how the duty to settle aligns insurer and policyholder interests).

to settle and produce what appears to be the socially preferable result.

Although courts consistently specify that the duty to settle only requires insurers to accept settlement demands that are reasonable, the duty would seem to serve its conflict-correction function even if this qualification were dropped and the duty were triggered by *any* settlement demand within the insurer's policy limit.<sup>63</sup> Under this alternative, the prospect of uncapped trial liability would automatically align the insurer's interest with those of its policyholder. For example, if the insurer in the hypothetical case summarized in Table One faced unlimited trial liability, and the defense's trial expenses would be \$0.4M, then the insurer would face total expected trial costs (expected damages plus expenses) of \$1.9M. In that case the insurer would accept a pre-trial settlement demand of \$1.5M but not \$2.0M, because if the plaintiff insisted on \$2.0M then the insurer would be better off going to trial. In this way, the duty to settle is self-regulating, as it encourages insurers to accept actuarially fair settlement demands but not those in which the plaintiff is overreaching.

Based on similar reasoning, several commentators have concluded that the duty to settle should be converted to a strict-liability rule under which an insurer automatically forfeits its policy limit whenever it rejects a settlement demand within that limit, regardless of whether the demand is reasonable.<sup>64</sup> This version of the rule has two apparent advantages. It removes the structural conflict of interests caused by the policy limit when the settlement demand is within that limit, thereby avoiding strategic bargaining by the insurer and the policyholder. And it further reduces litigation costs by eliminating the need for follow-up lawsuits between policyholders and insurers over the reasonableness of rejected settlement offers.<sup>65</sup>

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63. See, e.g., Hyman et al., *supra* note 56, at 79 (finding that a strict-liability rule "would give insurers the right incentives to settle" and would "reduce litigation costs"); Sykes, *supra* note 43, at 94–95 (finding that a duty to settle corrects the conflict of interests even when not limited to settlement demands that are less than the expected damages).

64. See, e.g., Hyman et al., *supra* note 56, at 79; Keeton, *supra* note 43, at 1183–84; Victor E. Schwartz, *Statutory Strict Liability for an Insurer's Failure To Settle: A Balanced Plan for an Unresolved Problem*, 1975 DUKE L.J. 901, 911; see also *Crisci*, 426 P.2d at 177 (Cal. 1967) (collecting law review notes advocating a strict-liability rule).

65. See *Crisci*, 426 P.2d at 177 (describing the benefits of a strict-liability version of the duty to settle); Keeton, *supra* note 43, at 1183–84 (arguing that a strict-liability rule would reduce the costs of duty-to-settle litigation); Schwartz, *supra* note 64, at 910 (same); Syverud, *supra* note 43, at 1168 (same).

Despite the apparent advantages of a strict-liability approach, courts continue to subject the duty to settle to a reasonableness standard.<sup>66</sup> In practice, however, many insurers treat any settlement demand within their policy limit as creating a high risk of liability.<sup>67</sup> These insurers probably fear hindsight bias: the duty to settle is litigated only after a plaintiff has won an above-limit damages award,<sup>68</sup> at which point the insurer may find it difficult to convince a judge or jury that the within-limit settlement demand that the insurer previously rejected was unreasonable. Indeed, the California Supreme Court has held that the mere fact of an above-limit damages award supports an inference that accepting a pre-trial demand within the limit would have been “the most reasonable method of dealing with the claim.”<sup>69</sup>

2. *Demands Above the Cap: The Duty To Contribute.* Scholars who have analyzed the settlement conflict among liability insurers and policyholders have focused on the fact pattern that triggers the traditional duty to settle: a settlement offer within the policy limit. Much less has been written about the nature of the conflict when the plaintiff demands more.<sup>70</sup> And next to nothing has been written about how courts actually define insurer duties in above-limit demand cases.<sup>71</sup> One possible explanation for this lack of commentary is that

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66. ROBERT JERRY II, UNDERSTANDING INSURANCE LAW 902 (3d ed. 2002).

67. See Tom Baker, *Blood Money, New Money, and the Moral Economy of Tort Law in Action*, 35 LAW & SOC'Y REV. 275, 292 (2001) (“Although the duty to settle is evaluated on a reasonableness standard, the lawyers spoke as if it was subject to a strict liability standard. As a result, once the plaintiff makes an offer to settle within limits, it appears that all the lawyers involved assume that the insurance company will ‘make good’ on any judgment . . . .” (citations omitted)).

68. The duty might also be invoked if the damages award is within the limit but the total litigation costs—damages plus defense costs—exceed it.

69. *Crisci*, 426 P.2d at 177. On the other hand, some courts have held that breaching the duty to settle does not make the insurer responsible for punitive damages assessed against the policyholder, as these are uninsurable as a matter of public policy. *E.g.*, *PPG Indus., Inc. v. Transamerica Ins. Co.*, 975 P.2d 653, 652 (Cal. 1999).

70. Although several commentators have addressed above-limit settlement offers, they have treated them as requiring only a simple extension of their analyses of below-limit offers, and thus as raising no interesting new questions. See, e.g., Sykes, *supra* note 43, at 108–10 (considering in an appendix the implications of imposing a settlement duty on insurers when the settlement offer is above the policy limit and concluding “[a]lthough the details have changed, the basic structure of the solution has not”); Syverud, *supra* note 43, at 1131 (finding that the essential conflict of interests is the same regardless of whether the settlement demand is above or below the policy limits).

71. The most extensive discussion of legal duties in this situation is provided by Professor Robert Keeton, who devoted three pages to it in his fifty-one-page law review article on insurer

the analysis of such cases seems, at least at first glance, straightforward: the policyholder has paid for only a limited amount of coverage, and so the insurer should be under no presumptive obligation to settle for amounts above that limit.<sup>72</sup> To hold otherwise would effectively read coverage limits out of policies, which ultimately would hurt policyholders by driving up insurance premiums. It is probably for this reason that most judicial statements of the duty to settle are careful to specify that the duty applies only to within-limit settlement offers.<sup>73</sup>

Matters become more complicated, however, when a settlement demand is above the insurer's policy limit but the defendant or an excess insurer is willing to pay the above-limit portion. If the insurer is asked to participate in such a settlement and refuses, what should its liability be, if any? Strictly speaking, this fact pattern is not encompassed by the traditional duty to settle, as the total settlement is greater than the policy amount. Moreover, the consequences of imposing a duty on the insurer in such a case are different in important ways from those of the traditional duty to settle. For these reasons, it is useful to have a separate term for the insurer's obligations in such a case, which is why this Article refers to a distinct "duty to contribute."

The duty to contribute almost never comes up in cases involving personal liability coverage such as automobile and homeowners insurance,<sup>74</sup> as plaintiffs in such cases rarely try to settle for more than the defendant's policy limit. For the typical holder of, for example, a personal automobile policy, the policy itself may be her most valuable

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settlement duties. Keeton, *supra* note 43, at 1148–50. Those pages are concerned primarily with the risks that the insurer faces when asking the policyholder to contribute to a settlement. This Article's focus, by contrast, is on the opposite fact pattern: when the policyholder or an excess insurer asks the primary insurer to contribute. In his article on the duty to settle, Professor Alan Sykes observed only that "[s]ome controversy exists [over] whether liability will attach when the settlement offer exceeds the policy limits but the insured would have been willing to make up the difference." Sykes, *supra* note 43, at 98. His article thus does not countenance a duty to contribute in the type of case in which the duty seems most often to arise: when the defendant or excess insurer actually settles the case and then sues the primary insurer for the primary policy amount. *See infra* notes 79–81 and accompanying text.

72. *See* Wierck v. Grinnell Mut. Reinsurance Co., 456 N.W. 2d 191, 195 (Iowa 1990) ("It is an extraordinary thing to require an insurer to pay more than the policy limits.").

73. *See, e.g.*, Jackson v. Am. Equity Ins. Co., 90 P.3d 136, 142 (Alaska 2004); *Crisci*, 426 P.2d at 176; Ganaway v. Shelter Mut. Ins. Co., 795 S.W.2d 554, 556 (Mo. Ct. App. 1990); *Birth Ctr. v. St. Paul Cos.*, 787 A.2d 376, 379 (Pa. 2001).

74. *See, e.g.*, Hyman et al., *supra* note 56, at 61 & tbl.1 (finding in medical-malpractice cases that a high percentage of final settlement demands are at or below the policy limit).

recoverable asset: her home may be mortgaged to the bank, and her other personal assets may be trivial. A plaintiff suing such a policyholder for injuries covered by her policy will often be better off demanding no more than her policy amount, thereby permitting the plaintiff to negotiate exclusively with the liability insurer, an experienced litigant who has deep pockets and who is accustomed to reaching into them to end a lawsuit.<sup>75</sup>

Fact patterns that implicate the duty to contribute are more common in lawsuits against corporate defendants, as such defendants often buy tiered liability coverage from multiple insurers. Tiered coverage means that liability above the primary policy limit is borne not by the defendants but rather by another insurer. It is thus predictable that, in lawsuits against defendants protected by insurance towers, the plaintiff often makes a demand that exceeds the primary limit, thereby pulling at least one excess insurer into the settlement negotiation.<sup>76</sup> And the excess insurer and plaintiff may then reach a settlement conditioned on the willingness of the primary insurer, and any other subsituated excess insurers, to contribute their policy amounts. The question of interest then becomes, what happens if one (or more) of these lower-level insurers refuses to participate? One possible outcome is that the proposed settlement falls apart and the case goes to trial. Courts might then be tempted to hold that the logic underpinning the traditional duty to settle extends to this fact pattern as well, making the dissenting insurer liable for the full damages award—including any portion outside its policy limits—if the rejected settlement offer was reasonable.<sup>77</sup> And this is in fact how courts presented with this scenario have ruled.<sup>78</sup>

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75. For a model of settlement negotiations in which the insurer and policyholder are jointly made better off by a clause in the insurance policy that credibly disables the policyholder from contributing to a settlement, see Meurer, *supra* note 43, at 510.

76. See BAKER & GRIFFITH, *supra* note 1, at 145–47.

77. Commentators who see no legally relevant differences between above-limit and below-limit settlement offers appear to have this particular fact pattern in mind. See *supra* note 70.

78. See *Ranger Ins. Co. v. Travelers Indem. Co.*, 389 So. 2d 272, 277 (Fla. Dist. Ct. App. 1980) (holding that a primary insurer can be liable to an excess insurer for damages above the primary limit if the primary insurer rejects an above-limit settlement demand on which the excess insurer offered to pay the above-limit portion); see also *Lexington Ins. Co. v. Royal Ins. Co.*, 886 F. Supp. 837, 839–40 (N.D. Fla. 1995) (applying *Ranger Ins. Co. v. Travelers Indem. Co.*, 389 So. 2d 272 (Fla. Dist. Ct. App. 1980)). A wrinkle is that the duty to settle is formally owed to the policyholder, whereas excess insurers may be the main victims of a lower-level insurer's settlement veto. Most courts get around this technicality, which also comes up in traditional duty-to-settle claims asserted by excess insurers against primary insurers, by holding that an excess insurer is subrogated to the policyholder's rights when another insurer's bad faith

The second potential outcome of such a settlement negotiation—and the one that seems more common in practice—is that, after the lower-level insurer refuses to participate, the excess insurer that negotiated the settlement pays the full settlement out of its own pocket and then sues the dissenting insurer for the latter’s policy amount. In such cases, must the dissenting insurer, which in most cases is the primary insurer, pay over its policy amount to defray the costs of a settlement to which it did not consent? In the decisions that have addressed this question directly, most courts have held that the answer is yes.<sup>79</sup> California courts in particular have consistently held that the dissenting insurer’s duty to contribute in such cases is essentially automatic.<sup>80</sup> By contrast, opinions from other jurisdictions hold that the dissenting insurer’s duty to contribute (again, not the courts’ term) shares a common foundation with the duty to settle and hence arises only if the overall settlement amount is reasonable.<sup>81</sup>

Although none of the decisions recognizing a duty to contribute says so explicitly, one possible rationale for the duty is that it, like the duty to settle, counteracts the structural disincentive of lower-level insurers to accept actuarially fair settlement demands. As an illustration, consider again a hypothetical defendant who has a primary liability policy of \$2M and an excess policy of \$3M. As before, we will assume that the defendant faces a lawsuit in which the plaintiff has a 50 percent chance of prevailing, but now we will assume that the potential damages are \$5M rather than \$3M. In

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causes the excess insurer to suffer a loss. *See* Hartford Accident & Indem. Co. v. Aetna Cas. & Surety Co., 792 P.2d 749, 752–53 & 752 n.2 (Ariz. 1990) (collecting such cases).

79. *See, e.g.*, *Westerholm v. 20th Century Ins. Co.*, 130 Cal. Rptr. 164, 165–68 (Ct. App. 1976); *Cont’l Cas. Co. v. Reserve Ins. Co.*, 238 N.W.2d 862, 868 (Minn. 1976); *Fireman’s Fund Ins. Co. v. Sec. Ins. Co. of Hartford*, 367 A.2d 864, 869 (N.J. 1976); *Evans v. Cont’l Cas. Co.*, 245 P.2d 470, 479 (Wash. 1952); *see also* *Pac. Indem. Co. v. Liberty Mut. Ins. Co.*, 48 Cal. Rptr. 667, 671–72 (Ct. App. 1966) (holding that an excess insurer which settled a case for a reasonable amount within the primary policy limit could recover the full settlement amount from the primary insurer). The only contrary holding is in the case of *Sentry Ins. v. U.S. Fidelity & Guar. Co.*, No. LF-2387-4, 2000 WL 288467, at \*1–2 (Va. Cir. Ct. Mar. 15, 2000).

80. *See, e.g.*, *Pac. Indem. Co.*, 48 Cal. Rptr. at 671; *see also* *Schwartz v. Liberty Mut. Ins. Co.*, 539 F.3d 135, 141 (2d Cir. 2008) (applying California law).

81. *See, e.g.*, *Fireman’s Fund*, 367 A.2d at 869; *Evans*, 245 P.2d at 479. Some courts recognize a more expansive duty to contribute when the insurer in bad faith denies coverage or refuses to defend its policyholder, in which case the policyholder may settle and then sue the insurer to recover the *full* settlement amount, including any above-limit portion. *See* *Traders & Gen. Ins. Co. v. Rudco Oil & Gas Co.*, 129 F.2d 621, 627 (10th Cir. 1942) (“Some courts permit a recovery by the assured against the insurer for losses sustained in excess of the limits of the policy, based upon the negligent conduct of insurer, resulting in losses to the assured in excess of the limits of the policy.”).



contrast with the hypothetical lawsuit summarized in Table 1, the expected damages in this case (\$2.5M) exceed the primary policy limit.<sup>82</sup>

*Table 2. Liability When Expected Damages Exceed Primary Limit*

	Expected Trial Liability	Share of Collective Settlement	Benefit (Cost) of Collective Settlement
(Primary) Insurer, \$2M limit	\$1.0M	\$2.0M	(\$1.0M)
Defendant/Excess Insurer	\$1.5M	\$0.5M	\$1.0M
Total	\$2.5M	\$2.5M	—

To avoid trial expenses, the defense-side parties are collectively better off settling pre-trial for the expected damages of \$2.5M. And the plaintiff prefers this result as well, for the same reason. But the primary insurer will resist, as its liability would then be \$2M (its policy amount), whereas its expected trial liability is only \$1M.<sup>83</sup> To overcome this obstacle to an insured settlement, a court might create a rule under which the primary insurer forfeits its policy limit whenever it refuses to participate in a settlement that requires it to contribute no more than its policy amount.<sup>84</sup> Alternatively, the court could permit an excess insurer who settles the case for a “reasonable” amount to recover the primary policy amount from the primary insurer. In either of these forms, a duty to contribute placed on the primary insurer seemingly moves settlement negotiations toward the socially preferable result.

Professors Baker and Griffith have observed that excess D&O insurers often put settlement pressure on the insurers below them in an insurance tower, especially when the excess insurers are willing to pay the portions of the settlement demand that fall within their slices of the liability range.<sup>85</sup> Court decisions recognizing a duty to

82. The Appendix contains a generalized model of insurer-policyholder conflict in above-limit demand cases.

83.  $(50\% \times \$2M) \text{ (the policy limit)} + (50\% \times \$0) = \$1M$ .

84. Without a policy limit the insurer’s expected trial liability is \$2.5M, the same as the settlement offer, giving the insurer the necessary incentive to accept that offer, especially if the insurer would also be responsible for the defense’s trial expenses.

85. See BAKER & GRIFFITH, *supra* note 1, at 149.

contribute explain the source of this pressure. Objecting to settlement is of little advantage to a lower-level insurer if the case will settle anyway and a court then will force the insurer to pay over its policy amount—plus, most likely, interest. And if its objection scuttles the settlement, the insurer may be forced to pay the entire subsequent damages award, including the portion above its policy limit.

Besides counteracting lower-level insurers' bias against settling when the trial outcome is uncertain, the duty to contribute may also ameliorate a problem with collective settlements that can arise even in cases in which the plaintiff has a 100 percent chance of prevailing at trial. Settling such a case pre-trial confers a benefit on the insurers in the tower that are responsible for liability in excess of the lawsuit's potential damages, as it is those insurers, rather than the insurers below them, whose overall liability would be increased by the litigation expenses that settlement avoids. Knowing that settlement reduces the liability of these upper-level insurers, lower-level insurers might strategically withhold their consent to settlement in order to negotiate for a reduced share of the overall settlement burden. This risk of holdouts, which constitutes a classic collective-action problem, increases with the number of insurers in the tower. Strategic negotiating of this type can introduce delay and cause negotiations to collapse.<sup>86</sup> The duty to contribute can be seen as a device for defeating such holdouts and forcing them to pay their contractually assigned share of the settlement burden.

The discussion to this point has considered only the apparent virtues of the duty to contribute, one of which—counteracting lower-level insurers' bias against settling—it shares with the duty to settle. The implication might seem to be that the duty to contribute should be governed by a strict-liability rule rather than a reasonableness standard, just as scholars have advocated for the duty to settle.<sup>87</sup> But drawing this inference would be a mistake. As will be discussed in the next Part, the duty to contribute lacks the duty to settle's self-regulating virtue. Rather than discouraging plaintiff overreach, the duty to contribute rewards it, producing a plaintiff-overcompensation hazard that does not arise under the duty to settle even when that duty is not restricted to "reasonable" settlement offers. This downside of the duty to contribute raises the question whether the better

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86. See Lloyd Cohen, *Holdouts and Free Riders*, 20 J. LEGAL STUD. 351, 359 (1991) (describing how holdouts can cause negotiation breakdowns).

87. See *supra* notes 64–65 and accompanying text.

solution to the conflict that arises from above-limit settlement offers would be to eliminate the collective settlement process that is that conflict's source.

## II. THE SOCIAL COSTS OF DEFENSE-SIDE CONFLICT CONTROL

The previous Part described how the bundling of liability coverage with defense coverage, the duty to settle, and the duty to contribute all act against an insurer's structural disincentive to settle when the trial outcome is uncertain and the potential damages exceed the insurer's policy limit. None of these conflict-control devices directly addresses the countervailing bias, which is the overeagerness of defendants and upper-level excess insurers to settle pre-trial when doing so would shift liability onto primary and lower-level excess insurers.<sup>88</sup> The implication is that the current set of conflict-control devices increases the proportion of lawsuit settlements paid by lower-level insurers rather than by upper-level insurers and defendants. To the extent that defendants are risk-averse, this shifting of their liability onto insurers may seem efficient.<sup>89</sup> But the conflict-control devices achieve this result by introducing several costly distortions, all of which are byproducts of the practice whereby defense-side parties settle collectively.

### A. *Plaintiff Overcompensation Under the Duty To Contribute*

Although scholarly commentary on insurer-policyholder conflict in settlement negotiations has been extensive, it has overlooked how the duty to contribute systematically encourages settlements that overcompensate plaintiffs.<sup>90</sup> And courts that enforce that duty seem unaware of this hazard as well. Yet the hazard should be heeded, as systematic plaintiff overcompensation will tend to generate a variety of social costs including too many lawsuits, overspending on lawyers, and, ultimately, more expensive liability insurance.

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88. At least in theory, subjecting the duty to contribute to a reasonableness standard could help countervail this bias toward pre-trial settlement. As noted, not all courts apply a reasonableness standard in such cases. *See supra* note 80 and accompanying text.

89. POSNER, *supra* note 34, at 131.

90. Other scholars have spoken of a plaintiff-overcompensation problem in connection with the awarding of non-economic damages (such as punitive damages) for breach of the duty to settle. *See, e.g.,* Chandler, *supra* note 56, at 744. The plaintiff-overcompensation hazard described here, by contrast, arises specifically in duty to contribute cases, and occurs even if economic ("compensatory") damages are the only type available in the lawsuit.

To see how the duty to contribute distorts negotiations in favor of plaintiffs, consider again the hypothetical lawsuit summarized in Table 2, in which the defendant has a \$2M primary policy and a \$3M excess policy, and the plaintiff has a 50 percent chance of losing at a trial and a 50 percent chance of winning \$5M. Rather than assuming, however, that the plaintiff makes an actuarially fair settlement demand of \$2.5M, consider what could happen instead if the plaintiff made a more aggressive demand of \$3M. In that case, it is cheaper in expected value terms for the defense-side parties to go to trial, at least as long as their trial expenses would be less than \$0.5M.<sup>91</sup> But from the individual perspective of the excess insurer, accepting the \$3M settlement demand is still better than trial as long as it can use the duty to contribute to force the primary insurer to tender its policy amount of \$2M. The excess insurer's net settlement liability would then be \$1M, whereas its expected trial liability, as noted in Table 2, is \$1.5M (plus potential trial expenses).<sup>92</sup> In this way, the duty to contribute has what we might call a "cramdown" effect: it enables a plaintiff and excess insurer (or defendant) to improve their positions relative to trial by shifting liability down the tower onto the primary insurer. The result in this hypothetical lawsuit is a settlement that overcompensates the plaintiff relative to the expected damages.

A possible objection is that the plaintiff's settlement demand of \$3M seems noncredible given that the expected damages are only \$2.5M. The excess insurer seemingly could negotiate the plaintiff down to the actuarially fair amount, saving itself \$0.5M. By the same logic, however, the excess insurer's rejection of the \$3M settlement demand is noncredible given that settling for that amount would cost it only \$1M, whereas its expected trial liability is at least \$1.5M. The plaintiff therefore should be able to negotiate the total settlement amount *up* to \$3.5M, thereby capturing the \$2.5M in expected damages plus the \$1M potential benefit to the excess insurer of avoiding trial. In fact, any settlement between \$2.5M and \$3.5M would be mutually beneficial to the excess insurer and the plaintiff relative to trial.<sup>93</sup> And only at the bottom end of this range is the plaintiff not overcompensated as measured by the expected damages.

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91. Because the expected damages are \$2.5M, trial is preferable to settlement as long as trial costs would be less than \$0.5M.

92.  $50\% \times (\$5M - \$2M) = \$1.5M$ .

93. Including defense costs widens the potential settlement range. For example, if the plaintiff and the excess insurer would have to incur \$0.2M each in trial costs, the settlement range widens to \$2.3M through \$3.7M. This aspect of the negotiation dynamic is not, however,

What is happening here is that the plaintiff and excess insurer are bargaining to divide between themselves a \$1M transfer away from the primary insurer. The transfer equals the difference between the primary insurer's policy amount (\$2M) and its expected trial liability (\$1M).<sup>94</sup> The transfer is available to the other parties to a collective settlement, which is why the range of settlements mutually beneficial to the plaintiff and excess insurer is \$1M wide. Excluding trial expenses, the transfer away from a primary insurer produced by the duty to contribute, and hence the potential amount of plaintiff overcompensation, can be expressed as follows:

- (1) If  $L < D$ , then  $T = L - pL$   
 (2) If  $L \geq D$ , then  $T = 0$

where  $T$  is the transfer,  $L$  is the primary limit,  $D$  is the potential damages (the damages award if the plaintiff wins at trial), and  $p$  is the probability (between 0 and 1) of a verdict for the plaintiff. Equation (1) states that, as long as the potential damages exceed the primary limit, the transfer equals the primary limit minus the primary insurer's expected trial liability. Equation (2) states that no transfer will occur if the potential damages do not exceed the primary limit.<sup>95</sup> In that case the excess insurer (or, in the absence of excess insurance, the defendant) has no financial incentive to participate in a settlement, and thus the duty to contribute will not normally be invoked.<sup>96</sup>

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particular to duty-to-contribute cases, as it applies to any negotiation in which the alternative to settlement is trial. See Spier, *supra* note 43, at 330. For a fuller treatment, see the Appendix.

94. In theory, plaintiff overcompensation is also a hazard in the hypothetical illustrated in Table 1, in which the expected damages of \$1.5M are within the primary limit of \$2M. The excess insurer faces \$0.5M in expected trial liability and therefore should be willing to settle for as much as \$2.5M as long as it can use the duty to contribute to force the primary insurer to pay \$2M. As the equations in the text indicate, plaintiff overcompensation is a possibility whenever the *potential* damages exceed the primary limit—even if, as is true in Table 1, the *expected* damages are within that limit. But the hazard is smaller in that instance because of the larger gap between the expected damages and the minimum settlement demand that would bring the excess insurer into the case. This gap makes it less likely that the plaintiff will be able to make a credible settlement demand that entails liability for the excess insurer.

95. Including trial expenses would generally reduce the transfer by the defense's trial expenses multiplied by the probability of a verdict for the defendant. A more general formula that includes trial expenses is derived in the Appendix.

96. The same consideration also means that the plaintiff must have a chance of prevailing, i.e.,  $p$  must be greater than 0. And  $p$  must be less than 1 for  $T$  to have a positive value. Thus, as noted in Part I.B, the conflict of interest arises only if the trial outcome is uncertain.

These equations have two worrisome implications from a social-welfare perspective. The first is that the overcompensation hazard is greatest in those cases that are the least meritorious. Our proxy for merit is  $p$ , the plaintiff's probability of winning at trial. If we hold  $L$  (the primary limit) constant in Equation (1),  $T$  (the value transfer) rises as  $p$  falls.<sup>97</sup>

The second worrisome implication is that, if the defendant has constructed an insurance tower, then the overcompensation hazard increases with the number of policies in the tower. To see why, we must first broaden the definition of  $L$  to signify not the primary policy limit per se but rather the limit of whichever policy in the tower is closest to the potential damages without exceeding them. The equations remain valid with this modification because once any excess insurer or the defendant agrees to a settlement that would fall within its contractually allocated slice of the liability range, all subsituated insurers (the primary insurer plus any lower-level excess insurers) are collectively subject to the duty to contribute, and hence are like a single primary insurer for purposes of calculating the value transfer captured by the settlement.

With this adjustment in mind, two observations lead to the conclusion that the overcompensation hazard rises with the number of policies in the tower. First, note that if the plaintiff's probability of success ( $p$ ) and the potential damages ( $D$ ) are held constant, the transfer ( $T$ ) increases with the policy limit ( $L$ ) as long as the limit does not reach the potential damages. Put another way, the transfer is largest when the distance between the potential damages and the nearest underlying policy limit is smallest. Second, note that if the defendant faces a set of possible lawsuits with potential damages that are randomly distributed across the liability range encompassed by the tower, then the expected distance between the potential damages in any given suit and the nearest subsituated policy limit decreases as the number of policies in the tower increases. In combination, these observations mean that, if the total damages range covered by the tower is held constant, then the potential for plaintiff overcompensation increases with the number of policies in the tower.

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97. For example, if we take the hypothetical lawsuit summarized in Table 2 but assume that  $p = 25\%$  rather than  $50\%$ , then  $T$  is \$1.5M rather than \$1M. On that assumption, the actuarially fair settlement amount is \$1.25M, which is less than the excess policy limit. But the excess insurer faces expected trial liability of \$0.75M and therefore would be willing to accept any settlement up to \$2.75M as long as it can use the duty to contribute to defray its costs by the \$2M primary policy amount.

When an excess insurer negotiates with a plaintiff to divide the wealth transfer created by the duty to contribute, which of them will have the stronger bargaining position? At least in the context of shareholder litigation, there are reasons to think that both parties will be under pressure to settle. Because the excess insurer will have sold a diversified portfolio of policies, it may be more risk-neutral than the plaintiff. On the other hand, the plaintiff's settlement decision will likely be made by a plaintiffs' attorney, who may be part of a firm that itself has a diversified set of pending lawsuits. In addition, the excess insurer will probably be under strong settlement pressure from the defendant-managers, who will want the lawsuit settled quickly. Professors Baker and Griffith report that corporate managers desire quick settlements of shareholder lawsuits, and are willing to tolerate higher settlement amounts to attain them, in order to avoid ongoing negative publicity.<sup>98</sup> These observations suggest that plaintiffs and excess insurers typically negotiate on roughly equal footing. If this suggestion is correct, then settlement negotiations indeed are biased strongly toward plaintiff overcompensation, which is avoided only if the excess insurer has such a strong bargaining advantage that it captures the entire value transfer for itself.

A question to be addressed at this point is whether the insurers in a tower could prevent the plaintiff-overcompensation hazard by bargaining among themselves after a lawsuit is brought. For example, in the hypothetical lawsuit summarized in Table 2, could the excess insurer pay the primary insurer to accept responsibility for the excess policy? Doing so would effectively collapse the primary and excess policies into one, rendering the duty to contribute inapplicable and eliminating the cramdown dynamic that leads to plaintiff overcompensation.<sup>99</sup> To transfer its policy to the primary insurer, however, the excess insurer would need permission from the policyholder under the common law rule that forbids a promisor (here, the excess insurer) from delegating its obligations to a third party (the primary insurer) without a "novation" from the promisee

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98. See BAKER & GRIFFITH, *supra* note 1, at 155.

99. The primary insurer would be willing to accept responsibility for the excess policy for a payment of as little as \$0.5M, which is clearly better for the excess insurer than the hypothetical \$1M it would have to pay into a \$3M settlement. The primary insurer presumably would then settle the entire lawsuit with the plaintiff for the \$2.5M in expected damages, giving it net liability of \$2M, the same as its liability in a cramdown settlement.

(the policyholder).<sup>100</sup> And the policyholder in our hypothetical would have little reason to permit the transfer. Reassignment of policies among insurers would defeat one of the main functions of insurance towers, which is to reduce the policyholder's exposure to each insurer's individual bankruptcy risk.<sup>101</sup> Indeed, if the insurers in a tower could freely reassign liability among themselves, they could mutually profit by transferring all of their liability to the insurer who is least creditworthy, which is the type of result that the novation rule seems intended to avoid.<sup>102</sup>

Alternatively, the primary insurer might try to prevent a cramdown settlement by selling a reinsurance policy to the excess insurer for the full excess-policy amount. Like an outright transfer of the excess policy to the primary insurer, such a reinsurance policy would seemingly consolidate liability in the primary insurer, but without requiring a novation from the policyholder. Reinsurance by itself would, however, only exacerbate the plaintiff-overcompensation risk, as then the excess insurer would be fully insulated from liability and hence have no incentive to refuse any settlement demand at all. For this reason, a cramdown settlement could be avoided only if the excess insurer bought a reinsurance policy from the primary insurer *and* transferred to the primary insurer full authority to settle on behalf of both insurers. But such a delegation of authority would create a significant liability risk for the excess insurer, as courts have consistently held that an insurer cannot use reinsurance to relieve itself of the duty to settle it owes its policyholder.<sup>103</sup> This rule against

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100. ROBERT E. SCOTT & DOUGLAS L. LESLIE, *CONTRACT LAW AND THEORY* 939–40 (2d ed. 1993) (“An effective delegation does not discharge an obligor until contracted performance is provided by the delegate. A discharge may result, however, if the parties engage in a novation.”).

101. See *TOWERS WATSON*, *supra* note 42, at 26 (finding that purchasers of primary D&O insurance identify “financial strength” as the most important insurer selection criterion).

102. Imagine that Insurer A could sell a given policy for a \$100 premium but Insurer B, due to credit risk, could sell the same policy for only \$50. The two could mutually gain at the expense of a policyholder if Insurer A sold the policy for \$100 and then paid Insurer B \$75 to assume it.

103. *Royal Transit, Inc. v. Ctr. Sur. & Ins. Corp.*, 168 F.2d 345, 350 (7th Cir. 1948); *Zumwalt v. Utils. Ins. Co.*, 228 S.W.2d 750, 754 (Mo. 1950); accord *Unigard Sec. Ins. Co. v. N. River Ins. Co.*, No. 88 CIV.0789 (RWS), 1990 WL 102879, at \*10 (S.D.N.Y. July 13, 1990) (“[A]n insurer owes to its insured a good faith obligation to make coverage determination[s] without regard to whether or not the risk is reinsured.”); see also STEPHEN S. ASHLEY, *BAD FAITH ACTIONS: LIABILITY AND DAMAGES* § 4:20 (2d ed. 1997) (“In the reinsurance context . . . the primary insurer does not relinquish control to the reinsurer . . . .”); Keeton, *supra* note 43, at 1150 (“As between [insurance] company and insured, the company cannot escape any of its responsibilities by reinsurance.”). Could an excess insurer that has delegated control over settlement



delegation of settlement authority is consistent with the novation rule, as both protect the policyholder from actions by an insurer that might deprive the policyholder of the full benefits of the insurance contract.

Going a step further, the excess insurer could try to include a clause in its policy that expressly permitted it to delegate settlement authority to another insurer. But there is reason to doubt that corporate managers would be willing to buy a D&O policy that contained such a clause. As will be discussed in Part IV, managers have a strong incentive to preserve the duty to contribute's cramdown dynamic in order to encourage insurer-covered settlements even when the total settlement amount exceeds the expected damages. Therefore, *ex post* bargaining among insurers in a tower—that is, bargaining that occurs after a lawsuit is filed—does not seem to be a viable solution to the plaintiff-overcompensation hazard created by the duty to contribute.

Although they seem unable to bargain around cramdown settlements *ex post*, insurers can adjust to the risk of such settlements *ex ante* by charging higher premiums. The burden of the higher premiums is ultimately borne by the shareholders of the corporations that buy the insurance. For this reason, corporate shareholders, despite being the plaintiffs in shareholder lawsuits, derive no net benefit from systematic plaintiff overcompensation in such cases. Rather, the lawsuits benefit shareholders only if they deter managerial misconduct in a cost-effective manner, a result that excessive settlements will tend to undermine.<sup>104</sup> And if the damages set by the legal system already overstate the actual costs of the underlying managerial conduct—as is likely the case in securities class actions<sup>105</sup>—then excessive settlements will only exacerbate the problem.

While the actual plaintiffs in shareholder litigation do not generally benefit from excessive settlements, the same cannot be said

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negotiations to the primary insurer also seek indemnification from the primary insurer for its liability to the policyholder under the duty to settle? According to Professor Keeton, that question is a “close” one, raising doubts about whether the excess insurer in our hypothetical would be willing to run that chance. Keeton, *supra* note 43, at 1151.

104. The overdeterrence hazard is blunted to the extent that D&O insurers fail to adjust premiums for firm-specific risk. See BAKER & GRIFFITH, *supra* note 1, at 77–84.

105. See Amanda Rose & Richard Squire, *Intraportfolio Litigation*, 105 NW. U. L. REV. 1679, 1702 (2011) (arguing that damages in fraud-on-the-market class actions overstate the net social costs of the fraud).

for their attorneys, who are paid on contingency.<sup>106</sup> This boon for plaintiffs' attorneys comes at the expense of social wealth, as it encourages the filing of marginal lawsuits that the attorneys deem worthwhile only because of the possibility of an excessive settlement. The costs of these suits are like a tax on shareholder returns and hence discourage capital formation.

Importantly, the duty to settle does not produce a plaintiff-overcompensation hazard analogous to that caused by the duty to contribute. If an insurer believes that a within-limit settlement demand is greater than the expected damages plus any trial expenses the insurer would bear, then the insurer is better off rejecting the demand and going to trial, even if by doing so it breaches the duty to settle and hence forfeits its policy limit.<sup>107</sup> This is the duty to settle's self-regulating virtue mentioned earlier: the fact that the duty, even when not subject to a reasonableness standard, cannot be used to force an insurer to settle for more than the insurer's estimate of the lawsuit's value.

As the hypothetical lawsuit summarized in Table 2 illustrates, the duty to contribute does not share this virtue. Thus, whatever the merits of applying a strict-liability rule to the duty to settle, the analysis here shows that applying the same rule to the duty to contribute would be a mistake. Insurers who refuse to participate in above-limit settlements need some means for vindication, as otherwise excess insurers or policyholders will collude with plaintiffs to force the dissenting insurers to pay for settlements that overcompensate the plaintiffs and hence are socially inefficient. Fortunately, some duty-to-contribute precedent holds that the duty is breached only if the settlement amount was reasonable.<sup>108</sup> But this solution is hardly ideal: enforcing this standard requires follow-up litigation over the reasonableness of settlement amounts, which

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106. Lisa L. Casey, *Reforming Securities Class Actions from the Bench: Judging Fiduciaries and Fiduciary Judging*, 2003 B.Y.U. L. REV. 1239, 1251; Jeffrey Michael Smith, *The Role of the Attorney in Protecting (and Impairing) Shareholder Interests: Incentives and Disincentives To Maximize Corporate Wealth*, 47 DUKE L.J. 161, 167 n.44 (1997).

107. An exception occurs where the insurer is responsible for the defense's trial costs and those costs are greater than the difference between the settlement demand and the expected damages. For example, if the expected damages are \$1.5M, the defense's trial expenses are \$0.3M, and the plaintiff demands \$1.7M, it would be cheaper for the insurer to accept the demand than to go to trial.

108. See *supra* note 81 and accompanying text.

besides being costly may often be distorted by a pro-settlement bias among courts that makes overcompensation more likely.

*B. Insurer Underspecialization*

The previous section described what is probably the most important distortion produced by the duty to contribute: a wealth transfer that biases settlements toward plaintiff overcompensation. But there is a second distortion produced by that duty, and by the duty to settle as well, which is the compression of settlement burdens on primary insurers in a manner that may interfere with insurer specialization.

As a general matter, shareholder lawsuits that present meaningful liability risks can be divided into two types: high-merit suits that the plaintiff has a high probability of winning at trial, and long-shot suits that the plaintiff has a low probability of winning but that entail high potential damages. By developing expertise in covering one lawsuit type or the other, insurers might be able to appraise risk more accurately, thereby permitting them to operate with smaller loss reserves. And this reduction in the insurers' operating costs would, in turn, lead them to charge lower premiums.<sup>109</sup> But the duties to settle and contribute impede such specialization because they force insurers on lower stories of an insurance tower to bear most of the burden from both types of lawsuit.

Insurance towers already seem to reflect a degree of insurer specialization, as there are several D&O insurers that sell excess policies only.<sup>110</sup> These insurers presumably have developed a measure of expertise in pricing the risk of lawsuits with high expected damages. Without the duties to settle and contribute, however, the opportunity for specialization would be greater. To see why, imagine a corporation with a D&O tower that consists of a \$2M primary policy, a \$3M first-layer excess policy, and a \$5M second-layer excess policy. Imagine further that the corporation faces the risk of a long-shot suit with \$10M in potential damages and a 10 percent probability of a verdict for the plaintiff. At first glance, the risk of this type of lawsuit seems to be the reason for the second-layer excess policy. But

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109. See BAKER & GRIFFITH, *supra* note 1, at 79 (noting that insurers which fail to assess policy risks accurately will have higher risk-related expenses).

110. Although many companies sell excess D&O policies, the market for primary policies is dominated by just two, AIG and Chubb. *Id.* at 53.

note that the actuarially fair settlement amount is only \$1M,<sup>111</sup> well within the primary policy limit. And the duty to settle would require the primary insurer to accept a settlement demand of \$1M even though the primary insurer's expected trial liability is only \$0.2M, excluding defense costs.<sup>112</sup> Similarly, if the probability of a verdict for the plaintiff were 30 percent rather than 10 percent, the primary insurer would still bear the bulk of the settlement burden via the duty to contribute.<sup>113</sup> In either case, the lawsuit's settlement burden is concentrated on the primary insurer even though the potential damages reach the top of the tower.

This example suggests that insurance towers entail a large amount of risk compression. Because of the duties to settle and contribute, lower-story insurers bear most of the risk from both high-merit lawsuits and long-shot lawsuits. For this reason, towers might be conceptualized as having a pyramidal shape, with wide bases and progressively thinner upper floors. As will be described in Part III.B, risk compression would be eliminated if settlements were segmented, which would shift much of the settlement burden of long-shot lawsuits up the tower to the excess insurers.<sup>114</sup>

### C. *Overspending on Defense Lawyers*

As was observed in Part I.B, there is a third legal device that works against the structural disincentive of lower-level insurers to settle: the bundling of coverage for liability with coverage for defense costs.<sup>115</sup> But bundling also encourages overspending on defense lawyers because of the moral hazard that arises when the parties who hire the lawyers—namely, the manager-defendants—are not the parties paying them. Defense costs are a significant portion of the financial burden imposed by shareholder litigation: Professors Baker and Griffith estimate that defense costs in the typical shareholder suit

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111.  $10\%$  (the probability of a verdict for the plaintiff)  $\times$  \$10M (the damages award if the plaintiff prevails) = \$1M.

112.  $10\%$  (the probability of a verdict for the plaintiff)  $\times$  \$2M (the policy limit) = \$0.2M.

113. If the potential damages remained \$10M but the probability of a verdict for the plaintiff were 30 percent, then the primary insurer's expected trial liability would be only \$0.6M, equal to 30% (the chances of a verdict for the plaintiff)  $\times$  \$2M (the policy limit). But the actuarially fair settlement amount would then be \$3M, of which \$2M would likely be the primary insurer's responsibility if the case settled and the excess insurers were able to use the duty to contribute to force the primary insurer to pay its full policy amount.

114. Note that, in the lawsuit summarized in Table 2, segmenting the settlement process would shift \$1M in expected liability from the primary insurer to the excess insurer.

115. *See supra* Part I.B.

equal about 30 percent of the settlement amount.<sup>116</sup> And even when a case is dismissed rather than settled, the defendants may have to incur large legal bills to achieve that result.<sup>117</sup>

Besides explaining bundling, the conflict of interests created by collective settlements also helps explain why D&O insurance appears to rely less than other types of liability insurance on deductibles and co-payments. These features of insurance policies reduce moral hazard by causing policyholders to bear more of the costs of their decisions that result in covered losses.<sup>118</sup> In the D&O context, they could be used to discourage managers from overspending on defense lawyers. And, indeed, when D&O policies do employ these incentive-correction devices, corporate managers tend to spend much less on their own defenses.<sup>119</sup> But these curatives are often not used, at least at effective levels.<sup>120</sup> Instead, the main way that D&O insurers seem to protect themselves against overspending on defense attorneys is simply to charge higher premiums. The implication is that the corporate managers who buy D&O insurance think that encouraging insurers to accept plaintiff settlement demands is more important than keeping insurance premiums down.

To be sure, liability coverage creates moral hazard as well, as it weakens managers' incentive to avoid the types of conduct that result in shareholder lawsuits. But this moral hazard is more attenuated due to the delay between the conduct and the lawsuit and because even the most scrupulous managers cannot eliminate their risk of being sued altogether. These observations imply that defense coverage and liability coverage should have different structures. But instead they are typically merged under a single D&O policy and subject to the same deductible, if any. Were it not for lower-level insurers' structural disincentive to settle, this degree of bundling would be unnecessary and overall defense costs would be lower.

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116. BAKER & GRIFFITH, *supra* note 1, at 134–35.

117. Although defense costs are not true fixed costs, they are less variable than the potential damages in shareholder lawsuits, making insurance for them less economically valuable as a risk-spreading device. Thus, Professors Baker and Griffith find that the ratio of a lawsuit's defense costs to its settlement amount tends to fall as the settlement amount rises. *Id.*

118. Jacob Loshin, Note, *Insurance Law's Hapless Busybody: A Case Against the Insurable Interest Requirement*, 117 YALE L.J. 474, 506 (2007).

119. For a vivid description of how defendants in shareholder lawsuits behave differently depending on whether an insurer is covering their legal bills, see BAKER & GRIFFITH, *supra* note 1, at 135–36.

120. *Id.*

The fact that the manager-defendants rather than the insurers control the defense of the typical shareholder lawsuit also helps explain a second unusual structural feature of D&O insurance. In most automobile and homeowners policies, the policy limit applies to liability coverage only. Defense coverage is unlimited,<sup>121</sup> which makes sense given that the insurer rather than the policyholder controls the defense and hence is unlikely to spend more on defense attorneys than is justified by the expected damages.<sup>122</sup> The typical D&O policy, by contrast, is a “burning candle” arrangement in which defense costs and liability costs count cumulatively toward the same policy limit.<sup>123</sup> In a liability-insurance market in which buyers want defense coverage but also want to control their defenses, using the policy limit to cap coverage for defense costs may be the insurers’ only practical means of reining in spending on defense lawyers.

### III. ELIMINATING THE STRUCTURAL CONFLICT THROUGH SEGMENTED SETTLEMENTS

The last Part described the distortions caused by the three devices that have been developed to encourage settlements by insurers. These distortions occur because the devices fail to correct the defense-side conflict of interests at its source, which is the mismatch between settlement liabilities and expected trial liabilities that arises when the trial outcome is uncertain and settlements are collective. As long as that mismatch persists, defense-side parties will have an incentive to reduce their liability by shifting losses onto each other rather than by pursuing settlements that minimize the total costs of a lawsuit. Only the duty to settle comes close to correcting the mismatch, but it does so by selectively disregarding policy limits.<sup>124</sup> And policy limits serve valuable functions such as protecting insurers against risks that are too large for them to bear in a cost-effective

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121. See, e.g., INS. SERVS. INC., HOMEOWNERS 3 (SPECIAL FORM), app. A at 16 (1999), available at <http://wps.aw.com/wps/media/objects/3808/3900110/appendices/AppendixA.pdf> (capping coverage for personal liability but assuming an uncapped duty to defend); ISO PROPS., INC., PERSONAL AUTO POLICY, app. B at 2 (2003), available at <http://wps.aw.com/wps/media/objects/3808/3900110/appendices/AppendixB.pdf> (same).

122. Interestingly, the moral hazard here goes the other way: the insurer bears damages liability only up to the policy limit, and thus faces an incentive to underinvest in defending cases in which the potential damages exceed that limit.

123. *In re Enivid, Inc.*, 364 B.R. 139, 143–44 (Bankr. D. Mass. 2007); *In re Metro. Mortg. & Sec. Co.*, 325 B.R. 851, 853 (Bankr. E.D. Wash. 2005).

124. See *supra* Part I.C.1.

manner. Meanwhile, the duty to contribute exacerbates incentives for strategic behavior by forcing insurers to pay into settlements that were negotiated between the plaintiff and another insurer or the defendant. Finally, bundling defense coverage with liability coverage substitutes one externalization problem for another: by curbing the insurer's power to shift liability for damages onto the defendant, it encourages overspending on lawyers by permitting the defendant to shift defense costs to the insurer.

This Part describes how segmented settlements would remove the defense-side structural conflict of interests, thus mitigating or eliminating each of the distortions that arise when settlements are collective. Segmented settlements would supersede the duties to settle and contribute, and they would reduce the need to bundle defense coverage with liability coverage. Segmentation is also more efficient than other settlement approaches that scholars have discussed, including a strict-liability rule for the duty to settle and “vertically” sliced insurance towers.

#### *A. The Mechanics of Segmented Settlements*

Under the prevailing method for structuring D&O coverage, a range of potential damages in shareholder lawsuits is divided into segments, and each segment is contractually assigned to a different insurer. Any damages beyond that range are by default the responsibility of the defendants, whose potential liability also forms a segment capped at the amount of the defendants' wealth. Under the collective approach to settlements, no settlement can be reached unless all of the implicated defense-side parties either consent or are forced to contribute. Under a segmented approach, by contrast, each defense-side party would have the authority to settle its own liability segment with the plaintiff, and in doing so would neither require permission from other defense-side parties nor be able to force them to participate.

To see how the segmented approach would work, consider again the lawsuit summarized in Table 1, in which the plaintiff's probability of winning at trial is 50 percent, the potential damages are \$3M, and the defendant has a \$2M primary policy and a \$3M excess policy. Recall that the lawsuit's expected damages are \$1.5M, which given the policy limits break down into expected trial liability of \$1M for the primary insurer, \$0.5M for the excess insurer, and zero for the defendant. Under a segmented approach, the plaintiff would make separate settlement demands to each defense-side party, presumably

based on their respective expected trial liabilities. If only the primary insurer settled, trial would occur, and a verdict for the plaintiff would entitle him to collect only those awarded damages in excess of the \$2M primary limit. The first \$2M in damages would be uncollectable, as the plaintiff would have waived his right to collect these in exchange for whatever settlement payment he received from the primary insurer.<sup>125</sup> Conversely, if only the excess insurer settled, trial again would occur, but the plaintiff would be able to collect only the first \$2M of the damages award, to be paid by the primary insurer.<sup>126</sup> The additional \$1M in potential damages would be uncollectable, as the plaintiff in settling with the excess insurer would have waived his right to collect any awarded damages that fell within the excess insurer's segment of the tower. If both insurers settled, the only remaining defense-side party would be the defendant, but on these assumptions the plaintiff has no reason to go to trial against the defendant alone since the potential damages do not reach the defendant's liability segment. The defendant and plaintiff would thus have found it to be in their mutual interest to settle the defendant's liability segment early in the case for no payment or perhaps a nominal amount.

Note that the actuarially fair total settlement amount for this case remains \$1.5M. What has changed is the distribution of that amount among the defense-side parties. Now there is no mechanism by which one defense-side party can, by rejecting an actuarially fair settlement offer, expose other defense-side parties to the risk of a damages award at trial. As a result, there is no longer a difference between the distribution of the expected trial liability and the distribution of the settlement burden. The structural conflict of interests is eliminated: the primary insurer is no longer undermotivated to settle before trial, and the excess insurer is no longer overeager to do so. The justification for the duties to settle and

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125. Importantly, the size of the waiver would be the amount of the settling insurer's policy, not the amount of the settlement payment. Otherwise, the segmented approach could produce its own plaintiff-overcompensation hazard analogous to that which arises in settlements involving defendants with joint and several liability. See Kathryn E. Spier, *A Note on Joint and Several Liability: Insolvency, Settlement, and Incentives*, 23 J. LEGAL STUD. 559, 562 (1994) (describing how a plaintiff can extract total settlement payments that exceed the expected damages when settling with multiple defendants whose liability is joint and several, as long as the plaintiff's probability of prevailing at trial is less than 100 percent).

126. As under current practice, the jury would have no knowledge of the insurance arrangement, FED. R. EVID. 411, or of prior settlements, *id.* 410.



contribute—both of which counteract the structural bias of lower-level insurers against settling—has been eliminated.<sup>127</sup>

In the absence of judicial resistance, the possibility of which is discussed Part IV.A, settlements could be segmented contractually. Liability policies would specify that the insurer and policyholder are permitted to settle separately, subject to the condition that the insurer can settle only if the plaintiff agrees to waive his right to collect from the policyholder any damages that would be covered by that insurer's policy. The policyholder and the other liability insurers would be third-party beneficiaries of this waiver and hence able to enforce it.

As for coverage for defense costs, segmented settlements are compatible with bundled D&O policies as they are now written. If settlements were segmented and defense and liability coverage continued to be linked, insurance policies presumably would specify that an insurer that settles its own liability segment has no continuing obligation to cover defense costs either. This would be the sensible rule, as it would make defense-side parties who hold out internalize the trial costs that result from their refusal to settle. There is, however, no reason to assume a static liability-insurance market: segmenting settlements would almost certainly cause at least a partial decoupling of defense coverage from liability coverage, as is described in the next section.

### *B. Segmentation's Economic Benefits*

The segmented approach to settlements is superior to the conflict-control devices now in use because it respects policy limits while removing the structural conflict that those limits introduce when settlements are collective. One clear benefit of the segmented approach would be the elimination of the systematic plaintiff-overcompensation hazard caused by the duty to contribute. That duty would lose its justification and hence would be discarded. As an illustration, consider again the hypothetical lawsuit summarized in Table 2, in which the potential damages are \$5M, the plaintiff has a 50 percent chance of winning at trial, and the defendant has a \$2M primary policy and a \$3M excess policy. As in Part II.A, we will consider what happens when the plaintiff makes an aggressive

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127. Deductibles could also be accommodated without complication. If, for example, the primary policy had a deductible, then the defendant would be responsible for both the bottommost and topmost liability slices in the tower, which it could negotiate to settle separately or as a package.

settlement demand of \$3M. Putting aside for a moment the question of trial costs, a risk-neutral uninsured defendant would reject that demand because the expected damages are only \$2.5M. But because the excess insurer faces expected trial liability of \$1.5M, it prefers a \$3M settlement to trial as long as it can use the duty to contribute to force the primary insurer to tender its policy amount of \$2M. If settlements were segmented, however, this outcome could no longer occur. The plaintiff would have no hope of collecting \$3M in total settlement money, as the primary insurer would not settle for more than \$1M (its expected trial liability), the excess insurer would not settle for more than \$1.5M (its own expected trial liability), and there would be neither an incentive nor a mechanism for one insurer to force the other to pay more.

Once trial expenses are factored in, the possibility arises that the defense-side parties in combination might be willing to settle for more than the total expected damages to avoid trial. But settling avoids trial expenses for the plaintiff as well, which means that he may be willing to settle for *less* than the expected damages. The fact that the common desire to avoid trial expenses creates a range of possible settlement amounts remains true regardless of whether the settlement approach is collective or segmented. The relevant point here is that the collective approach shifts that range upward—that is, in favor of the plaintiff—by the amount of the wealth transfer produced by the cramdown effect of the duty to contribute.<sup>128</sup> Segmented settlements eliminate that shift, lowering the settlement range so that it centers around the expected damages, as is true in the absence of liability insurance.<sup>129</sup>

By eliminating the systematic plaintiff-overcompensation hazard caused by the duty to contribute, segmentation not only would reduce total settlement amounts, but it also would weaken the incentive for plaintiffs to bring lawsuits of marginal merit. Total litigation costs would fall for the additional reason that there would no longer be follow-up suits over the reasonableness of rejected settlement demands. This last benefit is enhanced by the fact that segmented settlements would also eliminate the need for the duty to settle, which under current law is similarly subject to a reasonableness standard.<sup>130</sup>

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128. A simple model that depicts this shift is provided in the Appendix.

129. See Spier, *supra* note 125, at 561 (modeling settlement negotiations in the absence of insurance).

130. See *supra* Part I.C.1.

Each of these changes would reduce the cost of D&O insurance, to the ultimate benefit of shareholders.

A possible concern with the segmented approach described here is that it would redistribute liability up the insurance tower, seemingly increasing liability for policyholders. This possibility can be seen in the previous example if we assume there is no excess insurer; in that case, the defendant's share of an actuarially fair settlement is \$0.5M under current practice but \$1.5M under the segmented approach. Such a liability shift seems to undermine the economic function of insurance, which is to transfer risk from a policyholder to an insurer that through diversification can bear the risk more easily.<sup>131</sup> But this analysis ignores how parties would respond contractually to a change in the settlement rules. If segmented settlements became the norm, policyholders would adapt by erecting higher insurance towers, which they could afford to do because segmentation would eliminate risk compression and hence make the policies toward the bottom of the tower cheaper. Note how segmentation reduces the primary insurer's settlement liability in the previous hypothetical from \$2M to \$1M. The primary insurer would respond to the reduction in its expected liability by charging a lower premium, and the policyholder could use the savings to raise the limit on that policy or to buy another excess policy. In general terms, segmented settlements would make the bases of insurance towers "thinner," as lower stories would bear less weight from potential damages at higher levels. And this change would, in turn, allow towers to be taller without making them more expensive to construct.

Eliminating risk compression would also promote insurer specialization and thereby allow for more accurate pricing of litigation risk. As noted in Part II.B, collective settlements conflate insurance coverage for two distinct types of lawsuit: high-merit suits that the plaintiff would be likely win at trial, and long-shot suits that the plaintiff would be less likely to win but that have high potential damages. The duties to settle and contribute concentrate the settlement burden of both lawsuit types on lower-story insurers. Segmented settlements would shift much of the settlement burden of the long-shot lawsuits up the tower. And this shift in settlement burdens would encourage specialization by producing greater separation between the settlement burden from suits with low potential damages, which would continue to be focused on lower-

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131. POSNER, *supra* note 34, at 131.

level insurers, and the burden from long-shot suits with high potential damages, which would be more concentrated on the excess insurers on upper floors.

A further benefit of segmented settlements is that they would reduce spending on defense lawyers by decreasing the need to bundle defense coverage with liability coverage as a mechanism for overcoming lower-level insurers' structural disincentive to settle. As was described in Part II.C, bundling encourages overspending on lawyers due to the moral hazard that arises when the corporate managers run their defense but their insurers pay for it. If lower-level insurers' bias against settling were eliminated, defense coverage could make more aggressive use of deductibles, copayments, and other devices for managing the overspending hazard. The net result would be lower overall defense costs and hence, through lower premiums, higher profits for shareholders.

There is one scenario in which full bundling would probably persist: when the corporation and its managers have settled out of the lawsuit but at least one insurer has declined settlement and opted for trial. We can predict that liability policies would be written so that the nonsettling insurers in such cases bore the defense's trial expenses without regard to policy limits,<sup>132</sup> as otherwise those insurers could externalize onto other defense-side parties some of the costs of their refusal to settle.<sup>133</sup> Notably, as each insurer settles out of the case, the burden of the trial expenses would be increasingly focused on the remaining insurers, thereby strengthening their incentives to settle as well. This dynamic is the opposite of the typical holdout problem, in which each party who joins the collective resolution strengthens the bargaining position of the holdouts who remain.<sup>134</sup> Moreover, each separate settlement would also increase the plaintiff's incentive to

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132. The policyholders presumably would still control the defenses in such cases, thus avoiding the conflict of interests that would arise from coverage exclusions if the insurers were in charge. For this reason, the moral hazard that encourages overspending on defense attorneys would persist, albeit in a more limited context. Strictly speaking, this particular social cost of D&O insurance does not result from the structural conflict that segmented settlements would eliminate, as it would occur even if liability policies had no limits. Rather, this cost is a byproduct of the insistence by insured defendants on running their own defenses in shareholder lawsuits.

133. If multiple insurers remained in the case, the allocation rule might be that the litigation expenses would all fall on one insurer—perhaps the lowest-ranked insurer in the tower that remains. Such a rule would maximize that insurer's incentive to settle, which would then shift the expected trial liability to the next insurer, and so on.

134. For a general description of holdout dynamics, see Cohen, *supra* note 86, at 354–59.

settle with remaining defense-side parties, as each settlement would reduce the amount the plaintiff could win at trial but not his likely trial expenses.

*C. Other Reform Proposals: Strict Liability and Vertically Sliced Towers*

Two other approaches to alleviating insurer-policyholder conflict have been discussed by scholars. Neither, however, fully eliminates the source of that conflict, and thus neither would go as far as the segmented approach in reducing the costs of the current system. The first approach has already been mentioned: converting the duty to settle into a strict-liability rule under which an insurer automatically forfeits its policy limit whenever it rejects a within-limit settlement demand, regardless of the demand's reasonableness.<sup>135</sup> This proposal's main virtue is that it would reduce the need for follow-up lawsuits between insurers and policyholders, which besides generating direct litigation costs present a risk of legal error.<sup>136</sup> But the proposal has an overlooked downside, which is that it would increase risk compression on primary insurers and hence further undermine insurer specialization.<sup>137</sup> Moreover, as long as settlements remain collective, a reasonableness standard will still be needed in duty-to-contribute cases in order to police the plaintiff-overcompensation hazard. For these reasons, making the duty to settle a strict-liability rule would not be as efficient as segmented settlements, which remove the structural conflict that makes such a duty necessary in the first place.

A second approach to liability insurance, which is used in Europe, is called the "quota share" system.<sup>138</sup> Insurance towers are sliced vertically rather than horizontally, meaning that each participating insurer, instead of assuming all liability within its exclusive segment of the liability range, accepts a percentage of the liability range covered by the tower as a whole. For example, four liability insurers might agree with a policyholder that each insurer will cover 25 percent of the liability and defense costs, up to a common limit of \$10M per lawsuit. The main apparent advantage of this approach is that, among the insurers themselves, there is no longer a

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135. *See supra* note 64 and accompanying text.

136. *See supra* notes 64–69 and accompanying text.

137. *See supra* Part II.B.

138. BAKER & GRIFFITH, *supra* note 1, at 148.

structural difference between the distribution of the expected trial liability and the distribution of the settlement burden.<sup>139</sup> Hence, there is no opportunity for insurers to engage in cramdown settlements that create a plaintiff-overcompensation hazard. In this way, the quota share system seems to mark an improvement over horizontally sliced towers. And this very lack of a cramdown dynamic among insurers gives managers of corporations in the United States an incentive to resist the quota share system, for reasons discussed in Part IV.

The quota share system only partly removes the cramdown dynamic, however, because it does not eliminate the structural conflict of interests between the insurers as a group and the defendants sitting atop the tower. The division in the tower between these two groups is still horizontal, as it is in American-style towers. Therefore, duties to settle and contribute, running from the insurers as a group to the policyholders, would still be necessary. And the need for a duty to contribute, in turn, implies the possibility of cramdown settlements negotiated directly between defendants and plaintiffs.

Another drawback of the quota share system is that it apparently requires all insurers to consent to a settlement in order to be bound by it. The system thus may suffer from collective-action problems such as holdouts. And a third drawback is that there is less opportunity for insurer specialization because all insurers bear equally the risks of different types of lawsuit. For these reasons, it is not obvious that the quota share system marks a significant improvement over towers that are sliced horizontally. It is nonetheless worth noting that a segmented approach to settlements is also compatible with the quota share system and would mitigate its apparent collective-action problems. If each insurer in a vertically sliced tower could settle separately with the plaintiff, holdouts would not be able to force trial on other insurers who would rather settle. Segmented settlements in this context mean that each insurer could make a payment to the plaintiff in exchange for a waiver of the plaintiff's right to collect the percentage of the damages within the tower covered by that insurer.

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139. *Id.*

#### IV. REFORM OBSTACLES: OLD-FASHIONED JUDGES AND PROFIT-SMOOTHING MANAGERS

This Article has argued that segmented settlements are superior not only to the collective approach now in use but also to the alternatives that other scholars have considered. But if the segmented approach really is more efficient, why has it not been adopted already? Two potential obstacles to reform seem most likely. The first is judges who might think that the approach is inconsistent with insurers' traditional "duty to defend." The second, and probably more important, potential reform obstacle is corporate managers. While collective settlements reduce shareholder profits, they serve managerial interests by increasing the likelihood that settlement payments will be fully covered by D&O insurance, thereby shielding reported corporate earnings—and managers' incentive-based pay—from the impact of shareholder lawsuits brought in response to the managers' conduct. If settlements were segmented, a larger proportion of settlements would be paid by corporations rather than their insurers, thereby increasing the volatility of reported corporate earnings and reducing the managers' reputations and compensation.

There are two situations in which the collective approach is especially likely to advance managers' interests. Both involve the use of the duty to contribute to overcome insurer resistance to settlement. The first is when the plaintiff thinks that the expected damages are significantly higher than the D&O insurers do. And the second is when there is a good chance that a coverage exclusion would be triggered if the case went to trial. In both situations, the duty to contribute's cramdown effect can help bring about a covered settlement. And the potential for a cramdown settlement increases with the number of policies in the tower, encouraging managers to divide coverage among more insurers than they would otherwise. Segmented settlements would supersede the duty to contribute and hence eliminate this incentive to overdivide coverage.

##### *A. Judicial Conservatism and the Duty To Defend*

Considering the judicial obstacle first, some courts might consider it an act of bad faith for a liability insurer to enter into a settlement that does not include a full release for the policyholder. Under the segmented approach, an insurer could settle in exchange for a release that extends only to damages covered by the policy. The basis for such judicial resistance would be the common law's duty to

defend, under which a liability insurer must represent its policyholder's best interests both in court and in negotiations with plaintiffs.<sup>140</sup> A judge who is mindful of this duty might be sympathetic to a policyholder who complained that her insurer abandoned her by settling out of the case, notwithstanding that the insurer obtained a liability waiver from the plaintiff up to the policy limit.

Judicial resistance to segmented settlements would probably be strongest in the context of traditional liability insurance such as automobile and homeowners coverage. People buy such insurance not only to shield their wealth but also to enlist a litigation expert who can choose a lawyer for them and manage their defenses. This is why automobile and homeowners policies assign both the right and the duty to defend to the insurer, giving the policyholder the benefit of the insurer's expertise throughout the litigation. It is also why many courts hold that an insurer acts in bad faith if it asks its policyholder to contribute to a settlement unless the insurer is also tendering its full policy amount.<sup>141</sup> Such a request implies a negotiation between the insurer and policyholder over the division of the settlement burden, a negotiation in which the asymmetry of expertise presumably puts the policyholder at a disadvantage.

With D&O insurance, however, the relationship between insurer and policyholder is quite different. The corporate managers covered by D&O insurance usually have experience with litigation and are likely to retain control over their own defenses. For this reason, most D&O policies explicitly abrogate the insurer's duty to defend, and they require the policyholder to consult with the insurer before settling so that the insurer is not left out of settlement negotiations altogether. In this context, the policyholder has paid only for an underwriter, and so there is no reason for courts to force the insurer to serve as a fiduciary as well.

A second judicial concern with segmented settlements has arisen in what might be called "sandwich" settlements, which occur when both the primary insurer and the defendant settle but an excess insurer remains in the case. Sandwich settlements are the only type of segmented settlement that seems to have been attempted with any frequency, perhaps because they include a full release for the defendant and hence create no liability risk to the primary insurer under the duty to defend. But some courts have blocked sandwich

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140. *See, e.g., Gray v. Zurich Ins. Co.*, 419 P.2d 168, 171 (Cal. 1966).

141. *See Syverud, supra* note 43, at 1155–56.



settlements on different grounds, namely that a trial involving only the plaintiff and an excess insurer would be a “sham” because the nominal defendant (the policyholder) no longer has any liability exposure. In the 1978 case *United States Fire Insurance Co. v. Lay*,<sup>142</sup> the Seventh Circuit cited this concern in holding that a sandwich settlement also extinguished the excess insurer’s liability even though the excess insurer was not a party to the settlement agreement.<sup>143</sup>

The *Lay* court’s concern about sham lawsuits is unconvincing, as it seemingly would require that all liability policies have limits so that policyholders always have residual exposure. Few courts would agree that a liability policy must have a limit to be enforceable at all. Unsurprisingly, most courts that have considered sandwich settlements have rejected *Lay*’s reasoning.<sup>144</sup>

In recent years, however, excess insurers have mounted successful objections to sandwich settlements on purely contractual grounds.<sup>145</sup> This trend seems to be the result of more careful drafting, with excess policies now specifying that coverage begins only when the primary insurer has actually paid out its full policy amount. Earlier policies could be interpreted to permit liability for the excess insurer when the primary policy was merely “exhausted.”<sup>146</sup> Since settling is advantageous to the primary insurer only if it can do so for less than its policy limit, this more explicit wording makes sandwich settlements infeasible.

The fact that insurers are drafting excess policies to preclude a particular type of segmented settlement implies that the judiciary is not the only obstacle to reform. The buyers of corporate liability insurance, who otherwise would penalize insurers for inserting inefficient clauses into policies, seem not to want segmented settlements either. When it comes to D&O insurance, the buyers are, of course, the corporate managers who often are sued in shareholder

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142. *U.S. Fire Ins. Co. v. Lay*, 577 F.2d 421 (7th Cir. 1978).

143. *Id.* at 423.

144. Decisions upholding such settlements include *Zeig v. Mass. Bonding & Ins. Co.*, 23 F.2d 665 (2d Cir. 1928); *Kelley Co. v. Cent. Nat’l Ins. Co. of Omaha*, 662 F. Supp. 1284 (E.D. Wis. 1987); *Siligato v. Welch*, 607 F. Supp. 743 (D. Conn. 1985); *Allstate Ins. Co. v. Riverside Ins. Co.*, 509 F. Supp. 43 (E.D. Mich. 1981); *Drake v. Ryan*, 498 N.W.2d 29 (Minn. 1993); *Loy v. Bunderson*, 320 N.W.2d 175 (Wis. 1982).

145. *E.g.*, *Comerica Inc. v. Zurich Am. Ins. Co.*, 498 F. Supp. 2d 1019, 1034 (E.D. Mich. 2007); *Qualcomm Inc. v. Certain Underwriters at Lloyd’s, London*, 73 Cal. Rptr. 3d 770, 786 (Ct. App. 2008).

146. *Zeig*, 23 F.2d at 666; *see also Qualcomm*, 73 Cal. Rptr. 3d at 786 (collecting cases).

lawsuits. Why would managers resist an approach to settlements that, as is argued here, would increase corporate profits?

*B. Collective Settlements as Reputation and Compensation Shields*

A commonplace among corporate-law commentators is that managers' top priority in shareholder lawsuits is avoiding trial.<sup>147</sup> Trial can bring to light unflattering information about the managers' performance, and it threatens their personal wealth because a judicial finding of deliberate misconduct would preclude both insurance coverage and indemnification by the corporation. Managers therefore will prefer settling even some cases in which shareholder interests would be better served by a trial.

Although the risks to managers from trial explain why essentially all shareholder lawsuits that are not dismissed are settled, they do not explain why corporate managers cause their firms to purchase as much D&O coverage as they do. Even without insurance, managers could pay to settle shareholder lawsuits pre-trial and then obtain indemnification from their corporation. D&O insurance is needed to protect managers' personal wealth only in the rare lawsuit that is large enough to bankrupt the corporation. This implies "catastrophic" D&O policies with high deductibles.<sup>148</sup> But D&O policies do not make aggressive use of deductibles,<sup>148</sup> suggesting that corporate managers are averse not just to trial but also to pre-trial settlements that, if not covered by insurance, would put an unsightly dent in their firm's reported earnings. As noted previously, the average securities class-action settlement in recent years equaled 18 percent of the average quarterly earnings of Fortune 500 firms.<sup>149</sup> Adding in the typical defense costs in shareholder lawsuits raises the total costs of such suits as a percentage of quarterly earnings to 23 percent.<sup>150</sup> In other words, most of the D&O coverage that corporations purchase serves not to protect managers in case of their corporations' bankruptcy, but rather to reduce the volatility of their corporations' reported earnings. The price of this lower volatility is a reduction in the baseline earnings level by the amount of the insurance premiums, a

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147. See ALLEN ET AL., *supra* note 22, at 407.

148. See *supra* notes 119–120 and accompanying text.

149. See *supra* note 8 and accompanying text.

150. As noted previously, defense costs typically equal about 30 percent of the settlement amount. See *supra* note 116 and accompanying text.

price that the managers who make the D&O purchase decisions are evidently willing to accept.

At first blush it might seem that risk-averse shareholders would benefit from the reduction in earnings volatility that D&O insurance provides. But this perception is inaccurate as applied to shareholders of publicly traded corporations, who can hedge firm-specific risk in the same way that an insurer does, namely by holding a diversified investment portfolio.<sup>151</sup> In other words, the volatility of returns on a diversified stock portfolio is not lower when the firms in the portfolio own D&O insurance, a point that becomes especially clear once one recognizes that the D&O insurers will also likely be represented in the portfolio. But the overall returns on the portfolio will be lower due to the administrative costs of buying and selling the policies and running the insurance companies. A rough estimate of these costs suggests that they equal at least 20 percent of total insurance premiums.<sup>152</sup>

While D&O insurance will not reduce the volatility of the returns on a diversified stock portfolio,<sup>153</sup> it will reduce the earnings volatility of those individual firms whose managers are sued. It does this by replacing large but infrequent settlement payments with smaller but regular premium payments. In other words, D&O insurance protects earnings reports from the dip that a large settlement payment would otherwise cause. And managers benefit from litigation-proof earnings reports because investors use such reports to evaluate the managers' performance, and because most managerial compensation is tied to the firm's stock price and reported

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151. See BAKER & GRIFFITH, *supra* note 1, at 58.

152. The insurance industry uses the term "loading costs" to describe those expenses that are added to the insurer's actual expected liability on an insurance policy to calculate the premium charged. Loading costs are usually between 20 and 30 percent of the total premium amount. *Id.* A portion of these costs include the necessary returns on investment for the insurer's shareholders, and thus are not a true cost from the perspective of diversified shareholders. On the other hand, loading costs exclude the administrative expenses incurred by the insurance buyers, which are a true cost to diversified investors.

153. Even diversified shareholders might benefit from D&O insurance to the extent that it reduces the likelihood that portfolio firms will incur costs of financial distress such as bankruptcy. But, again, this concern would justify "catastrophic" coverage rather than the policies with lower deductibles that we actually observe. Professors Baker and Griffith have considered other potential benefits to diversified shareholders of D&O insurance, such as tax savings, but they have concluded that none of these are convincing either. *Id.* at 63-68.

financial results.<sup>154</sup> Although the D&O premiums themselves also reduce reported profits, their impact is both smaller and more predictable, and they may not affect managers' compensation at all if they are priced into the baseline stock price or profit level used for issuing stock options or calculating earnings-based bonuses.<sup>155</sup>

This discussion suggests that corporate managers actually have two important objectives in shareholder lawsuits: they want all suits that survive the motion to dismiss to be settled before trial, and they want the cost of the settlements to be covered entirely by insurers. The managers have a great deal of control over the first objective, as they can always choose to settle a case pre-trial and arrange for their corporation to pay for it. They have less control over the second objective, which requires the cooperation of the D&O insurers. And the insurers may resist paying for a settlement even when they are not structurally biased against settling by the collective settlement approach. There are two situations in which this type of insurer resistance to settlement is particularly likely. The first is when the plaintiff honestly thinks that his case is worth more than the D&O insurers do. And the second is when there is a good chance that trial would result in a finding of deliberate misconduct, triggering a coverage exclusion. To force insured settlements in such cases, managers have an incentive to structure their insurance coverage to maximize the likelihood of a cramdown settlement under the duty to contribute. In this way, managers' interest in shielding earnings reports from volatility caused by shareholder litigation gives them a reason not only to preserve the current regime of collective settlements, but also to divide their D&O coverage among more insurers than they would otherwise.

#### 1. *Insurer Resistance Due to Plaintiff or Insurer Overconfidence.*

When negotiating to settle a shareholder lawsuit, the most important factor that parties consider is the damages that would be awarded if the case went to trial. After conducting extensive interviews with

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154. Rose & Squire, *supra* note 105, at 1693 (describing how corporate liability for managerial misconduct can provide useful information to diversified shareholders even if damages payments constitute mere pocket-shifting).

155. See Elaine Buckberg & Frederick C. Dunbar, *Disgorgement: Punitive Demands and Remedial Offers*, 63 BUS. L. REV. 347, 364 (2008) (describing a typical bonus plan using earnings per share as the baseline); Michael T. Higgins, *A Better Approach to the Bonus Question*, BUS. WK. ONLINE (Nov. 4, 2003), [http://www.businessweek.com/smallbiz/content/nov2003/sb2003115\\_9919.htm](http://www.businessweek.com/smallbiz/content/nov2003/sb2003115_9919.htm) (explaining that earnings-based performance bonuses are awarded only for performance in excess of a baseline).

individuals who are regularly involved in shareholder litigation—including defense-side and plaintiff-side lawyers, insurance underwriters, insurance claims managers, and corporate managers who purchase D&O insurance—Professors Baker and Griffith wrote: “Damages, our respondents insisted, drive settlements.”<sup>156</sup> This description of settlement behavior in the D&O context accords with the standard economic model of litigation settlements, under which litigants’ willingness to settle is based on their estimates of the benefits and costs of trial.<sup>157</sup>

In the hypotheticals this Article has used to illustrate settlement dynamics, the plaintiff and the defense-side parties share a common estimate of the expected damages. But of course such estimates can differ, and they can do so in ways that make settlement more or less likely. For example, if a liability insurer thinks that the plaintiff’s case is worth more than the plaintiff does, then an insurer-covered settlement is especially likely, for the same reason that a sale is more likely if the prospective buyer values the sales item more than the seller does. But if the plaintiff thinks his case is worth more than the insurers do, then the parties will be less likely to agree on a settlement price.

Even, however, when a plaintiff’s estimate of the expected damages is greater than that of the defense-side parties, the parties’ common interest in avoiding trial expenses might enable them to reach a settlement. The trial expenses that settlement avoids can be seen as a “surplus” that the parties divide between themselves in the settlement agreement.<sup>158</sup> If this surplus is big enough, it can bridge a gap between the parties’ damages estimates that would otherwise preclude settlement. As a simple illustration, imagine a lawsuit in which the plaintiff thinks that the expected damages are \$1.5M, but the defendant thinks they are only \$1M. This difference in the damages estimates opens up a \$0.5M gap between the plaintiff’s minimum settlement demand and the defendant’s maximum settlement offer. But imagine further that the trial would cost each party \$0.3M in litigation expenses. Now the defendant would be willing to offer up to \$1.3M to avoid trial, while the plaintiff will be

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156. BAKER & GRIFFITH, *supra* note 1, at 161.

157. See POSNER, *supra* note 34, at 764–65 (noting that trial rather than settlement occurs when the plaintiff’s estimate of expected damages minus the defendant’s exceeds total trial costs).

158. Another motive to settle is risk-aversion, which can cause a party to favor the certainty of a settlement payment to the uncertainty of a trial.

willing to accept as little as \$1.2M. The desire to avoid trial expenses has created a range of values—between \$1.2M and \$1.3M—in which settlement is mutually beneficial.<sup>159</sup> Put in general terms, and assuming that the parties are risk-neutral, a settlement will occur so long as the total expected trial expenses are greater than the plaintiff's expected damages estimate minus the defendant's.<sup>160</sup> On the other hand, if the gap in estimates is greater than the surplus attributable to the avoidance of trial expenses, then negotiations will break down.

The likelihood that the parties will differ in their estimates of the expected damages is particularly high in the context of shareholder litigation. Very few shareholder lawsuits actually go to trial, and so litigants must rely on indirect predictors of hypothetical damages awards such as investor losses and intangible factors such as how scandalous the managers' behavior seems.<sup>161</sup> Parties will naturally vary in their estimates of the magnitude and relevance of these factors, creating a high probability of honest differences in their appraisals of the lawsuit's value. Although risk-aversion and avoided trial expenses may sometimes bridge these differences, the likelihood of a negotiations breakdown nonetheless seems particularly high in the shareholder litigation context.

One of the most important implications of the duty to contribute is that it creates an additional form of surplus for the parties to a settlement agreement. That surplus is the value transfer that a cramdown settlement captures from the lower-level insurers in the insurance tower. And the addition of this further advantage of settling may be enough to bring the parties to an agreement in cases in which risk-aversion and avoided trial expenses are not alone sufficient to bridge a gap in damages estimates. Put another way, the wealth transfer captured by the duty to contribute raises the maximum settlement amount that is acceptable to the upper-level insurers in the tower, increasing the likelihood that this amount equals or exceeds the minimum amount the plaintiff is willing to accept. Therefore, corporate managers who want to reduce the risk that D&O insurers will refuse to meet a plaintiff's settlement demand will subdivide coverage among multiple insurers to increase the likelihood that the duty to contribute is implicated.

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159. The range may be wider if the parties are risk-averse.

160. See *infra* Appendix.

161. BAKER & GRIFFITH, *supra* note 1, at 156–66.

As an illustration, consider a shareholder lawsuit against a corporate manager protected by a single, \$5M D&O policy.<sup>162</sup> Assume that the parties agree that the potential damages are \$5M but disagree about the plaintiff's chances of winning at trial: the plaintiff thinks he has an 80 percent chance of winning, making his estimate of the expected damages \$4M, while the insurer thinks the plaintiff has only a 50 percent chance, making its estimate of the expected damages \$2.5M. Assume further that trial expenses would be \$0.5M on each side. On these assumptions, the plaintiff would rationally be willing to settle for as little as \$3.5M. The insurer, in turn, would be willing to settle for up to \$2.75. This figure represents the insurer's estimate of the expected damages plus half the defense's trial costs, since on these assumptions the insurer would bear trial costs only if the plaintiff loses.<sup>163</sup> Thus, even with trial costs factored in, a \$0.75M gap between the plaintiff's minimum demand and the insurer's maximum offer remains. This gap means that the manager will be able to avoid trial only by agreeing to a settlement that is paid by herself or her corporation rather than the insurer.<sup>164</sup>

Now consider what would happen in the same hypothetical if the manager, instead of buying just one \$5M policy, divided her coverage between a \$2M primary policy and a \$3M excess policy. In this case, the insurers' estimate of the expected liability distribution is given by Table 2: the primary insurer believes it faces \$1M in expected trial liability (plus \$0.5M in defense costs if the defendant prevails), and the excess insurer believes it faces expected trial liability of \$1.5M. Therefore, to avoid trial, the excess insurer will be willing to settle the case for up to \$3.5M so long as it can use the duty to contribute to force the primary insurer to tender its policy amount of \$2M. Because, as noted in the previous paragraph, the plaintiff is willing to settle for \$3.5M, the possibility now exists of a pre-trial settlement paid by the insurers notwithstanding that they believe the plaintiff's

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162. A version of this hypothetical lawsuit using more generalized terms is provided in the Appendix.

163. Because the potential damages equal the policy limit, the insurer will disregard the defense's expected trial expenses to the extent it expects the plaintiff to prevail, as these expenses will then be borne by the manager or her corporation. This insurer bears the defense's trial expenses only if the verdict is for the defendant.

164. After settling the manager might try to seek reimbursement from the insurer under an aggressive version of the duty to contribute, which she would argue is applicable here even though the settlement demand was within the insurer's policy limit. Except, however, when they are applying California law, courts appear to be disinclined to permit such claims. *See infra* notes 184–190 and accompanying text.

suit is worth significantly less than the plaintiff does. In other words, the \$1M value transfer produced by the duty to contribute has increased the plaintiff's and excess insurer's mutual gains from settling by an amount large enough to bridge the difference in their estimates of the expected damages.

A possible reaction to this hypothetical is that the duty to contribute seems to be providing a social benefit: by bridging a gap in expected damages estimates, the duty is making possible a settlement that avoids the expenses of trial. But it must be remembered that, at least in the context of shareholder litigation, the most likely consequence of a breakdown in negotiations between the liability insurers and the plaintiff is not a trial; it is instead a settlement that is paid by the defendant corporation instead of the insurers. Thus, there is little reason to think that the duty to contribute is actually avoiding trial expenses in most shareholder lawsuits. In addition, the duty to contribute widens the range of potential settlement amounts in an asymmetrical way: it increases the amount that upper-level insurers are willing to pay rather than lowering the amount that plaintiffs are willing to accept. Thus, when the duty to contribute bridges a difference in the parties' estimates of the expected damages, it always does so by moving the settlement amount toward the plaintiff's (higher) rather than the insurers' (lower) estimate, regardless of which of them is mistaken about the lawsuit's real value. Unless plaintiffs are *never* the mistaken ones, the necessary conclusion is that the duty to contribute biases settlement negotiations toward plaintiff overcompensation, thereby generating social costs such as too many lawsuits and pricier liability insurance. For these reasons, it would be a mistake to conclude that the duty to contribute, by bridging gaps between parties' estimates of expected damages in shareholder lawsuits, is increasing social wealth rather than destroying it.

2. *Insurer Resistance Due to Coverage Exclusions.* The second scenario in which liability insurers are especially likely to resist a pre-trial settlement is when there is a good chance that trial would result in a finding of deliberate defendant misconduct that forfeits coverage.<sup>165</sup> Thus, Professors Baker and Griffith have found that when

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165. See, e.g., CHUBB GRP. OF INS. COS., CHUBB FOREFRONT PORTFOLIO 3.0: DIRECTORS & OFFICERS AND ENTITY LIABILITY § V(A)(9)(a) (2011), available at <http://www.chubb.com/businesses/csi/chubb13760.pdf> (disclaiming liability for "any deliberately fraudulent act or omission, or any willful violation of any statute or regulation, by an Insured").



D&O insurers have a strong coverage defense—the most important type being the exclusion for deliberate fraud—they use it in settlement negotiations to reduce their liability and increase the portion of the settlement paid by the corporate defendant.<sup>166</sup> Similarly, Professors Michael Klausner and Jason Hegland have found that the percentage of settlement amounts paid by insurers rather than defendants is lower in securities actions in which a coverage exclusion is more likely.<sup>167</sup>

Just as it can overcome the obstacle to settlement caused by differences in damages estimates, the value transfer produced by the duty to contribute can overcome insurer settlement resistance due to coverage defenses. For this reason, the risk of a coverage exclusion creates an additional motive for managers to increase the likelihood of a cramdown settlement by subdividing D&O coverage among multiple insurers.

Consider again the example of a corporate manager who is covered by a \$5M D&O policy and who faces a shareholder lawsuit that she and her insurer estimate has potential damages of \$5M and a 50 percent probability of a verdict for the plaintiff. To isolate the effect of coverage exclusions, assume for now that the plaintiff agrees with these estimates. Assume further that the D&O policy contains an exclusion for deliberate misconduct. Finally, assume all parties agree that, if the plaintiff wins at trial, there is a further 50 percent chance that the verdict will include a finding that triggers the exclusion. Trial thus presents three possible outcomes: a verdict for the defendant (50 percent chance), a damages award that is covered by insurance (25 percent), and a damages award that is not covered (25 percent).<sup>168</sup>

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166. BAKER & GRIFFITH, *supra* note 1, at 197.

167. Klausner & Hegland, *supra* note 9, at 2.

168. Again, a version of this hypothetical lawsuit using more generalized terms is provided in the Appendix.

*Table 3. Liability with Coverage Exclusion and a Single Insurer*

	Expected Trial Liability	Share of Collective Settlement	Benefit (Cost) of Collective Settlement
Insurer, \$5M limit	\$1.25M	\$2.5M	(\$1.25M)
Defendant	\$1.25M	—	\$1.25M
Total	\$2.5M	\$2.5M	—

The lawsuit's fair settlement value is \$2.5M, well within the \$5M policy limit. But because of the policy exclusion, the insurer's expected trial liability (disregarding litigation expenses) is only \$1.25M.<sup>169</sup> Unless the plaintiff is willing to settle at a deep discount, perhaps due to risk aversion or high expected trial costs, he will not make a settlement demand that the insurer will accept. Thus, to achieve a pre-trial settlement, the manager will have to pay the plaintiff with her corporation's money rather than the insurer's.<sup>170</sup>

Now consider what would happen in this same case if instead of being covered by a single \$5M policy, the manager divided coverage between a \$2M primary policy and a \$3M excess policy, both of which contained exclusions for deliberate misconduct.<sup>171</sup>

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169. The insurer's expected liability of \$1.25M = \$5M (the potential damages) x 50% (the probability of a verdict for the plaintiff) x 50% (the probability that a verdict for the plaintiff does not trigger the exclusion).

170. Moreover, the manager may not be able to wield the duty to settle to force the insurer to pay the actuarially fair amount, as courts have held that this duty does not create liability for damages that would otherwise be uninsurable as a matter of public policy, such as those resulting from intentional wrongdoing. *See, e.g., PPG Indus., Inc. v. Transamerica Ins. Co.*, 975 P.2d 652, 658 (Cal. 1999) (enforcing a "policy of not allowing liability for intentional wrongdoing to be offset or reduced by the negligence of another," including an insurer's negligent failure to settle).

171. Alternatively she could have three or more policies providing \$5M in total coverage, a variation that would not change the conclusions reached here.

Table 4. Liability with Exclusions and a Tower

	Expected Trial Liability	Share of Collective Settlement	Benefit (Cost) of Collective Settlement
Primary Insurer, \$2M policy	\$0.5M	\$2.0M	(\$1.5M)
Excess Insurer, \$3M policy	\$0.75M	\$0.5M	\$0.25M
Defendant	\$1.25M	—	\$1.25M
Total	\$2.5M	\$2.5M	—

In this case the duty to contribute comes to the manager's rescue. Note that the primary insurer is deeply reluctant to settle pre-trial: its share of an actuarially fair settlement is \$2M (i.e., its policy limit), while its expected trial liability is only \$0.5M.<sup>172</sup> Yet the excess insurer is willing to settle for the actuarially fair \$2.5M assuming it can use the duty to contribute to transfer \$2M of that cost to the primary insurer. That transfer leaves the excess insurer with net liability of \$0.5M, as compared with its expected trial liability of \$0.75M.<sup>173</sup> As in the case of differing damages estimates, the duty to contribute has made an insured pre-trial settlement possible even though the plaintiff perceives that he has significantly more to gain from trial than the insurers collectively think they have to lose.

In combination with the discussion of the duty to contribute in Part II.A, this analysis indicates that the duty distorts settlements in two ways: it increases the likelihood that plaintiffs will be overcompensated, and it increases the likelihood of an insurer-covered settlement in cases in which insurance seemingly should be unavailable because there is a good chance that the defendant engaged in deliberate wrongdoing. These distortions will trade off against each other. For example, considering again the hypothetical lawsuit summarized in Table 4, the largest settlement in which the

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172.  $\$0.5M = \$2M$  (the primary policy limit)  $\times$  50% (the probability of a verdict for the plaintiff)  $\times$  50% (the probability that a verdict for the plaintiff does not trigger the exclusion).

173.  $\$0.75M = \$3M$  (the portion of a \$5M verdict that falls within the excess policy)  $\times$  50% (the probability of a verdict for the plaintiff)  $\times$  50% (the probability that a verdict for the plaintiff does not trigger the exclusion).

excess insurer would reasonably participate is \$2.75M,<sup>174</sup> only \$0.25M higher than the fair settlement amount of \$2.5M. By contrast, the otherwise identical lawsuit summarized in Table 2 presented a potential of up to \$1M in plaintiff overcompensation. In general, the duty to contribute is more likely to result in plaintiff overcompensation when the probability of a coverage exclusion is low, and more likely to result in coverage of an otherwise uninsurable loss when the probability of an exclusion is high.

To be sure, the duty to contribute's cramdown effect will not be sufficient to overcome an insurer's reluctance to settle in all cases. A primary insurer might not be overborne if, for example, both of the aforementioned sources of settlement resistance were present in the same case. Consider what would happen in the lawsuit summarized in Table 4 if the plaintiff thought that his probability of winning at trial were 80 percent while the insurers continued to place that probability at 50 percent. Now the plaintiff's estimate of the expected damages is \$4M, well above the \$2.75M figure that Table 4 indicates is the largest settlement demand the excess insurer, putting aside trial expenses, would be willing to accept. To avoid trial in that case, the manager-defendant will have to use the corporation's money to pay the difference. Concordantly, Professors Baker and Griffith observe that defendant corporations sometimes contribute to shareholder litigation settlements even when the total settlement amount is within the limits of the available insurance.<sup>175</sup> But the amount the corporation must pay—and hence the negative impact on reported earnings—still is likely to be smaller than it would be without the duty to contribute. Note in Table 4 that the insurers in combination will pay a maximum of \$2.75M toward a settlement if we assume that the primary insurer can be forced to tender its policy amount, as contrasted with the maximum of \$1.25M they would pay if each could settle separately for its expected trial liability.

3. *Segmentation's Impact on Towers and Profit Reports.* The foregoing discussion suggests that one of the primary benefits to corporate managers of insurance towers is the smoothing of reported corporate earnings. But towers provide this benefit only because

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174. As Table 4 reflects, the excess insurer's expected trial liability is \$0.75M. Therefore, assuming it can obtain a \$2M contribution from the primary insurer, the largest settlement in which the excess insurer would participate is \$2.75M.

175. BAKER & GRIFFITH, *supra* note 1, at 143.

settlements are collective. If defense-side parties could settle separately, lower-level insurers would no longer be structurally undermotivated to settle, thereby eliminating the rationale for the duty to contribute. And without that duty, there would be no cramdown mechanism to force lower-level insurers to settle for more than their own estimates of their expected trial liability. It follows that, if settlements were segmented, managers would often have to rely more on their corporation's checkbook and less on insurance to pay for settlements of shareholder lawsuits.<sup>176</sup>

A potential concern here is that increased indemnification would not in fact be available, and thus that segmented settlements would cause managers to bear significantly more personal liability. Except, however, for cases in which the corporation goes bankrupt, this would not be likely. Thus, in most securities class actions, indemnification by the corporation is readily available: such actions are typically brought directly against corporate managers, and state incorporation statutes permit indemnification for amounts paid to settle direct suits against corporate agents so long as there is no judicial finding that the agents acted in bad faith or in knowing violation of law.<sup>177</sup> In derivative suits, on the other hand, corporations are statutorily barred from indemnifying managers for damages awards or settlement payments.<sup>178</sup> Even in derivative cases, however, there is reason to doubt that segmented settlements would present managers with a significant risk of personal liability. Essentially all public corporations have charter provisions that immunize managers from personal

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176. If the segmented approach were adopted, a question that would arise is how the settlement burden would be divided in cases in which a policy exclusion is likely. For example, in the case summarized in Table 4, the primary insurer would be willing to offer only \$0.5M to settle its \$2M liability segment. Even if the plaintiff agreed that the probability of a guilty verdict were only 50 percent, the plaintiff would place an expected value on this slice of the liability range of \$1M, creating a potentially insurmountable negotiation gap. The solution would be for the settlement between the primary insurer and the plaintiff to include a stipulation that the plaintiff's waiver of his right to collect the first \$2M of any subsequent damages award is subject to the condition that the verdict not include a finding that would have triggered an exclusion. Such a condition on the waiver would close the valuation gap and make the separate settlement possible. In this way, segmentation would acquire a new dimension, with the potential liability range containing not just a series of horizontal slices based on policy limits, but also a vertical slice based on the probability of a policy exclusion. The vertical slice of the tower representing the expected value of the uninsurable damages would be the settlement responsibility of the defendant rather than the insurers.

177. DEL. CODE ANN. tit. 8, § 145(a) (2012).

178. See *supra* note 23 and accompanying text.

liability for violating the duty of care.<sup>179</sup> Most derivative suits thus settle for injunctive relief, such as corporate-governance changes, rather than monetary damages.<sup>180</sup> To be sure, these settlements also typically include an award of the plaintiff's attorneys' fees.<sup>181</sup> Unlike amounts paid in settlement, however, the plaintiff's attorneys' fees can be reimbursed in derivative suits by the corporation as long as a judge finds that the lawsuit conferred a "substantial benefit" on the corporation and its shareholders.<sup>182</sup> Therefore, if a D&O insurer were unwilling to settle pre-trial in a derivative suit because it thought that the plaintiff's attorneys' fees were excessive, the manager-defendants could cause the corporation to pay to settle that insurer's share of the liability burden.

These observations suggest that the most likely consequence of segmented settlements is not more personal liability for managers. Nor, importantly, is it more litigation or trials. To the contrary, segmented settlements would eliminate the need for follow-on litigation to enforce the duties to settle and contribute. Instead, the primary consequence of segmented settlements would be an increase in the proportion of settlement money paid by corporations rather than by their insurers. And this result, perhaps counterintuitively, is one that corporate shareholders should welcome. A decrease in the proportion of shareholder lawsuit settlements paid by D&O insurers would cause premiums to fall, and so this aspect of the change should be essentially a wash in terms of corporate profits. But D&O insurance premiums would fall an additional amount to reflect the social benefits of segmented settlements noted previously: less plaintiff overcompensation, less spending on defense lawyers, and greater insurer specialization. And these reductions in costs would represent a gain to shareholders.

In addition to generating this direct increase in overall corporate profits, segmented settlements would have an important corporate-governance benefit: they would reduce managers' ability to use D&O insurance to insulate corporate earnings reports from the impact of shareholder lawsuits. By displacing liability costs onto insurers,

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179. See, e.g., DEL. tit. 8, § 102(b)(7).

180. Erickson, *supra* note 48, at 1749.

181. Steven D. Frankel, Note, *The Oracle Cases Settlement: Too Charitable to Ellison and the Plaintiffs' Attorneys?*, 4 DEPAUL BUS. & COMM. L.J. 625, 629 (2006) (pointing out that the "vast majority" of derivative action settlements include an award of attorneys' fees).

182. E.g., *Fletcher v. A.J. Indus., Inc.*, 72 Cal. Rptr. 146, 150 (Ct. App. 1968).

insurance weakens the link between each corporation's reported earnings and the contribution of that firm's managers to diversified shareholder wealth. Thus, if the managers of a particular corporation generate a disproportionate amount of shareholder litigation—the costs of which, as noted, shareholders themselves ultimately bear—this fact is unlikely to be evident from the corporation's reported earnings, as the litigation costs are shifted to the firm's D&O insurers.<sup>183</sup>

For this reason, segmented settlements would make each corporation's reported financial results a more accurate measure of the costs to shareholders of litigation resulting from the conduct of that corporation's managers. Segmented settlements therefore would help diversified shareholders better monitor—and, through earnings-based compensation, better motivate—the managers of their portfolio firms.

A related benefit of segmented settlements would be the rationalization of insurance towers. Segmenting settlements probably would not cause insurance towers to disappear altogether, as dividing coverage among insurers would still serve the valuable function of limiting each corporation's exposure to the risk that a particular insurer will fail. But with the duty to contribute discarded as unnecessary, managers would no longer face an incentive to subdivide coverage further in order to encourage cramdown settlements. Instead, their incentive would be to divide coverage among insurers only to the extent that doing so is efficient.

### *C. Reform's First Step: Reversing the Bias of the Duty To Contribute*

This Article has argued that social welfare generally, and shareholder wealth specifically, would be enhanced if settlements of shareholder lawsuits were segmented rather than collective. If this

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183. In theory, insurers could raise the premiums they charge a corporation with a history of submitting large insurance claims. However, as Professors Baker and Griffith describe, the connection between premiums and firm-specific risk is imperfect, and D&O insurance pricing has a cyclical nature that may tend to blur distinctions among buyers. BAKER & GRIFFITH, *supra* note 1, at 97–101. In addition, the increase in the corporation's earnings volatility attributable to the rise in the premium would be much smaller than the volatility increase that would occur if the corporation had to pay for its shareholder-lawsuit settlements entirely by itself. And a volatility increase is what is most useful for corporate-governance purposes because it will call more investor attention to the managers' performance and be more likely to reduce managerial payouts under earnings-linked compensation plans.

argument is correct, the practical question becomes, how can the segmented approach be realized?

The prospects for reform are clouded by the fact that the current system for settling shareholder lawsuits reflects a state of equilibrium under which several politically important groups appear to benefit. Corporate managers benefit because collective settlements camouflage the costs to shareholders of lawsuits brought in response to the managers' behavior. Plaintiffs' attorneys benefit from the larger settlements produced by the duty to contribute. And defense attorneys benefit from the increased spending that results from the coupling of defense coverage with liability coverage. Although larger settlements and attorneys' bills are paid as an initial matter by D&O insurers, the insurers can adjust to these higher costs by charging higher premiums. Thus, the costs of the system are ultimately borne not by the insurers but rather by public-company shareholders and, more broadly, by society as an implicit tax on capital formation. In other words, the costs of the current system are dispersed, while the benefits are concentrated in groups that are likely to be well organized and politically influential.

The most direct way to reduce the costs of collective settlements in shareholder lawsuits would simply be to prohibit public companies from buying D&O insurance, except perhaps in the form of high-deductible policies whose sole purpose is to keep companies out of bankruptcy. This change would not cause managers themselves to bear substantially more personal liability, as they could still be indemnified by their corporate employers. But the costs of shareholder litigation caused by the managers' conduct would no longer be camouflaged, as these costs would have a direct impact on the corporate earnings reports that form the basis of the managers' evaluations and compensation. As a practical matter, however, such reform seems unlikely: D&O insurance is directly authorized by general incorporation statutes, and state legislatures would likely find it politically difficult to enact amendments that almost certainly would be opposed by corporate executives, plaintiffs' attorneys, and defense attorneys alike.

A more promising avenue for reform may be through the courts. Judges probably cannot prohibit collective settlements outright, at least without disregarding language in commercial-liability policies that, as indicated in Part IV.A, seem to preclude a segmented approach. But judges could reinterpret the duty to contribute in a way that would make the current settlement regime less attractive to



managers. Judicial opinions on that duty have paid little attention to the plaintiff-overcompensation hazard created by the duty's cramdown mechanism, implying that many courts are unaware that the hazard exists.

A clear illustration of the judicial failure to police the plaintiff-overcompensation hazard is the Second Circuit's 2008 decision in *Schwartz v. Liberty Mutual Insurance Co.*<sup>184</sup> The decision involved a securities class action against a corporate CEO who was protected by a multi-level insurance tower that provided \$50 million in total coverage.<sup>185</sup> The CEO was particularly anxious for the case to settle because his corporation was bankrupt and hence indemnification was unlikely.<sup>186</sup> The insurers and plaintiffs were, however, unable to reach a settlement agreement before trial. On the day before he was to testify, the CEO accepted the plaintiffs' settlement demand of \$20 million, which he paid with a personal check.<sup>187</sup> He then sought to recover this amount plus interest by suing the bottom four insurers in the tower for bad-faith failure to settle.<sup>188</sup> In an opinion affirming a jury verdict for the CEO, the Second Circuit treated the case as no different from those that implicate the traditional duty to settle. The court cited duty-to-settle cases from California, whose law governed the action, describing how policy limits can make insurers undermotivated to settle relative to their policyholders.<sup>189</sup> No mention was made of the countervailing hazard, which is not implicated in the standard duty-to-settle case: the overeagerness of upper-level insurers and policyholders to settle, which can cause them to favor settling even when the plaintiff's settlement demand exceeds the expected damages.

*Schwartz* depicts the duty to contribute's plaintiff-overcompensation hazard in its most extreme form. By permitting a policyholder to negotiate a within-limit settlement and then send the entire bill to his insurers, the court sanctioned a settlement agreement in which the conflict of interests was at its zenith because the policyholder was negotiating entirely with the insurers' money. In such a situation, the policyholder has no incentive to reject even a

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184. *Schwartz v. Liberty Mut. Life Ins. Co.*, 539 F.3d 135 (2d Cir. 2008).

185. *Id.* at 139.

186. *Id.*

187. *Id.* at 140.

188. *Id.*

189. *Id.* at 142.

settlement demand that greatly exceeds the expected damages—which may well have been true of the \$20 million figure in the case—so long as the demand does not exceed the total coverage provided by the insurance tower. If *Schwartz* were widely followed, it almost certainly would destroy the market for D&O insurance, as every securities action that survived the motion to dismiss would immediately be settled by the defendants, presumably for the full amount of the available insurance. The resulting increase in premiums would make policies unmarketable.

Fortunately, not all courts have completely neglected the conflict of interests inherent in the duty to contribute. For example, the New Jersey Supreme Court has held that one defense-side party cannot force others to pay for a settlement that falls entirely outside the party's segment of the liability range.<sup>190</sup> In other words, in New Jersey the duty to contribute can be invoked only by a party who will bear a portion of the settlement burden itself. This sensible rule avoids the extreme form of the plaintiff-overcompensation hazard that arises when a defense-side party is able to negotiate entirely with funds that others will be forced to provide. But it does not eliminate the hazard altogether: as the hypothetical lawsuits summarized in Tables 2 through 4 illustrate, the duty to contribute creates an overcompensation hazard even when, unlike in *Schwartz*, the total settlement amount reaches the liability segment of the defense-side party that negotiated the settlement.

Cases like *Schwartz* illustrate how courts seem to apply a presumption in favor of cramdown settlements, apparently reasoning that the willingness of an excess insurer or defendant to settle is prima facie evidence of the settlement's fairness. This Article has shown that such reasoning is flawed. The presumption needs to be reversed: courts should recognize that duty-to-contribute claims present a plaintiff-overcompensation hazard that more traditional duty-to-settle claims do not, and therefore that the former needs closer rather than laxer judicial review. If duty-to-contribute claims were harder to win, corporate managers would derive fewer private benefits from the collective approach to settlements, and they therefore would be less likely to resist the more efficient settlement approach described here.

The most logical judge-made reform would be for courts simply to refuse to enforce the duty to contribute in cases in which the

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190. *Fireman's Fund Ins. Co. v. Sec. Ins. Co. of Hartford*, 367 A.2d 864, 870 (N.J. 1976).

defendants rather than the insurers run the defense. As was described in Part I.C, the justification for applying any type of settlement-related duty on insurers is to protect defendants against an above-limit damages award when the insurers could have reduced or eliminated the defendants' liability by negotiating a pre-trial settlement. This justification necessarily presupposes that the defendants rely on the insurers to negotiate a settlement of the defendants' own potential liability. But this presupposition is false when the defendants are sophisticated enough to be active in the negotiations and hence could negotiate a separate settlement that protects them from the risk of an above-limit award, regardless of whether their insurers remain in the case. In that situation, the duty to contribute serves no socially valuable purpose. The same logic also applies, incidentally, to the duty to settle, which similarly is difficult to justify in cases in which the defendants are running the defense and hence could protect themselves by settling separately. But the enforcement of that duty is less problematic given the duty's self-regulating nature.

A possible objection to a judicial policy of refusing to enforce the duty to contribute when the defendants run the defense is that the duty arguably has a contractual basis, namely the standard clause in liability policies providing that the insurer's consent to settlement will not be "unreasonably withheld."<sup>191</sup> But with respect to D&O policies in particular, courts could plausibly interpret such clauses to mean only that the insurer will not unreasonably refuse to settle *its own segment* of the damages range in cases in which the defendant has already settled out of the case. Given that an ongoing shareholder lawsuit can distract managers from their main job of running the corporation, shareholders would want D&O insurers to be under a minimum obligation to make good-faith efforts to settle even if settlements were segmented.

In evaluating the prospects for reform, a final question is whether a judicial reinterpretation of the duty to contribute would have much of a practical impact given that D&O insurers face an incentive to compete for business by cultivating reputations for paying out on claims. As might be expected, corporate managers report that a D&O insurer's "claim-paying reputation" is an important selection criterion (albeit less important than the insurer's

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191. BAKER & GRIFFITH, *supra* note 1, at 140 (quoting a common policy form) (internal quotation mark omitted).

financial strength and prices).<sup>192</sup> But at the same time, the insurers face a countervailing incentive to assume tough negotiating postures as a way of discouraging plaintiffs from suing the corporations and managers that they insure. In addition, Professors Baker and Griffith found that D&O insurers, despite their incentive to be attractive to corporate managers, sometimes threaten to refuse to settle as a way to induce corporations to contribute more to pre-trial settlements.<sup>193</sup> Insurers are particularly likely to push for a policyholder contribution when there is a strong possibility of a finding of deliberate misconduct at trial.<sup>194</sup> This approach to negotiations presumably protects insurers from an adverse-selection problem: an insurer that became known for paying out even in clear cases of fraud would be most attractive to managers with the highest expectations of being sued. When settlements are collective, however, the duty to contribute constrains the ability of insurers to resist pre-trial settlement even in cases of deliberate misconduct. Segmented settlements would give insurers—and especially primary insurers—more negotiating leverage, thereby shifting settlement liability onto the books of corporate defendants. And given that the likelihood of a coverage exclusion is positively correlated with the merits of the lawsuit, a decrease in net insurance coverage in such cases would raise the informational value to shareholders of corporate earnings reports and hence advance the deterrence goals that shareholder lawsuits are supposed to serve.

#### CONCLUSION

The current system for settling lawsuits against insured defendants rests on an assumption so widely accepted that it goes unnoticed. The assumption is that any lawsuit settlement will be a single agreement that collectively binds the defendant and all of its liability insurers. The unchallenged nature of this assumption is surprising in light of the costly conflict of interests it produces. The conflict stems from the fact that liability policies typically assign each insurer and the policyholder a different segment of the range of potential damages in a lawsuit. This combination of collective settlements and segmented liability means that, when a case settles pre-trial for the expected damages, some defense-side parties pay more, and others pay less, than their expected trial liability. Several

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192. TOWERS WATSON, *supra* note 42, at 26 fig.46.

193. BAKER & GRIFFITH, *supra* note 1, at 197.

194. *Id.* at 197.

legal devices have been developed to correct the disincentive to settle that the collective approach creates for lower-level insurers. But because these devices all preserve the collective approach, they introduce their own costly distortions.

Among the most important of these distortions is a systematic plaintiff-overcompensation hazard that arises when an excess insurer or defendant is able to force the primary insurer, and any subsituated excess insurers, to contribute their policy amounts in support of a settlement that the excess insurer or defendant has negotiated with the plaintiff. Like the collective nature of settlements, this “duty to contribute” has gone unnoticed by commentators. Besides encouraging settlements that overcompensate plaintiffs, the duty to contribute interferes with insurer specialization and generates other costs that will drive up liability insurance premiums.

If defense-side parties could settle separately their respective segments of the damages range, the separation between settlement liability and trial liability would collapse. In this way, segmented settlements would eliminate the conflict of interests that courts and commentators now treat as an unavoidable byproduct of policy limits. Courts could thus dispense with the duty to contribute and the more widely discussed duty to settle, both of which are designed to overcome the structural disincentive of insurers to settle when the potential damages exceed the insurers’ policy limits and settlements are collective.

The fact that segmented settlements are not already used in shareholder lawsuits is difficult to attribute to judicial conservatism alone. Principal-agent conflict between shareholders and corporate managers must also bear some blame. Segmented settlements would increase shareholder profits by reducing or eliminating distortions that drive up D&O insurance premiums. But the current system advances managers’ interests by insulating their reputations and performance-based pay from the higher earnings volatility that would occur if the impact of shareholder lawsuit settlements were not deflected onto insurers.

The private benefits to corporate managers of collective settlements also help explain why public companies purchase tiered D&O coverage from multiple insurers. Insurance towers increase the likelihood that a plaintiff’s settlement offer will trigger the duty to contribute, enabling defense-side parties on upper floors to impose a collective settlement that lower-floor insurers resist. This cramdown mechanism can produce an insured settlement even when the insurers

collectively believe that the plaintiff is overestimating the expected damages or when there is a strong chance that trial would result in a finding of deliberate defendant misconduct that exempts coverage. By dividing coverage among multiple insurers, managers can pit insurers against each other in a way that makes an insured settlement more likely, thereby camouflaging the costs of shareholder lawsuits.

This Article has focused on D&O insurance because the economic benefits of segmented settlements are likely to be greatest in the context of shareholder litigation. But towers are not unique to D&O coverage. Cases involving settlement conflicts between primary and excess insurers have arisen in the contexts of insurance for legal malpractice liability,<sup>195</sup> property damage liability,<sup>196</sup> products liability,<sup>197</sup> and marine liability.<sup>198</sup> Segmenting settlements should provide similar benefits in lawsuits covered by these types of liability insurance as well, assuming that the defendants are public corporations or their managers. Such cases would benefit from the segmented approach because they involve agents (corporate managers) who often wish to run their own defenses and who have a conflict of interests with their principals (public shareholders) that encourages overspending on liability coverage. The arguments advanced in this Article suggest that courts also should encourage segmented settlements on public-policy grounds in this broader context, despite likely resistance from corporate managers. At a minimum, courts should recognize that the conflict of interests in negotiations to settle shareholder lawsuits is not inevitable. Rather, the conflict most likely persists because it favors the interests of attorneys and corporate managers, even while a more efficient approach is available.

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195. *E.g.*, *Fireman's Fund*, 367 A.2d at 866.

196. *E.g.*, *Me. Bonding & Cas. Co. v. Centennial Ins. Co.*, 693 P.2d 1296, 1298 (Or. 1985).

197. *See e.g.*, *Syverud*, *supra* note 43, at 1194–95 (describing coverage purchased by the manufacturer of the Dalkon Shield intrauterine device).

198. *E.g.*, *Keystone Shipping Co. v. Home Ins. Co.*, 840 F.2d 181, 183 (3d Cir. 1988) (involving a shipping company that had purchased six layers of marine-liability coverage).

### *Appendix*

This Appendix presents in general terms the various settlement-negotiation scenarios that the Article has illustrated through numerical examples. A few simplifying assumptions are retained: that the time value of money is zero, the parties are risk-neutral, the trial outcomes are dichotomous, and the defendant has sufficient wealth to pay any damages award. Another assumption, later relaxed, is that the parties have common estimates of the potential damages.

Terms are defined as follows:

$D$	potential damages
$p$	probability (between 0 and 1, exclusive) of a verdict for the plaintiff
$k_p$	plaintiff's trial costs
$k_d$	defense's trial costs
$L$	policy limit
$S$	total pre-trial settlement amount
$S_l$	settlement amount paid by the liability insurer
$S_d$	settlement amount paid by the insured defendant
$T$	transfer captured by the duty to contribute

#### *1. No insurance*

Considered first is a lawsuit against a defendant without insurance. The plaintiff will be willing to settle pre-trial for no less than  $pD - k_p$ , and the defendant will be willing to settle for no more than  $pD + k_d$ , making the following true:

$$(3)^{199} \quad pD - k_p \leq S \leq pD + k_d$$

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<sup>199</sup> Numbering is continuous with that begun with the two equations in Part II.A.

The width of the range of possible settlements is  $k_p + k_d$ , which is the surplus from settling.

## 2. *Collective settlements without settlement duties*

Next is considered a scenario in which the defendant has liability insurance, settlements are collective, and there are no settlement duties. As is typical with D&O insurance, the assumption throughout is that the insurer provides both liability coverage and defense coverage and that both are subject to the same policy limit. In this and subsequent scenarios involving collective settlements, two further assumptions are necessary in order that the insurer has a conflict of interests with the defendant. First, it is assumed that  $L < D + k_d$ , meaning that the policy limit is less than the potential damages plus the defense's trial costs, and hence that the defendant faces potential trial liability. Second, it is assumed that  $k_d < L$ , meaning that the defense's trial costs are less than the policy limit. Without this second assumption, the insurer would be liable for its full policy amount regardless of what happened at trial, and therefore it would not be undermotivated to settle.

On these assumptions, the insurer's expected trial liability is  $pL + (1 - p)k_d$ , meaning that the insurer expects to pay its policy limit when the plaintiff prevails at trial, and to pay the defense costs when the defendant prevails. In negotiations between the plaintiff and the insurer, the settlement amount is as follows:

$$(4) \quad \text{If } p(L - D) + (1 - p)k_d + k_p < 0, \text{ then } S_i = \emptyset$$

$$(5) \quad \text{If } p(L - D) + (1 - p)k_d + k_p \geq 0, \\ \text{then } pD - k_p \leq S_i \leq pL + (1 - p)k_d$$

A possibility exists that a settlement will not be reached between the plaintiff and insurer, which will occur if the potential damages ( $D$ ) are too large relative to the policy limit ( $L$ ). Whereas the width of the settlement range was previously  $k_d + k_p$ , it is now  $p(L - D) + (1 - p)k_d + k_p$ . This second amount could be negative, precluding settlement.

In this and all subsequent scenarios involving negotiations with the defendant, the defendant could be replaced with an excess insurer, and the same results would apply assuming that the damages plus the defense's trial expenses do not exceed the excess limit.



### 3. *Segmented settlements*

If instead the segmented settlements approach were used, two different negotiations would occur, one between the insurer and the plaintiff, and the other between the defendant and the plaintiff. As suggested in Part III.A, the assumption will be that when one defense-side party settles, the other is responsible for the full defense costs of trial. Therefore, the maximum amount that each defense-side party will be willing to pay to settle equals the defense's trial costs plus the expected value of the party's segment of the damages range. Because the plaintiff needs to settle with both defense-side parties to avoid trial, he will be willing to accept from each defense-side party that party's potential damages liability minus the plaintiff's full trial costs. The following inequalities are thus true:

$$(6) \quad pL - k_p \leq S_I \leq pL + k_D$$

$$(7) \quad p(D - L) - k_p \leq S_D \leq p(D - L) + pk_D$$

Both inequalities have a solution for all possible values of the variables; thus, unlike in the collective settlements scenario without settlement duties, there is no possibility of trial. The total settlement amount, equal to  $S_I + S_D$ , is given as follows:

$$(8) \quad pD - 2k_p \leq S \leq pD + 2k_D$$

The width of the possible settlements range is  $2k_p + 2k_D$ , which is wider than that given in inequality (3) by the amounts of the trial costs on both sides. The widening is symmetrical around the expected damages, indicating no systematic bias toward plaintiff overcompensation or undercompensation relative to the scenario without insurance.

### 4. *Collective settlements with the duty to settle*

The next scenario returns to the collective settlements approach, except that settlement duties now apply, and an additional assumption is made that  $pD < L$ . Based on this assumption, the case is considered where the plaintiff makes a settlement offer within the policy limit, triggering the duty to settle. Assuming a court would consider this offer reasonable, the range of potential settlements is

the same as that given by inequality (3), above. Thus, when the expected damages are less than the policy limit, under the collective settlements approach the duty to settle achieves a negotiated settlement without biasing the negotiations toward plaintiff overcompensation or undercompensation relative to the case without insurance.

5. *Collective settlements with the duty to contribute*

The alternative scenario with collective settlements and settlement duties arises when  $pD > L$ , meaning that the expected damages are greater than the policy limit. Based on this assumption, the case is considered in which the plaintiff makes an above-limit settlement offer, implicating the duty to contribute. As long as a court deems the settlement amount reasonable, the defendant can settle for an amount above  $L$  and then use the duty to recover  $L$  from the insurer. The range of possible settlements in negotiations between the defendant and the plaintiff becomes:

$$(9) \quad pD - k_p \leq S_d \leq L + p(D - L) + pk_d$$

This inequality has a solution for all possible values of the variables, assuring settlement.

As noted, the insurer contributes  $L$  to this settlement, whereas the maximum it would pay without the duty to contribute—equal to its expected trial liability—is  $pL + (1 - p)k_d$ , as shown in inequality (6). The difference between the two is the transfer captured by the duty to contribute, which as discussed in Part II.A is the amount of potential plaintiff overcompensation:

$$(10) \quad T = (1 - p)L - (1 - p)k_d$$

Notably, the amount of the transfer also equals the difference between the maximum amount the defendant is willing to pay as expressed in inequality (9), where she has insurance, and the maximum amount she is willing to pay in inequality (3), where she lacks insurance. In other words, the duty to contribute has widened the potential settlement range by  $T$ . And it has done so asymmetrically, increasing the defendant's willingness to pay by the amount of the transfer without lowering the minimum amount the plaintiff is willing to accept.

The transfer as represented in equation (10) is smaller than that given by equation (1) in Part II.A, which ignores trial costs. The difference is  $(1 - p)k_d$ , which reflects the insurer's expected share of the trial costs, and which is avoided in case of settlement. The transfer will always be positive given the assumption noted earlier that  $k_d < L$ .

The adjustment for trial costs does not change the two observations about the plaintiff-overcompensation hazard emphasized in Part II.A: that the size of the transfer (and hence the potential amount of plaintiff overcompensation) rises as the probability of a verdict for the plaintiff falls; and, in an insurance tower, that the size of the transfer increases with the number of policies. This second observation remains true because, as described in Part II.A, an increase in the number of policies raises  $L$ , which in the multi-insurer setting represents the policy limit nearest  $D$  without exceeding it. In addition, because the defense trial costs ( $k_d$ ) are unlikely to increase linearly with the potential damages ( $D$ ),<sup>200</sup> whereas in a tower the policy limit closest to the potential damages from below ( $L$ ) will increase linearly (albeit discontinuously) with the potential damages, the size of the transfer as expressed in equation (10) increases with the potential damages.

#### 6. *Duty to contribute with plaintiff or insurer overconfidence*

This Article argued in Part IV.B.1 that the duty to contribute can help achieve a covered settlement when the plaintiff places a higher value on his case than the defense-side parties do. This argument can be shown here by defining two additional variables:  $p_1$  and  $p_2$ , the plaintiff's and the defense-side parties' respective estimates of the probability of a verdict for the plaintiff if trial occurs. The assumption will be that  $p_1 > p_2$ , creating the type of disagreement that can cause negotiations to break down.

We will consider first the case in which the defendant has just one insurer. For this case, the assumption will be that  $D + k_d \leq L$ , meaning the full potential costs of trial to the defense-side parties would be covered by the insurer. In negotiations between the insurer and the plaintiff, the settlement amount is as follows:

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<sup>200</sup> See *supra* Part I.B.

$$(11) \quad \text{If } (p_2 - p_1)D + k_D + k_p < 0, \text{ then } S_I = \emptyset$$

$$(12) \quad \text{If } (p_2 - p_1)D + k_D + k_p \geq 0, \text{ then } p_1D - k_p \leq S_I \leq p_2D + k_D$$

The difference between the plaintiff's and the defense-side parties' estimates of the probability of a verdict for the plaintiff has created the risk that the plaintiff and the insurer will fail to reach a settlement, leaving the defendant to pay the plaintiff's settlement demand if she wishes to avoid trial.

To reduce the risk that she will be faced with a choice between paying for a settlement herself and going to trial, the defendant can divide coverage between two insurers, creating the possibility that one will use the duty to contribute to cram down a settlement on the other. To express this in general terms, we will assume that defendant acquires a primary policy with limit  $L_I$  and an excess policy with an attachment point of  $L_I$  and a limit of  $L_{II}$ . Consistent with previous scenarios, the assumption is that  $k_D < L_I$ . The duty to contribute is implicated if the plaintiff makes a settlement demand that equals at least his estimate of the expected damages, assuming that  $L_I < p_1D$  and that any settlement amount reached by the parties would be considered reasonable by a court. A further simplifying assumption will be that  $D + k_D \leq L_{II}$ . This last assumption excludes the defendant from settlement negotiations, limiting the negotiations to the plaintiff and the insurers. Now the range of possible settlements between the plaintiff and the excess insurer, expressed as  $S_{II}$ , is as follows:

$$(13) \quad \text{If } (1 - p_2)L_I + (p_2 - p_1)D + p_2k_D + k_p < 0, \text{ then } S_{II} = \emptyset$$

$$(14) \quad \text{If } (1 - p_2)L_I + (p_2 - p_1)D + p_2k_D + k_p \geq 0, \\ \text{then } p_1D - k_p \leq S_{II} \leq L_I + p_2(D - L_I) + p_2k_D$$

Comparing the condition on inequality (14) to that on inequality (12) shows the change in the range of potential values for which a settlement can be reached. This comparison shows that the settlement range has been widened by  $(1 - p_2)L_I - (1 - p_2)k_D$ . Comparing this difference to equation (10) indicates that this is the wealth transfer from the primary insurer produced by the duty to contribute as calculated by the defense-side parties—that is, based on their estimate of the probability of a verdict for the plaintiff. Since their estimate of this value is lower, the transfer is larger than it would be if

based on the plaintiff's estimate. Thus, the duty to contribute has increased the range of settlement demands that will produce an insurance-covered settlement by the amount of the wealth transfer away from the primary insurer.

### 7. *Duty to contribute with a possible coverage exclusion*

Part IV.B.2 explained that the duty to contribute can also increase the likelihood of a covered settlement when there is a possibility that trial will produce a finding of deliberate defendant misconduct that triggers an insurance coverage exclusion. This possibility can be represented by defining a new term,  $e$ , as the probability that, if the trial verdict is for the plaintiff, the verdict includes a finding that excludes coverage. By assumption the value of  $e$  is known to all parties. To isolate the effect of this new factor, we also will resort to the previous assumption that all parties have a common estimate of the probability of a verdict for the plaintiff, again represented by  $p$ .

As in the previous scenario, the first case considered is where the defendant has just one insurance policy and  $D + k_D \leq L$ . In negotiations between the insurer and plaintiff, the settlement amount is as follows:

$$(15) \quad \text{If } (1 - ep)k_D + k_p - epD < 0, \text{ then } S_I = \emptyset$$

$$(16) \quad \text{If } (1 - ep)k_D + k_p - epD \geq 0, \\ \text{then } pD - k_p \leq S_I \leq (1 - e)pD + (1 - ep)k_D$$

As is intuitive, the risk of a failed negotiation, given by equation (15), rises with  $e$ , the probability of a coverage exclusion.

As in the last scenario, the alternative case occurs when the defendant has acquired both a primary policy with limit  $L_I$  and an excess policy with an attachment point of  $L_I$  and a limit of  $L_{II}$ . Once again the assumptions are that  $k_D < L_I$  and  $D + k_D \leq L_{II}$ . The duty to contribute is implicated if the plaintiff makes a settlement offer equaling at least the expected damages and  $L_I < pD$ . Assuming again that a court would consider reasonable any settlement reached by the parties, the range of possible settlements between the plaintiff and the excess insurer, expressed again as  $S_{II}$ , is as follows:

(17) If  $(1 - p)L_i - ep(D - L_i) + (1 - e)pk_D + k_p < 0$ , then  $S_{ii} = \emptyset$

(18) If  $(1 - p)L_i - ep(D - L_i) + (1 - e)pk_D + k_p \geq 0$ ,  
then  $pD - k_p \leq S_{ii} \leq L_i + (1 - e)p(D - L_i) + (1 - e)pk_D$

Comparing the condition on inequality (18) to that on inequality (16) gives the change in the range of potential values for which a settlement can be reached. That comparison shows that the range has widened by  $(1 - p)L_i + epL_i - (1 - p)k_D$ . This is the wealth transfer from the primary insurer produced by the duty to contribute in this case. The transfer is larger than that calculated in equation (10) by  $epL_i$ , reflecting the capture by the cramdown settlement of the reduction in the primary insurer's expected trial liability caused by the possibility of a coverage exclusion. Thus, the duty to contribute has increased the range of settlement demands that will produce an insurance-covered settlement by the amount of the wealth transfer that the duty captures.