CHOOSING GATEKEEPERS: THE FINANCIAL STATEMENT INSURANCE ALTERNATIVE TO AUDITOR LIABILITY

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Contributing to a lively debate concerning how to design auditor incentives to optimize financial statement auditing, this Article presents the more ambitious financial statement insurance alternative. This approach breaks from the existing securities regulation framework to draw directly on insurance markets and insurance law. The author prescribes a framework to permit companies, on an experimental basis and with investor approval, to use financial statement insurance as an alternative to financial statement auditing backed by auditor liability.

A chief challenge for the efficacy of such an alternative is the relation of state insurance law to federal securities regulation. One solution is to develop for financial statement insurance the functional equivalent of the U.S. Trust Indenture Act of 1939, which is applicable to contracts governing public debt securities. This would allow substantial freedom of contract in policy terms, governed by state law, while mandating certain specific terms and establishing minimum federal parameters for others. Most other hurdles arising from the interplay between state insurance law and federal securities regulation can be overcome using disclosure. A broader challenge is preserving insurer solvency if financial statement insurance is placed at the center of the public-company financial reporting system.

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INTRODUCTION

A partial solution to corporate structure's separation of ownership from control requires managers to report the corporation's condition and performance to investors, using a generally recognized accounting system and a third-party auditor vouching for the report's veracity.[1] Auditors face inherent

1. The central challenge of corporate governance is the agency problem, the separation of ownership from control that dates back to the chartering of the Dutch and British East India companies four centuries ago. No ultimately satisfactory solution to the problem has been found. Various partial solutions provide rickety bridges across the chasm. Aside from this Article's subject of audited financial reporting, a related partial solution provides that directors owe the corporation and its owners common law fiduciary obligations to act selflessly. The traditional strength of this sealant decayed during the twentieth century. *See* Harold Marsh, Jr., *Are Directors Trustees?: Conflicts of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966). Modern efforts to seal cracks left by this erosion included requiring some or all directors to be otherwise independent of the corporation. These rules originated in stock exchange listing standards, and were fortified by federal law in the Sarbanes-Oxley Act. *See In re* N.Y. Stock Exch., Inc., Exchange Act Release No. 13,346, 11 SEC Docket 1945 (Mar. 9, 1977), *available at* 1977 SEC LEXIS 2252; *see also* Sarbanes-Oxley Act of 2002 § 206, 15 U.S.C.A. § 78j-1 (West Supp. 2004); Noyes E. Leech & Robert H. Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799 (1976). Contemporary efforts sought to bridge the separation by making owners out of managers, a theoretically coherent proposition twisted into irrationality by making managers into option-holders, not owners. *See* LUCIAN ARYE BEBCHUK & JESSE M. FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004). Even so, directors and officers are subject to liability for various breaches, and this exposure is routinely backstopped by insurance (and is also

conflicts and capture risks that impair this mechanism's efficacy. The resulting limits of this model were evident in the wave of audit failures of the late 1990s and early 2000s, which spawned numerous suggested prescriptions to strengthen this monitoring mechanism.

Repairs adopted in the wake of these audit failures include new auditor independence and oversight rules, as well as a new audit of internal control over financial reporting.[2] Other pending proposals contemplate imposing various forms of modified strict liability on auditors, and using debated mechanisms for establishing an ex ante damages formula intended to raise the stakes auditors face for audit failure.[3] These repairs and proposals mitigate conflict and capture risks, but only indirectly, stiffening structural and monetary incentives. To nip these problems closer to the bud, this Article considers financial statement insurance (FSI) as an alternative to traditional financial statement auditing (FSA) and auditor liability.

FSI removes auditors from capture and conflict risks inherent in their relationship with management by putting them in the employ of independent insurers with vested interests in quality financial reporting more closely aligned with investor interests. FSI would be an alternative to the traditional FSA model; it would be recommended by management and subject to investor approval. Companies would thus choose either to use traditional FSA or instead opt for FSI.

FSI policies would cover damages arising from audit failure—that is, damages due to financial misstatements auditors did not discover—and replace both auditor and issuer liability; they would not replace liability exposure of any other parties, such as directors and officers, attorneys, or underwriters. Existing federal securities laws governing FSA would remain in place and would be amended to permit FSI using federal minimum standards; relevant state insurance laws would be molded using these minimum standards to assure that FSI facilitates achievement of the same ultimate objectives as FSA.

Evaluating FSI requires a comparison to FSA as traditionally practiced, as recently modified, and as it would exist if modified according to pending reform proposals. Traditional FSA is appealing because of its general historical reliability, its familiarity, and its political acceptability; with strengthened auditor independence and oversight, FSA's traditional appeal is enhanced.

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limited by exculpatory devices and covered by indemnification mechanisms). *See* BERNARD BLACK ET AL., OUTSIDE DIRECTOR LIABILITY (Stanford Law & Econ., Olin Working Paper No. 250, 2003), *available at* http://papers.ssrn.com/abstract=382422. Part II discusses such insurance, and its relation to the insurance concept developed in this Article.

2. *See infra* Part I.A.
3. *See infra* Part I.B.

Supplemented by new control audits, it is now also designed to provide signals to investors concerning the reliability of a company's financial statements. Pending proposals prescribe modifying liability standards and damages in order to induce auditors to act more like insurers.

FSI compares favorably with FSA on each of these points: (1) it is insurance, making auditors agents of insurers; (2) it transcends the auditor-independence challenges recent reforms struggle with; (3) it sets damage payouts based upon capital market and insurance market information; and (4) it provides a financial statement reliability index through the resulting premium-coverage mix that companies are offered for FSI policies. On the other hand, problems of novelty, administrative details, and complexities associated with state insurance law integration with federal securities regulation objectives pose significant challenges to FSI's efficacy. On balance, this Article concludes that FSI, although it is not perfect, provides promise of superiority to FSA. Moreover, this Article suggests that one way to exploit FSI's potential is to offer it on an experimental basis to investors as an alternative to FSA, with FSA as the default model, and to establish minimum federal requirements for FSI policies to qualify as a lawful alternative to FSA.

Part I presents the basics of traditional FSA and the main features of FSI.[4] It identifies the core challenges of the traditional auditing model, shows how recent reforms and pending proposals mitigate these, and points out how the proposals impliedly suggest a formal insurance-auditing model as an attractive public policy option. It introduces the following key features of an FSI model: (1) it serves as an alternative to FSA that management proposes, subject to an approving investor vote based upon full disclosure of proposed policy terms, including premium and coverage; (2) auditors engaged by insurers perform a full financial statement audit, and only those companies earning unqualified opinions receive policies (for others, no changes from existing FSA practice occur); and (3) FSI would not alter the exposure to liability of any parties other than auditors and companies themselves, such that the liability of directors, officers, attorneys, underwriters and others would be unaffected.

4. The Financial Statement Insurance (FSI) model developed and evaluated here is a substantially modified, reinterpreted, and extended version of that sketched in Joshua Ronen, *Post-Enron Reform: Financial-Statement Insurance and GAAP Revisited*, 8 STAN. J.L. BUS. & FIN. 39, 48–60 (2002) [hereinafter Ronen, *Post-Enron Reform*]. *See also* Alex Dontoh et al., Financial Statements Insurance (Feb. 2003) (unpublished manuscript) (providing a formal economic model of certain aspects of FSI), *available at* http://www.stern.nyu.edu/ciio/ronenpaper.pdf; Joshua Ronen & Julius Cherny, *Is Insurance a Solution to the Auditing Dilemma?*, NAT'L UNDERWRITER, LIFE & HEALTH/FINANCIAL SERVICES EDITION, Aug. 12, 2002, at 26; Joshua Ronen, *A Market Solution to the Accounting Crisis*, N.Y. TIMES, Mar. 8, 2002, at A21 (short opinion piece for popular audience).

This discussion includes an assessment of the comparative incentive effects and the tradeoffs between FSA and FSI.

Part II undertakes a more elaborate examination of FSI, chiefly from the perspectives of insurance law and practice, which bear significantly on FSI's efficacy and appeal. FSI would be governed by state insurance law, yet obliged to serve goals of federal securities regulation. This part shows how aspects of insurance law and practice would need to be approached to achieve this marriage. Despite significant challenges, this part indicates that achievement is facilitated by FSI's sui generis character: While it bears superficial resemblance to other insurance such as directors' and officers' (D & O) insurance, FSI can and must be fundamentally different. Differences can be maintained using existing insurance law concepts and market practices, to be codified in federal securities law as minimum standards analogous to the federal securities law approach to public debt instruments under the Trust Indenture Act of 1939.[5]

Part III broadens this examination of insurance intricacies by generalizing discussion of the coordination between federal securities regulation and state insurance law that is necessary to make FSI workable. Essential to FSI's efficacy is the comfort that state insurance law provides a basis for promoting federal securities regulation's policy objectives, at least as well as the existing FSA approach. A key issue is preserving insurer solvency for the sake of systemic stability. In short, this Article concludes that recent reforms and various pending proposals seek to improve auditor effectiveness through independence enhancement, liability exposure, or damages specification. FSI, in contrast, would enable companies and their investors to choose a potentially more effective auditing function structure.[6]

5. Such matters can be handled using an approach equivalent to that taken in the Trust Indenture Act of 1939 relating to contracts governing public debt securities. In particular, FSI insurers would be required to be independent of issuers whose financial statements they insure, and meet other regulatory supervision and financial (claims-paying) capacity requirements. The SEC would be empowered to review applications for FSI policies appearing in proxy statements to determine FSI insurer qualifications. *See* Lawrence A. Cunningham, *A Model Financial Statement Insurance Act*, 11 CONN. INS. L.J. (forthcoming 2004) (draft statute including these and other relevant provisions to enable adoption of FSI).

6. This Article's title uses the word "gatekeepers" metaphorically, and the Article never uses the word again because it has no analytical utility or legal significance. The label originated to designate investment banking firms as among professionals participating in capital formation and securities pricing processes. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 613–21 (1984). The label has been applied to include auditors, lawyers, and even boards of directors, *see* John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1210–13, 1232–33 (1997) [hereinafter Coffee, *Brave New World*], as well as rating agencies and securities analysts, *see* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 354 (2004) [hereinafter Coffee, *Gatekeeper Failure and Reform*]. In text directing the SEC to undertake a study,

I. CHALLENGES

Since the 1930s, federal securities laws have required public companies to provide independently audited financial statements to the public.[7] This traditional financial statement auditing is an assurance mechanism. It relies on a tripartite principal-agent-beneficiary model. The process involves a company engaging and paying an auditor. The auditor provides assurance for third parties. The third-party assurance takes the form of the auditor's written

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the Sarbanes-Oxley Act implies the concept designates "securities professionals," defined illustratively, then tautologically, as "accountants, public accounting firms, investment bankers, investment advisors, brokers, dealers, attorneys, and other securities professionals." Sarbanes-Oxley Act of 2002 § 703(a)(i), 15 U.S.C.A. § 7201 (West Supp. 2004).

Scholars provide alternative definitions. One defines "gatekeepers" as "private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers." Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53 (1986). Another dubs them "parties who sell a product or provide a service that is necessary for clients wishing to enter a particular market or engage in certain activities." Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53, 58 (2003). Others narrow these capacious definitions, limiting it to those positioned to monitor effectively to prevent misuse of a product or service they contribute. *See* Coffee, *Gatekeeper Failure and Reform*, *supra*, at 308 n.14. Pursuing this definition, gatekeepers possess "significant reputational capital," and in any transaction enjoy a benefit that is small relative to the benefit to the company for which they work. *Id.* at 308. Under these approaches, it becomes contestable whether certain professionals, such as lawyers, can be "gatekeepers." *See id.* at 361. The label has even been used both to denominate outsiders who serve a board of directors and alternatively the board of directors itself. *Compare id.* at 308 (term "widely used to refer to the outside professionals who serve the board or investors"), *with id.* at 302 n.1 (discussing "the role of . . . directors as 'gatekeepers'" (citing Coffee, *Brave New World*, *supra*, at 1195)).

Despite futile efforts at creating a meaningful general category, it is obvious that professionals within any such category differ significantly. *See id.* at 306 & 346–64 (stating that "all gatekeepers are not alike," and developing proposals with entirely different content for auditors and for securities lawyers). Roles vary with product or service type and the information its buyers and users receive. Also varying are what professionals attest to or certify, such as fairness of financial statement assertions, legality of a securities issuance, quality of a debt instrument, and so on. Differing professional contributions pose differing results for overall wealth and welfare. Accordingly, also varying are all other public policy aspects of their respective performance, including requirements, expectations, capacities, incentives and legal liability for failure. The implicit scholarly stalemate in developing a useful definition of the term shows that, as with other metaphors, promiscuous use of the term is likely to become more misleading than useful. *See* Berkey v. Third Ave. Ry., 155 N.E. 58, 61 (N.Y. 1926) (Cardozo, J.) ("Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it.").

7. *See* Securities Act of 1933 § 26, 15 U.S.C. § 77aa (2000); Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78m(a)(2). Before these statutes imposed mandatory independent financial statement audits, the practice had been optional and generally used by select companies. *See* GARY JOHN PREVITS & BARBARA DUBIS MERINO, A HISTORY OF ACCOUNTANCY IN THE UNITED STATES: THE CULTURAL SIGNIFICANCE OF ACCOUNTING 457 n.98 (1998); JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 48 (rev. ed. 1995) ("[B]y 1933 at least 85 percent of the firms listed on the New York Stock Exchange were periodically audited by independent certified public accountants."); Sean M. O'Connor, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*, 45 B.C. L. REV. (forthcoming 2004).

opinion concerning managerial assertions. When third parties incur damages caused by the assured information, they have legal recourse to the auditor, among other parties, under various theories of common law and federal securities law. In turn, auditors buy general malpractice liability insurance covering claims made for losses arising from their various engagements. This insurance is aggregate, not tailored to the risks of particular engagements.

Auditor assurance is limited. Apart from the considerable epistemological challenges auditors face in vouching for managerial assertions,[8] structural limits exist. These include: (1) conflicting incentives because the auditor reviews the assertions of those responsible for hiring, firing and paying it; (2) capture, due to the protracted relationship that arises between those parties and the auditor; and (3) independence, necessary to provide objective assurance but subject to compromise from the effects of conflicts and capture. Limitations also arise from legal aspects of the relationship, including the absence of auditor liability for aiding and abetting those making fraudulent financial statement assertions[9] and the use of proportional rather than joint and several liability regimes.[10]

These limitations, alone and in combination, were identified as systemic contributors to the numerous and sizable audit failures of the late 1990s and early 2000s. Reform proposals proliferated. Those adopted centered on structural aspects, including: (1) replacing managerial auditor supervision with independent audit committee supervision;[11] (2) establishing as federal law mandatory audit-partner rotation on particular audit engagements;[12] (3) restricting the scope of the nonaudit services that auditors may perform for audit clients;[13] and (4) creating a quasi-governmental body to set auditing standards and review and discipline performance of auditing firms.[14] In addition, a new audit exercise concerning internal control over financial reporting was mandated to deepen transparency in the financial reporting process.[15]

8. Challenges emanate from the limitations of testing managerial assertions as well as the qualitative character of certain accounting principles. *See* MICHAEL POWER, THE AUDIT SOCIETY: RITUALS OF VERIFICATION 133 (1997).

9. *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

10. Private Securities Litigation Reform Act of 1995 § 201(a), 15 U.S.C. § 78u-4(f) (2000).

11. Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C.A. § 78j-1(m) (West Supp. 2004).

12. *Id.* § 203, 15 U.S.C.A. § 78j-1(j).

13. *Id.* § 301, 15 U.S.C.A. § 78j-1(g).

14. *Id.* § 101, 15 U.S.C.A. § 7211; *see* Donna M. Nagy, *Playing Peekaboo With Constitutional Law: PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. (forthcoming 2004) (on file with author) (the second word of the article's title expresses one commonly uttered acronym for the Public Company Oversight Accounting Board (PCAOB); the more formal pronunciation is *pea-cob*).

15. Sarbanes-Oxley Act of 2002 §§ 102, 404, 15 U.S.C.A. §§ 7212, 7262.

Despite these reform innovations, commentators identify continuing limitations in the structure of auditing. Commentators focus on legal liability aspects that could be adjusted to address remaining limitations on the traditional auditing arrangement. The concerns and reforms of these commentators, while generally addressing only the financial statement aspects of auditing, could also apply generally to the new audit of internal control, though this new exercise diminishes some of the concerns raised. Even so, these alternative reform models provide a variety of potential benefits—as well as costs—that are worth considering as the other reforms take hold and reveal relative effectiveness in achieving their objectives.[16]

A. Recent Reforms

The Sarbanes-Oxley Act (SOX) and its newly created Public Company Accounting Oversight Board (PCAOB) responded to diminished public confidence in the integrity of financial reporting caused by the accounting and auditing debacles of the late 1990s and early 2000s. SOX enhanced auditor independence rules and created and anointed PCAOB, the first conscious attempt to insulate audit standard setting from auditor lobbying.[17]

1. Independence

Auditor independence is essential to the reliability of financial statement audits. During the 1980s, auditors increasingly diversified their service offerings into various professional activities apart from auditing. When rendered for audit clients, these services threatened auditor independence, in fact or in appearance. In response, in the late 1990s, the Securities and Exchange Commission (SEC) restricted auditors from performing certain services for audit clients.[18] SOX elevated these regulatory restrictions to federal law.[19]

16. Prudence may suggest allowing the enacted reforms time to test effectiveness before pursuing alternatives. *Cf.* U.S. GEN. ACCOUNTING OFFICE, REPORT ON MANDATORY ROTATION OF AUDIT FIRMS (2004) (study required by the Sarbanes-Oxley Act concluding that the panoply of reforms need to be given time to determine whether additional federal steps, such as mandatory rotation of audit firms at companies, are indicated). Enacted reforms should not prevent developing alternative proposals, however, for they may yet be needed when weaknesses appear. A swirling range of extant reform concepts, after all, formed the basis for nearly every provision of the Sarbanes-Oxley Act. *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, 35 CONN. L. REV. 915 (2003) (documenting provenance of Sarbanes-Oxley's provisions in existing law, practice, or proposal).

17. Sarbanes-Oxley Act of 2002 § 101, 15 U.S.C.A. § 7211.

18. *See* Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6044–48 (Feb. 5, 2003) (amending 17 C.F.R. § 210.2-01).

Additional efforts to enhance auditor independence include empowering audit committees rather than managers to hire, supervise and terminate auditors,[20] and requiring audit firms to rotate lead audit partners on audit engagements every five years.[21]

2. Oversight

PCAOB is charged with reviewing auditor performance, replacing the previous peer review system in which auditing firms evaluated each others' performance.[22] It is also charged with articulating standards autonomously using a public process, jettisoning the former process of standard generation in which the large auditing firms directly participated with a coterie of standard-setters drawn largely from those firms.[23] The standards that PCAOB has promulgated indicate a level of audit-profession oversight that is unprecedented in modern U.S. financial reporting history. This enhanced oversight is intended to strengthen the quality and reliability of traditional financial statement auditing as a mechanism bridging corporate structure's separation of ownership from control.[24]

3. Control Auditing

The new independence and oversight features of auditing are accompanied by an elaborate new exercise involving audits of internal control over

19. Under SOX, as under the preexisting SEC rules, auditors in no event may perform any of the following services for audit clients: (1) bookkeeping; (2) financial information systems; (3) appraisal, valuation or fairness opinions; (4) actuarial; (5) internal audit; (6) human resources; (7) broker/dealer, investment adviser, or investment banking services; or (8) legal and expert services. Sarbanes-Oxley Act of 2002 § 201(a), 15 U.S.C.A. § 78j-1(g); *see also* SEC Reg. S-X, 17 C.F.R. § 210.2-01(c)(4)(i)–(ix) (2004).

20. Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C.A. § 78j-1(m).

21. *Id.* § 203, 15 U.S.C.A. § 78j-1(j). Previous auditing standards set this term limit at seven years.

22. PUB. CO. ACCOUNTING OVERSIGHT BD., INSPECTION OF PUBLIC ACCOUNTING FIRMS, PCAOB RELEASE NO. 2003-019, PCAOB RULEMAKING DOCKET MATTER NO. 006 (2003) (adopted pursuant to SOX section 104(a) to provide a continuing program of registered audit firm inspections by PCAOB), *available at* http://www.pcaobus.org/Rules_of_the_Board/Documents/Release2003-019.pdf.

23. PUB. CO. ACCOUNTING OVERSIGHT BD., STATEMENT REGARDING THE ESTABLISHMENT OF AUDITING AND OTHER PROFESSIONAL STANDARDS, PCAOB RELEASE NO. 2003-005, PCAOB RULEMAKING DOCKET MATTER NO. 004 (2003), *available at* http://www.pcaobus.org/rules/Release2003-005.pdf.

24. *See* Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167 (2003) (identifying fatal flaws in existing audit firm structures, noting partial solutions provided in SOX and prescribing steps PCAOB must take to alter these structures in order to achieve quality independent financial statement audits).

financial reporting—the processes a company uses to promote reliability of its financial reporting. Traditionally, auditors provided opinions on financial statements, though they could also cover other agreed-upon procedures. The new system expands both the scope and quality of traditional assurance to cover a company's internal control over financial reporting. This approach employs narrative auditor disclosure of the results of the control audit as a way of providing more complete information to investors about the reliability of a company's financial statements.[25]

A key attraction of this new exercise is to deepen transparency in the financial reporting process by explaining a company's likely ability to generate reliable financial statements in future accounting periods.[26] Weaknesses in internal control require auditors to provide early warnings of impaired financial statement reliability to investors. Associated public rebuke is, in turn, intended to promote managerial diligence to strengthen financial statement reporting quality and thus to bolster investor protection.

4. Auditor Liability

Auditors are subject to civil and criminal liability when their work fails to satisfy applicable legal requirements. Applicable legal requirements generally derive from relevant auditing standards, established as legal requirements in numerous state professional obligation laws and federal securities law sections. Principal federal laws are Section 11 under the Securities Act of 1933[27] and Section 10(b) under the Securities Exchange Act of 1934.[28] The former applies to registered public offerings of securities and exposes auditors to liability under negligence theories, subject to an affirmative defense of reasonable investigation and belief; the latter applies to secondary trading in securities and exposes auditors to liability under fraud theories. Both standards have been

25. For a comprehensive analysis, see Lawrence A. Cunningham, *Facilitating Auditing's New Early Warning System: Control Disclosure, Auditor Liability and Safe Harbors*, 55 HASTINGS L.J. 1451 (2004).

26. PUB. CO. ACCOUNTING OVERSIGHT BD., AUDITING STANDARD NO. 2: AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS, PCAOB RELEASE NO. 2004-001, PCAOB RULEMAKING DOCKET MATTER NO. 008, at 3 (2004) [hereinafter AUDITING STANDARD NO. 2] (noting that exercise is intended to provide investors and the public "an independent reason to rely on management's description of the company's internal control over financial reporting").

27. 15 U.S.C. § 77k (2000).

28. *Id.* § 78j. Others include (1) Section 18(a) of the Securities Exchange Act of 1934, which creates private rights of action against persons, including accountants, who "make or cause to be made" materially misleading statements in reports or other documents filed with the SEC, *id.* § 78r, and (2) Section 17(a) of the Securities Act of 1933, which imposes on auditors the duties of inquiry and disclosure, *id.* § 77(q)(a).

the object of substantial modulation in recent years, the former through the control-auditing innovation just mentioned,[29] the latter through the Private Securities Litigation Reform Act of 1995,[30] and both, to some extent, under SOX.[31]

Auditors buy malpractice liability insurance (called errors and omissions, or E & O, policies) to backstop their exposure to such legal claims, using general policies for specific time periods that are not tailored to particular engagements and associated risks of audit failure. Such coverage generality may pose adverse incentive effects to calibrate auditing tasks to risks of particular engagements. Some pending reform proposals recognize this, along with various other limitations of the existing approach to FSA and related auditor liability.

B. Pending Proposals

Despite recent reforms, proposals proliferate that are designed either to address underlying issues better than these reforms or to resolve issues these reforms do not address.[32] These issues relate to agency problems associated with management-auditor relations and to auditor liability. Circulating proposals include concepts of self auditing, warranty auditing, and insurance auditing. The last of these is the focus of this Article, but to provide context, consideration of certain facets of the other proposals is useful.

1. Self-Auditing

One proposal calls for changing the existing financial reporting environment using two devices:[33] (1) requiring companies to report real-time bookkeeping information on publicly accessible web sites (including real-time journal entries, ledger summaries, monthly aggregations and so on), and (2)

29. *See* Cunningham, *supra* note 25, Part II.A (explaining the effect of control audits on Section 11 duties and liabilities of auditors).

30. Private Securities Litigation Reform Act of 1995 § 201, 15 U.S.C. § 78u-4 (adopting heightened pleading standards, staying discovery pending motions to dismiss and shifting to proportional from joint and several liability); *see also* Securities Litigation Uniform Standards Act of 1998 § 16, 15 U.S.C. §§ 77p, 78bb(f) (2000) (effectively banning related legal actions from state court adjudication).

31. *E.g.*, Sarbanes-Oxley Act of 2002 § 804, 28 U.S.C.A. § 1658 (West Supp. 2004) (extending the period of limitations on actions for private fraud claims under Section 10(b)).

32. For example, not all nonaudit services are restricted, and may be performed with audit committee preapproval, *id.* § 201(a), 15 U.S.C.A. § 78j-1, and a proposal to mandate audit firm rotation was deferred, *see supra* note 16.

33. Peter K.M. Chan, *Breaking the Market's Dependence on Independence: An Alternative to the 'Independent' Outside Auditor*, 9 FORDHAM J. CORP. & FIN. L. 347 (2004).

requiring management to respond publicly to questions concerning this information.[34] The theory of this substantive transparency (not mere disclosure) is to equip those investors with requisite interest and resources to perform their own financial statement audits of companies, or engage their own auditor to do so.[35]

The self-insurance component of this concept is appealing. But numerous practical problems appear. First, supplied information is raw bookkeeping data and limited questionnaire access to management; neither investors nor their auditors have access to a company's system of internal control, audit committees, walk-through exercises, or other essential resources used in traditional auditing. Second, it is doubtful that such deep transparency is in the best interests of corporations or investors.[36] Third, the result would require enormous investor coordination and/or result in numerous separate investor audits, generating wasteful duplicative costs.

Accordingly, while self-insurance through self-auditing can mitigate risks of financial misstatements, it can minimize neither costs nor risk, something achievable by other means, old and new.[37] The proposal's key value is its core insight that the challenge of auditing, however designed, is to address unavoidable but manageable risks, which has been the quintessential mission of insurance markets over thousands of years.[38]

2. Warranty Auditing

Pending reform proposals also appreciate that the core of auditing is an insurance concept, looking to liability aspects of auditing to refashion FSA

34. *Id.* at 349.
35. *Id.* at 348.
36. *See* UDO C. BRAENDLE & JUERGEN NOLL, A FIG LEAF FOR THE NAKED CORPORATION? (2004) (making the specific case against utter transparency in corporate financial reporting), *available at* http://papers.ssrn.com/paper.taf?abstract_id=523102. *See generally* Troy A. Paredes, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417 (2003) (elaborating a basis for more general reservations). This concern is wholly apart from protecting proprietary information that would necessarily be covered by such a proposal. *See* Chan, *supra* note 33, at 391–92; *see also* Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 847–61 (1995).
37. Somewhat related to the concept of self-auditing is a concept of statutory auditing appearing in certain Asian and European financial reporting systems. Statutory auditors are appointed from within the corporation, are monitored by shareholders, enjoy statutory protections, and face statutory liabilities. *See* Patricia A. McCoy, *Realigning Auditors' Incentives*, 35 CONN. L. REV. 989, 1009–10 (2003) (evaluating this concept and its inherent limitations as best suited for companies with concentrated shareholders, unlike typical U.S. companies).
38. *See* ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW 20–24 (3d ed. 2002) (noting crude forms of insurance dating to the Code of Hammurabi around 2250 B.C., spreading across civilizations among Egyptians, Chinese and Greeks, and flourishing beginning in seventeenth-century England).

to resemble an insurance model. Subject to adjustment in these proposals are the standard of auditor performance and the measure of auditor damages for audit failure. While hinting at the insurance element in auditing, these proposals are better described as warranty auditing, because they use a level of auditor promise matched by designated reimbursement levels for breach.

As to the standard of performance, one approach would move towards a strict or stricter auditor liability regime to replace the more modulated current system containing a mix of negligence-based and fraud-based liability theories.[39] A stricter liability regime, for example, would expose auditors to liability in all audit failure cases except when they can show a reasonable basis, after investigation, for believing their opinions about managerial assertions were true.[40] A strict liability regime would impose absolute auditor liability for audit failure, eliminating this due diligence defense entirely.[41]

As for the measure of damages, proposals range from an ex ante agreement between issuers and auditors for auditors to share a statutorily specified minimum percentage of total losses from audit failure[42] to a regulatory mandate that auditor liability be determined as a specified multiple of the auditor's average annual revenue from the engagement.[43]

These proposals follow a long scholarly and policy tradition of attempting to calibrate liability to optimal performance, avoiding excessive liability while also deterring inadequate investigation.[44] Two broad issues show modest likelihood of achieving this optimal balance.[45]

39. *See supra* Part I.A.4, text accompanying notes 27–31.

40. *See* Coffee, *Gatekeeper Failure and Reform*, *supra* note 6, at 353 (contemplating that the auditor must "prove as an affirmative defense that the auditor 'had, after reasonable investigation, reasonable grounds to believe and did believe'" its audit opinion was true, effectively shifting the burden in all Section 10(b) actions to prove nonnegligence and good faith (citing 15 U.S.C. 77k(b)(3)(B) (2000))).

41. *See* Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 540–46 (2001).

42. *See id.* at 540 ("Congress should [amend the securities laws] to enable experts [including auditors] to specify the range of liability as a percentage of the issuer's liability, subject to a specified minimum percentage.").

43. *See* Coffee, *Gatekeeper Failure and Reform*, *supra* note 6, at 349–53.

44. Debate has evolved from director and officer liability to "gatekeeper" liability. On the former, see Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1091–94 (1968) (banning coverage for conduct worse than negligence); Alfred F. Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L.J. 895 (capping negligence-based director liability at one-year's salary and outlawing indemnification and insurance). As for the label "gatekeeper," though widely used in recent years, it has neither analytical utility nor legal significance. *See supra* note 6.

45. A more narrow point concerns whether contractual or regulatory mechanisms are superior. To the extent issuers and auditors contract for auditors to indemnify issuers, no peculiar contract law issues arise. However, to the extent these contracts may be seen as stipulating damages auditors owe upon breach of an audit-engagement agreement, they may be evaluated as unenforceable penalties

The first issue concerns performance standards. Devotees of strict liability cite ease of adjudication as an advantage.[46] Attractive as this may be, real-world professional assignments in varying contexts justify tailored liability standards.[47] This is particularly true for auditing, which involves complex tasks and difficult judgments, and in which audit failure may be due to a range of circumstances from deft managerial concealment to outright auditor complicity. The complex system of liability standards appearing in the federal securities laws may better calibrate particularized contexts to requisite standards of obligation than any singular standard of obligation, strict liability included.

The second issue concerns measuring damages. One alternative is anchored in traditional tort concepts designed to deter volitional audit failure by internalizing externalities. Under this approach, liability is a portion of total damages. This captures private costs as well as social costs. The other alternative is rooted in concepts of prevention and sets liability according to expected private gain. Auditor liability is a multiple of related audit revenues. The alternatives show difficult tradeoffs. The ideal is further constrained by risks of bankrupting liable auditors, the threat of which may drive firms to exit the audit-services market.[48] The alternatives also must recognize risks of excessive compensation balanced against the need to deter and prevent—a notoriously difficult balancing challenge.[49]

Such proposals are appealing in their attempt to tailor liability risks to particular audit engagements. This is a marked improvement over a system in which auditors use general malpractice (E & O) liability insurance to cover all engagements, in which policies are not tailored to particular audit engagement risk. To this extent, the proposals enhance the probable effectiveness of auditor-liability risk in promoting optimal auditing practice.

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rather than as enforceable liquidated damages. Specifying the difference would be essential to optimizing the model, rather than rely on existing judicial mechanisms to draw the distinction. *See* Aaron S. Edlin & Alan Schwartz, *Optimal Penalties in Contracts*, 78 CHI.-KENT L. REV. 33 (2003). Related enabling legislation may be prudent to clarify this. This point reflects the frequent, but often overlooked, blurriness of distinctions between contractual or regulatory reform proposals.

46. *E.g.*, Coffee, *Gatekeeper Failure and Reform*, *supra* note 6, at 347 n.144 (citing STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 5–18 (1987)); Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365, 367 n.13 (2004) (citing SHAVELL, *supra*, at 8–9).

47. *See* Hamdani, *supra* note 6, at 103; Kraakman, *supra* note 6, at 101.

48. *Compare* Coffee, *Gatekeeper Failure and Reform*, *supra* note 6, at 346–54 (prescribing damages measured as a multiple of audit-engagement revenues to reduce risk of excessive liability threatening auditor bankruptcy and market unraveling), *with* Partnoy, *supra* note 46, at 373–74 (contending that damages measured as percentage of total losses would not pose meaningful bankruptcy risks).

49. *See* Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639 (1996) (reviewing existing literature and law to evaluate, for non-privity federal securities fraud cases, potentially appropriate types of liability caps and damages formulae).

Left unaddressed, however, are the more fundamental tensions associated with the traditional FSA tripartite arrangement. The proposals do not confront conflict or capture risks. They likely represent improvements over traditional financial statement auditing and associated liability and remedy standards, but they assuage symptoms without curing the disease. Conquering the underlying problems of conflicts and capture is a key design feature of insurance auditing.[50]

C. Insurance Auditing

Financial statement insurance can be created as an optional alternative to traditional financial statement auditing, as it now exists or with performance and damages standards adjusted as just discussed. Public companies would be required to use either FSA or FSI, though not both.[51] Providing registrants this option enables more effective self-tailoring of the financial reporting and assurance process.[52] It offers an alternative that holds greater promise of relieving the underlying conflict and capture risks that limit the efficacy of third-party financial statement attestations.

FSI would alter the existing principal-agent relationship in FSA's traditional principal-agent-beneficiary triangle.[53] Under FSI, a company buys

50. Proponents note how their proposed concepts move the traditional auditing framework towards an insurance model. *E.g.*, Coffee, *Gatekeeper Failure and Reform*, *supra* note 6, at 349 (stating that an auditor becomes the "functional equivalent of an insurer"); Partnoy, *supra* note 46, at 365 (stating that auditors "would behave more like insurers"). FSI makes the move complete.

51. Several commentators interpreted the original FSI proposal sketched in Ronen, *Post-Enron Reform*, *supra* note 4, to *require* public companies to adopt FSI. *E.g.*, Coffee, *Gatekeeper Failure and Reform*, *supra* note 6, at 364 n.101; Joseph A. Grundfest, *Punctuated Equilibria in the Evolution of United States Securities Regulation*, 8 STAN. J.L. BUS. & FIN. 1, 7 (2002); McCoy, *supra* note 37, at 1010. The proposal developed here treats FSI as an alternative option to FSA. Although Dr. Ronen does not specifically address this question, it is possible to read his original proposal as making FSI optional as well. *See* Ronen, *Post-Enron Reform*, *supra* note 4, at 50; *see also* David B. Kahn & Gary S. Lawson, *Who's the Boss? Controlling Auditor Incentives Through Random Selection*, 53 EMORY L.J. 391 (2004); *infra* Part I.C.1 (discussing shareholder approval mechanism and effects as part of FSI origination process). Some scholars advocate mandatory FSI. *See* Amy Shapiro, *Who Pays the Auditor Calls the Tune? Auditing Regulation and Clients' Incentives*, 30 SETON HALL L. REV. (forthcoming June 2005).

52. *See* Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916 (1998) (providing comprehensive economic analysis of the role of intermediaries in markets to show conditions under which self-tailored private contracting for performance levels and associated liability for failure can be superior to traditional law-supplied default provisions, with a short particular example for underwriters of public securities).

53. *See* Ronen, *Post-Enron Reform*, *supra* note 4, at 52. Yet another novel proposal would also reconstitute the agency relationship by assigning auditors to companies using random-selection from a qualified pool, coupled with limitations on company power to discharge them. Kahn & Lawson, *supra* note 51, at 393–94. One variation calls for the auditor pool to be designated by the company with a regulatory authority drawing the designated auditor; another calls for companies to invite public offers for their audit function on proposed terms, with auditors selected by lot from the bidding pool under stock exchange supervision. *Id.* at 414, 417. In both variations, auditor removal is limited

insurance covering a given set of financial statements[54] and pays a premium, and an insurer engages an auditor to assess risk and establish coverage. When losses occur, the insurer pays the covered third parties, up to the amount of policy coverage.[55] The FSI model would include disclosure of the premium and coverage, which is intended to provide information concerning financial statement reliability.

FSI moves auditors into the liability background. Auditors become insurer employees, subject to termination, as well as to legal claims by insurers for breach of contract, negligence, fraud, and other cognizable transgressions. FSI differs from the warranty-auditing proposals by setting auditor public liability at zero and establishing insurance coverage in its place. FSI would also cover damages assessed against the issuer itself. However, FSI would not alter the liability position of any other existing actors in the financial reporting process, including officers, directors, underwriters, and attorneys.[56] Thus, for example, officers and directors falsely certifying financial statements would remain exposed to direct liability and would forfeit bonuses and salaries received during periods covered by materially misstated financials.[57]

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and performed by a regulatory authority such as the SEC, PCAOB or stock exchanges. *Id.* The theory, and the appeal, of lottery-selection is to eliminate conflict in the audit function arising when companies select auditors (whether through managers or audit committees). *Id.* at 413. Limitations include depriving companies of discretion to choose and reducing auditor incentives toward optimal performance (all may be selected irrespective of excellence driven by competition).

54. The reason this is described as financial statement insurance is that existing insurance is available generally to cover entities and directors and officers for certain securities law violations, though not designed specifically for claims of financial misstatements. *See infra* Part II.A.1–.2.

55. Payment is subject to deductibles and other forms of self-insurance, as well as all other potential limitations of contract and insurance law applicable to a policy, considered in Part II *infra*.

56. *See* McCoy, *supra* note 37, at 1010–11 (noting importance of retaining managerial liability when using FSI). Professor McCoy believes for FSI to work, it would require damages caps at the policy-coverage level or else insurers would be exposed to investor claims like negligent hiring or supervision. This recommendation in effect combines a feature of warranty-auditing proposals discussed above with this embedded feature of FSI. As for attorneys and underwriters, these professionals do not prepare or certify the financial statements that FSI would cover.

57. SOX imposes forfeiture of executive bonuses when a company must restate its financials due to misconduct producing material noncompliance with financial reporting requirements. Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C.A. § 7243 (West Supp. 2004). Executives must repay bonuses and stock options received for the year after the incorrect report was made, along with any profits generated on such awards during that year. *Id.* FSI would not change this. The Act requires CEOs and CFOs to certify periodic SEC reports as fully complying with applicable securities laws and that financial statements fairly present condition and results. *Id.* § 302, 15 U.S.C.A. § 7241; § 906(a), 18 U.S.C.A. § 1350. They must certify that they designed corporate internal controls to promote reliable financial reporting, and that they disclosed discovered control irregularities to outside auditors and board audit committee as well as any fraud involving employees with significant internal control roles. *Id.* § 302; *see also id.* § 401(a), 15 U.S.C.A. § 78m(i)–(j) (concerning auditor attestations of such managerial assertions). FSI would not change the legal consequences of violations of these provisions.

FSI may ease a variety of other public policy challenges besetting effective regulation of the financial reporting process in recent decades. For example, FSI uses devices that could, in theory, eliminate regulatory concern about and needs for auditor independence and oversight that form the basis of recent reforms. FSI could enable insurers to decide questions concerning auditor independence, including other services auditors could provide to insured audit clients, and how frequently firms or lead partners should be rotated through audit cycles to minimize capture risks. On the other hand, some such concerns could reappear under FSI in different form, leading, for example, to the need for companies to rotate FSI carriers and for insurer independence from insureds.

These issues warrant evaluation, for while FSI is not perfect, it has conceptual appeal. Moreover, the FSI concept—first sketched by NYU accounting professor Joshua Ronen in a dozen pages of text at a law school symposium—has not been given a close or comprehensive critique, but deserves one.[58] The following analysis uses Dr. Ronen's innovative sketch as a springboard, both evaluating the initial proposal and interpreting and extending it as necessary to enable reaching an overall preliminary assessment of FSI's efficacy.

1. Security-holder Approval

To illustrate FSI in action, take a hypothetical walk-through of the process. A company wishes to consider buying FSI.[59] It contacts insurance carriers.[60]

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58. Ronen, *Post-Enron Reform*, *supra* note 4, at 48–60. A handful of legal commentators have noted the FSI concept and provided passing remarks, but none has developed a full-scale analysis. *See* sources cited *supra* note 51 (the most substantial of these assessments is Kahn & Lawson, *supra* note 51, at 424–30). While this Article will not be able to conduct an exhaustive definitive analysis, it is intended to present a sufficiently comprehensive analysis to provide preliminary conclusions about FSI's efficacy and prescriptions necessary to facilitate its use.

59. Company desire may originate with management or through shareholder voice exercised using devices such as SEC Rule 14a-8, 17 C.F.R. § 240.14a-8 (2003). For corporations, this would require board of director approval, and provision could be made to require internal company approval from audit committees meeting applicable federal securities law requirements.

60. Companies seeking competitive bids would contact several alternative insurers; for most companies, the insurers would select one of the several large (or handful of medium-sized) auditors. The total costs of the search would rationally be less than gains achieved from resulting premium-coverage mix payoffs. Some risk of an insurer race to the bottom appears. Insurers might be averse to writing policies for high-risk companies, but they also want to generate premium volume. Similar problems to FSA appear: competition driving the industry to use lenient auditors to generate premium volume instead of using optimal auditors whose review may reduce premium volume. *See* Chan, *supra* note 33, at 370 (noting that under FSI, insurers avoid high-risk companies but face incentives to generate premium volume that could provoke a race to the bottom). This risk is real but is likely less severe than among auditors under FSA. Insurers sign on for the express purpose of providing payouts on particular audit engagements and are empowered to retain, supervise, and terminate auditors; auditors primarily engage to render audits and related opinions, and are hired by the company (whether by

The company requests an insurance proposal from carriers, stating the maximum coverage sought and a contemplated premium (as well as lesser coverage amounts and associated premiums). Coverage would bear a relation to the company's average market capitalization, reflecting the risk that public market valuations based on reported financial statements are mistaken due to misstated financials.[61] This proposal is made before a company's annual proxy statement is circulated (so, for a company reporting on a calendar basis, in November or December of the year before coverage will apply; call this Year X-1).[62]

The carrier engages an auditor. The auditor performs a preliminary review of the company and its internal-control and external-competitive environment and other relevant factors.[63] On the basis of this investigation, the carrier furnishes proposals, specifying coverage, premium, and other policy terms. With one or more insurance proposals in hand, management decides whether to select one. If it does, the company discloses related material information in its proxy statement circulated during the year coverage is contemplated (call it Year X). The proxy statement, filed with the SEC, constitutes the issuer's application to the SEC for qualification of its FSI proposal.[64]

Adoption of FSI is put to a shareholder vote.[65] This is designed principally to enable shareholders to determine whether the company should use FSI or adhere to FSA. Those not opting for FSI would effectively opt for FSA; those opting for FSI would be relieved of federal securities law obligations to have

its management or audit committee). Even so, resulting insurer insolvency risk requires attention, given in Part III *infra*.

61. *See infra* Part II.B.1.

62. *See* Ronen, *Post-Enron Reform*, *supra* note 4, at 50.

63. *See id.* at 49 (noting factors to examine, including industry competition and health; company reputation, financial condition, and results; and company operating structure, control environment, and accounting policies).

64. The FSI qualification process follows that used in the Trust Indenture Act: Enabling legislation would specify minimum qualifications for FSI insurers, including ones relating to independence from the issuer, regulatory supervision, and financial capacity. Failure to so qualify would entitle the SEC to issue a stop order declaring the proposed FSI policy unqualified. Other terms federal securities law would require to be included in an FSI policy to meet federal securities law objectives would be deemed included in the FSI policy without regard to whether such terms physically appear in the policy. *Cf.* Trust Indenture Act of 1939 § 318, 15 U.S.C. § 77rrr(c) (2000); *see also* Cunningham, *supra* note 5.

65. *See* Ronen, *Post-Enron Reform*, *supra* note 4, at 50. The carrier's proposal is expressly conditional on both a favorable investor vote and the auditor issuing an unqualified audit opinion as discussed below. Contract formation follows a traditional contracting model, with no precontractual insurer liability except to direct the audit. *Compare* Lucian Arye Bebchuk & Omri Ben-Shahar, *Precontractual Reliance*, 30 J. LEGAL STUD. 423 (2001); *see also* Ronald J. Mann, *Contracts With Consent: A Contextual Critique of the No-Retraction Liability Regime*, 153 U. PA. L. REV. (forthcoming 2004).

financial statements audited under the traditional framework (and federal securities laws would be amended to enable this).[66]

This voting mechanism is desirable as a way to provide shareholder choice. Issues arise for companies with capital structures including more than a single class of common stock (that is, most companies). Who should be entitled to vote? No doubt voting common shareholders should be included. What about other security holders? All security holders have an interest in reliable financial statements, and hence in FSI, including debt holders and shareholders not otherwise eligible to vote on various matters. The best way to address this issue is probably to specify in debt instruments or corporate charters whether particular creditors or other claimants are entitled to vote on such matters.[67]

A related issue concerns the effects of security holder approval. At minimum, approval would relieve the registrant of obligations to provide FSA in the traditional manner (as amended federal securities laws would expressly permit). More difficult is the question as to whether approval should also limit investor recoveries against auditors or issuers for financial misstatements to the amount of coverage stipulated in the FSI policy. In theory, at least, a proxy vote manifests security holder notice and knowledge of approved proposals, and the effects could be designated as binding.[68] This assumes the resolution of rational apathy and collective action problems afflicting all shareholder decisionmaking in corporate governance. State courts, at least, have not treated shareholder approval as guaranteeing any particular result in subsequent litigation.[69]

66. Procuring insurance is within a board's power with or without shareholder approval under state corporation law. *E.g.*, DEL. CODE ANN. tit. 8, §§ 121, 122(13) (1999) (corporation powers); *id.* § 141 (boards manage the business and affairs of the corporation); MODEL BUS. CORP. ACT § 3.02 (1984). Providing for shareholder approval is designed to address federal securities law requirements relating to auditor attestation of financial statements. Federal securities law amendments permitting FSI would include provisions establishing minimum federal standards for the content of FSI policies, as discussed in Part II.

67. FSI would thus not foreclose debates about other constituencies, from creditors to labor. *See, e.g.*, Kent Greenfield, *The Unjustified Absence of Federal Fraud Protection in the Labor Market*, 107 YALE L.J. 715 (1997).

68. *Cf.* Ronen, *Post-Enron Reform*, *supra* note 4, at 58 (treating shareholder approval as an implicit contractual agreement that should have the effect of limiting any recoveries to the FSI policy limits, particularly given that holders were on notice and assuming that related policy coverage would be priced into the security under the semistrong form of the efficient market hypothesis).

69. *See, e.g.*, Lewis v. Vogelstein, 699 A.2d 327, 334 (Del. Ch. 1997) (noting four possible consequences of shareholder ratification of an interested-director transaction under Delaware corporation law: (1) no effect deserving judicial recognition given collective action problems; (2) insulating the transaction from judicial review completely; (3) shifting the judicial test from fairness to waste; or (4) shifting the burden of proof from directors to shareholders).

In this context, however, abundant policy analysis supports the concern that damages awards for many accounting-related claims overcompensate and imperfectly deter.[70] This shows a strong need for seeking a mechanism to improve damage measures imposed on the auditor and issuer, which FSI provides using a market-based and publicly disclosed mechanism, accompanied by minimum federal standards. FSI would not, moreover, preclude recovery from persons other than the auditor, issuer, or FSI carrier, so that directors, officers, attorneys, and underwriters would remain potentially liable.[71]

For the shareholder (or security holder) vote, the proxy statement disclosure and balloting would offer three choices: (1) take the maximum offered coverage, paying the related premium; (2) take lower levels of coverage recommended by management; or (3) take no insurance.[72] For companies opting to take no insurance, traditional FSA procedures and related liability rules would remain in place for that year.[73] For companies opting for one of the insurance alternatives, the next step would be for the insurer to engage an auditor to conduct a full audit of the company's Year X financial statements.

2. The Audit Condition

For companies opting into FSI coverage, the audit plan is developed for the fiscal year in which the related vote is held and for which coverage is contemplated (that is, Year X). The audit plan is designed by the auditor, subject to insurer oversight,[74] and the audit for Year X is conducted and concluded in the early months of the following year (call it Year X+1). The audit plan and execution are governed by generally accepted auditing standards (GAAS) as promulgated from time to time by the PCAOB or other bodies. The FSI policy contains a condition making it effective only if the auditor gives an unqualified financial statement audit opinion. Otherwise, the policy does not become effective, and the company remains subject to the FSA regime and all related liability rules.

A difficulty arises when holders have voted for FSI but the audit condition of an unqualified audit opinion is not met. In Dr. Ronen's initial FSI

70. *See* Langevoort, *supra* note 49; McCoy, *supra* note 37.

71. Part II.B.2 considers the relationship between FSI policies and directors' and officers' insurance policies when both types apply to a single claim.

72. *See* Ronen, *Post-Enron Reform*, *supra* note 4, at 50–51.

73. The warranty-auditing proposals discussed in Part I.B.2 remain potentially attractive for this class of issuers.

74. *See* Ronen, *Post-Enron Reform*, *supra* note 4, at 51, 55 (referring at page 51 to cooperative audit planning between the auditor and "the reviewer," presumably meaning "insurer," and referring at page 55 to the insurer).

proposal, the insurer and the company would negotiate anew, if they desired, with whether they are likely to do so depending on why the auditor could not issue an unqualified opinion. In fact, the outcome seems a bit more complex at this point. On one hand, investors have voted either for the maximum FSI coverage or for management's lower recommendation. For a renegotiated policy on other terms, management lacks investor authorization to agree to a policy. It could seek new approval using a special shareholder meeting or consent solicitation, but these methods are cumbersome and time-consuming compared to the time likely available.

On the other hand, the absence of an unqualified audit opinion signals financial statement irregularities discovered in the audit, suggesting reason for investor concern about managerial integrity and reliability. If the opinion is adverse or qualified in ways suggesting severe accounting irregularities, investors likely hold credible legal claims against management and other parties, though not against auditors, who are blowing the whistle. If so, insurers are unlikely to issue a policy, and any policy likely would be unenforceable as a matter of insurance law.[75] It doesn't really matter at this point whether a policy or the default model applies: The liability of these parties is not influenced by the presence or absence of FSI. In cases where the auditor's opinion is qualified for limited reasons, however, whether FSI is procured could still matter for the scope of the auditor's liability.

This raises a subtle structural issue, concerning the fact that auditors, when engaged under FSI, do not know whether FSI or FSA will govern their engagement and liability. If auditors face different incentives and pressure under FSA compared to FSI, then the possibility that either regime may apply, determined after they complete the audit, could influence audit quality and conclusions. Knowing that FSA applies yields conflict and capture pressure with a resulting level of investigation and diligence; knowing that FSI applies neutralizes those pressures and instead creates insurer-backed incentives for superior auditor investigation and diligence. Under FSI, auditors enter the engagement as insurer-employees and assume an FSI framework. But they also know that if they don't issue an unqualified opinion, their performance is governed by the FSA model.[76] What effect will this have on their incentives in performing the audit?

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75. *See infra* Part II.A.1 (discussing insurance law's fortuity requirement as limiting insurable risks to those uncertain to occur).

76. As a resulting contracting matter, issuers applying to insurers for FSI and contracting with them would also need to contract with the insurer-designated auditor to provide that the auditor is automatically and retroactively deemed engaged by the issuer if the FSI policy does not become effective. In addition, when FSI audits do not result in the FSI policy becoming effective, the company

This sequence should yield expected behavior concordant with the FSI model, not the FSA model, no matter what the audit's outcome. The fact that FSI shifts liability to insurers and away from auditors creates pressure for auditors to deliver unqualified opinions. But this bias will be offset in two ways: (1) audit failure still exposes auditors to liability to insurers for professional transgressions; and (2) the insurer will not allow auditors, as insurer employees, to provide unqualified opinions unless the insurer is comfortable with this conclusion. In addition, the absence of an unqualified opinion means auditors are potentially primarily liable, and this will likely lead them towards more conservative assessments in writing such opinions. This combination of factors should therefore encourage FSI auditors to work with management to pressure it into producing financial statements that faithfully reflect business reality and warrant an unqualified opinion. Management unwilling to meet auditor demands, which will thus be considerable, could find themselves without an auditor or insurance.

Moving beyond these subtleties associated with an FSI auditor issuing something other than an unqualified opinion, consider the case of companies opting for FSI and earning an unqualified FSI audit opinion. They are covered by an effective FSI policy (the FSI proposal provides that insurance becomes effective when the condition of earning an unqualified audit opinion is satisfied). The audit report, issued in Year X+1, includes a paragraph disclosing coverage associated with the Year X financial statements and related premium;[77] accompanying managerial disclosure provides material information concerning policy details.[78] FSI then substitutes for auditor and issuer liability for material financial misstatements for Year X, approved by an investor vote in that year, and taking effect in Year X+*1*.[79]

Investors may prefer FSI over FSA because of its prospects for providing superior audits. Insurance auditing may be superior to FSA because it more closely aligns auditor interests with investor interests. Under FSA, auditors face pressure to succumb to management preferences, either due to judgment inherent in

would be charged with reimbursing the insurer for all its out-of-pocket costs, including audit fees. This is akin to the binder in insurance parlance, though it differs in that no insurance is provided unless the audit condition is met or the parties successfully renegotiate.

77. *See* Ronen, *Post-Enron Reform*, *supra* note 4, at 51. Achievement requires amending generally accepted auditing standards, a step that would require the blessing of PCAOB. Dr. Ronen does not discuss amending Generally Accepted Accounting Standards (GAAS) (or federal securities laws), though he does discuss how FSI relates to various theoretical amendments to Generally Accepted Accounting Principles (GAAP). *Id.* at 66–67.

78. Ensuing discussion in this and the next Part identify subjects requiring disclosure.

79. These effects pose consequences for the terms of the policy, particularly that it must be an occurrence rather than a claims-made policy. *See infra* Part II.A.3.

accounting or to disincentives from conflict or capture to counter this pressure.[80] While FSI cannot alter the challenge of accounting's inherent judgment, it can alter the pressure dynamics between management and auditors. A key difference is that auditors are employed by insurers, not companies. Absence of conflict and capture risks should heighten auditor willingness to second-guess management and not give it the benefit of the doubt.

The superiority of FSI auditing compared to FSA likely holds true despite improvements under SOX. Vesting audit committees with auditor retention, supervision, and termination authority may incrementally reduce capture risk. Under either system, however, auditors plan and perform audits to maximize their expected compensation.[81] When auditors are paid by companies under FSA, a single engagement is at stake; when auditors are paid by insurers under FSI, a portfolio of engagements sponsored by the insurer is at stake. This difference should lead to superior audits using FSI compared to FSA.

Other recent reforms may contribute more significantly to the advantages of FSA over FSI. Consider the new control audit feature of FSA. Like FSI, it is designed to provide a gauge of financial statement reliability, though in somewhat different terms than FSI. In control audits, the mechanism is an audit report on internal control over financial reporting and the timing is prospective: The opinion states whether effective control was maintained during the previous accounting period with a view towards assessing the reliability of future financial statements.[82] With FSI, the signal is the premium-coverage mix and the timing is historical: a risk assessment concerning the likelihood that the most recent financial statements are reliable.

Which of these signaling devices is superior is difficult to gauge. Both devices can produce kindred improvements compared to traditional FSA. First, both use a publicly disclosed mechanism to pressure management to improve financial reporting reliability (the control-audit report and premium-coverage signal, respectively). Second, both are designed to promote superior audits by encouraging greater emphasis on verifying critical data such as assets and revenues rather than the more traditional mechanical sampling of various

80. *See* Ronen, *Post-Enron Reform*, *supra* note 4, at 55–56. Reform proposals addressing auditor performance or liability mute the concept of auditor professional skepticism, a cornerstone of auditing. *See generally* AM. INST. CERTIFIED PUB. ACCOUNTANTS, STATEMENT ON AUDITING STANDARDS NO. 53 (1988). Perhaps the audit failures of the late 1990s and early 2000 render reference to this professional doctrine naïve. In the era of enhanced auditor independence and oversight, and certainly under FSI, the concept's value should reappear.

81. *See* Ronen, *Post-Enron Reform*, *supra* note 4, at 56.

82. *See* Cunningham, *supra* note 25.

journal entries.[83] On the other hand, control audits and FSI are not mutually exclusive: One could insure current financials using FSI and not care whether controls were effective, but knowing that controls are effective remains useful to forecasting future financial statement reliability. As a result, the new control audit regime does not preempt FSI, and control auditing can be performed by auditors governed by FSI.

A final issue concerning FSI's audit condition relates to insurer incentives to conceal rather than to expose accounting irregularities. Given that FSI policy issuance is conditioned on an unqualified audit opinion, the insurer's incentive for any given year should be to discover, correct, and/or disclose all irregularities. But opposite incentives may arise for concealment in subsequent periods.[84] An FSI audit for a given year, say Year X_1, poses incentives to discover, correct, and/or disclose all irregularities; but Year X_2 may bring opposite pressure to conceal irregularities the auditor failed to discover during Year X_1 that affect Year X.

Auditors face similar pressure when engaged under FSA to perform successive annual audits for the same company.[85] The issue is whether concealment incentives would differ under FSI. Analytical and structural factors suggest prospects for comparatively weaker concealment incentives under FSI, with possible legal provisions to negate these.

Analytically, assessing the relative strength of the problem of deferred disclosure of later-discovered accounting irregularities under FSA compared to FSI should not involve comparing auditor incentives in the two regimes, but rather comparing auditor incentives under FSA with insurer incentives under FSI. In both regimes, a limited number of auditors exist (less than a dozen). At present, clients rarely account for significant portions of an auditor's

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83. *See* AUDITING STANDARD NO. 2, *supra* note 26; Ronen, *Post-Enron Reform*, *supra* note 4, at 55. Verification exercises are more costly and cumbersome than sampling techniques but are likely more useful; they are implicitly mandated by the new control audit regime and substantially encouraged by insurer oversight of auditors under FSI.

84. *See* Coffee, *Gatekeeper Failure and Reform*, *supra* note 6, at 349 n.151 (identifying as a problem with Dr. Ronen's FSI proposal that the "insurer might prefer that the auditor hide, rather than reveal, accounting irregularities discovered after the insurance policy was issued, if their revelation would trigger its obligation to pay under its policy").

85. *See* Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1969) (denying motion to dismiss complaint alleging auditor's failure promptly to disclose material misstatements in financials it audited when it discovered these in subsequent consulting engagement, rejecting firm's argument that it had no duty to disclose such subsequent discoveries to those relying upon its report); *see also* AM. INST. CERTIFIED PUB. ACCOUNTANTS, STATEMENT ON AUDITING PROCEDURES NO. 41 (1969) (establishing as professional auditing standard a continuing responsibility on auditors for validity of their reports and articulating procedures for auditors to follow upon discovery, including ascertaining information's reliability, requesting issuer disclosure and taking steps to ensure disclosure to applicable regulatory authorities and investors and others known specifically to be relying upon the report).

revenue; under FSI, insurers would account for sizable portions of an auditor's revenue. So auditors should face greater pressure from insurers under FSI than from clients under FSA. This comparison adds appeal to FSI: It makes auditors beholden to insurers (not to management), so greater pressure from concentrated auditor employment by limited numbers of insurers should be desirable.[86]

Apart from this analytical hypothesis, structural constraints applicable to insurers under FSI are likely to be stronger than those applicable to auditors under FSA. First, each annual FSI review and premium-coverage quote is made anew, and insurers face pressure in Year X_2's quote to reflect the realities of Year X_1's audit, whether or not discovered irregularities were previously disclosed. Second, insurers are removed from the internal cultural motif that engenders accounting irregularities. That should equip them more fully than auditors under FSA to recognize the inevitable public discovery of accounting irregularities.[87] Third, insurers enjoy a professional inclination as actuaries to see that accounting irregularities snowball with time, creating larger loss payout exposure the longer disclosure is deferred. While these neutralizing effects are imperfect, they are not inferior to those auditors face under FSA, and they may be incrementally superior.

To the extent that these differences between FSI and FSA are still seen as inadequate to support FSI, additional features can accompany FSI to assure its superiority. A leading feature would call for federal securities laws to impose additional penalties upon insurers whose auditors fail to generate disclosure in such circumstances. Monetary penalties against FSI insurers could be set as a multiple of losses otherwise payable had concealment not occurred. Criminal sentences could be applied to those persons employed by the FSI insurer responsible for facilitating the deception.[88]

86. The likely number of FSI insurers is hard to predict. Author conversations with major insurance brokers indicate interest in FSI but inadequate basis to model it and limited incentives to do so given the considerable regulatory hurdles (principally those considered in this Article). If FSI is permitted and commercially feasible, it is possible that a sizable number of insurers would underwrite FSI.

87. *Compare* Max H. Bazerman et al., *Why Good Accountants Do Bad Audits*, 80 HARV. BUS. REV. 96 (2002) (assigning as major contributing factor to audit failure unconscious auditor bias engendered in significant part by corporate context in which auditors perform functions); *see also* Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation*, 95 NW. U. L. REV. 133 (2000) (exploring wide range of biases auditors face given context and terms of traditional engagement).

88. These approaches resemble certain pending reform proposals for measuring damages against auditors under FSA. *See* text accompanying *supra* notes 40–43. A key difference is that these measures are related to coverage determined according to insurance policies defined using capital and insurance market references, rather than through damages or revenue baselines. This resemblance implies that approaches to FSA can likewise apply to FSI, including, for example, requiring periodic

3. Premium-Coverage and Related Disclosure

FSI's key information generation is the premium-coverage mix, which has value to the extent that public capital markets are somewhat efficient.[89] According to Dr. Ronen, FSI meets conditions of a signaling equilibrium.[90] While premium amount varies with coverage level, for a given coverage level, premiums vary inversely with quality (that is, they vary positively with assessed risk). Optimality is reinforced by higher quality risk assessment and audit. Likewise, for a given premium, coverage varies positively with quality (negatively with assessed risk). As a result, premium-coverage disclosure provides credible market signals, enabling meaningful intercompany comparisons. Dr. Ronen opines that, assuming market efficiency, the signals are accurately priced.[91]

FSI thus uses disclosure as a critical dimension to reveal a financial statement reliability index, with consequent pressure on management to enhance reporting quality and on auditors to apply that pressure.[92] While the premium-coverage mix is an integrated expression of risk, numerous other insurance policy terms can be used to adjust risk in ways that alter the premium-coverage mix.[93] Policy terms vary considerably in the corporate-liability line of the insurance business, which uses extensive endorsements and policy tailoring rather

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rotation of service-providers (whether auditors under FSA or insurers under FSI). Beyond the identified analytical, structural, legal and analogical constraints, moreover, remaining insurer incentives to hide later-discovered irregularities triggering coverage may be addressed by mechanisms used in the claims process, discussed further in Parts I.C.4 and II.C *infra*.

89. Dr. Ronen assumes semistrong form efficiency. Ronen, *Post-Enron Reform*, *supra* note 4, at 57. Specific assumptions of market efficiency should not be a condition to accepting FSI's efficacy. So long as consumers of financial information treat the information as important to their investment decisions and make decisions informed by the information, it is useful without regard to how swiftly or accurately the trading decisions of active market participants incorporate such information into trading prices. In other words, even efficiency skeptics (including this author) might find FSI appealing. *See* Lawrence A. Cunningham, *Behavioral Finance and Investor Governance*, 59 WASH. & LEE L. REV. 767 (2002) (critique of efficient market hypothesis using noise theory and prospect theory); Lawrence A. Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis*, 62 GEO. WASH. L. REV. 546 (1994) (critique of efficient market hypothesis using chaos theory and noise theory). *But see* Gilson & Kraakman, *supra* note 6 (still the leading statement by leading corporate law scholars on market efficiency despite many critiques).

90. Ronen, *Post-Enron Reform*, *supra* note 4, at 57.

91. *Id.* at 58; *cf.* discussion *supra* note 89 (efficiency assumption not necessary).

92. *See* Gilson & Kraakman, *supra* note 6.

93. For example, the premium-coverage mix will vary with the identity, claims-paying capabilities, and reputation of the insurer (such as size and attitude towards defending or settling claims), as well as applicable state law governing the policy. Tailored endorsements cover a wide range of issues, including: (1) self-insurance requirements (through co-insurance, deductibles, and retentions); (2) excess or primary coverage; (3) indemnity-only versus defend policies; and (4) various administrative provisions relating to the claims process. *See infra* Part II.

than relying on standardized forms as in most insurance lines.[94] While some standardization will be desirable to promote FSI's efficacy and some will be required (as discussed in the next part), tailored terms are inevitable. Disclosure of tailored terms will be necessary to enable accurate interpretation of the premium-coverage mix.

Such contractual tailoring can offer a potential advantage of FSI compared to FSA, including proposals to modify auditor liability: FSI exploits market forces to set coverage, premium, and other policy terms. Market effects channel premium-setting to maximize the accuracy of the premium calibrated to probability and magnitude of loss. Market forces constrain premiums in two directions: Competition pressures insurers to minimize premiums (knowing that competitors will underbid them), and self-preservation pressures insurers to maximize premiums to meet claims.[95] The net effect is premium accuracy that, in turn, drives optimal incentives for auditors to apply optimal pressure on managers to produce reliable financial statements.

FSI's contractual structure is congruent with objectives of federal securities regulation. Key objectives are deterrence and prevention, with an additional goal of compensating losses of misled investors. FSI follows this pattern, emphasizing prevention first and compensation second.[96] FSI also aligns with the deterrence rationale and traditional SEC opposition to indemnification mechanisms in favor of insurance that adds resources to compensate investor losses.[97]

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94. *See* JOHN F. OLSON ET AL., DIRECTOR & OFFICER LIABILITY: INDEMNIFICATION AND INSURANCE §12:17 (2003). The authors state:

> Unlike many other insurance forms, D&O policies have varied to such an extent in their particulars that the Insurance Service Organization (ISO) has never attempted to file a "standard policy form," [the Surety Association of America recently decided not to do so] and each insurer has continued to use a slightly different policy as its basic form. . . . [A] D&O policy begins to look more like a negotiated commercial agreement than an "off-the-shelf insurance" form.

Id.

95. *See* Ronen, *Post-Enron Reform*, *supra* note 4, at 53. Inefficiencies, such as short-time horizons, producing excessively low premiums (market skimming), can occur in other insurance markets. To permit FSI as an alternative to FSA would require federal comfort that state insurance law mechanisms or insurance markets are sufficient to minimize these risks to acceptable levels. *See infra* Part III. In addition, market forces relating to policy terms would be supported by minimum federal standards requiring qualifying FSI policies to contain certain terms. *See infra* Part II.

96. This feature is in common with the auditor-liability proposal establishing quasi-strict auditor liability measuring damages as a multiple of related audit revenue. *See* Coffee, *Gatekeeper Failure and Reform*, *supra* note 6.

97. For example, a longstanding SEC policy opposes using indemnification for officers and directors for violations of the Securities Act of 1933. The rationale is an interpretation of that Act as intended more to promote managerial diligence through deterrence and prevention than to provide recompense. *See* Joseph W. Bishop, Jr., *New Problems in Indemnifying and Insuring Directors: Protection Against Liability Under the Federal Securities Laws*, 1972 DUKE L.J. 1153, 1162 (quoting SEC brief in *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971) to the effect that the

In addition to FSI's structural congruence with federal securities regulation, various contract terms can be tailored to meet public policy objectives, as discussed in detail in the next part of this Article.[98]

4. Claims

Relevant to evaluating the relative merits of FSA versus FSI are the processes used to determine, measure, and pay recoveries for losses. Traditional FSA relies upon civil litigation. Debate rages as to the quality of this mechanism in delivering all related policy goals, including deterrence, prevention, and compensation. Plaintiffs' lawyers are major beneficiaries of the regime, and whether these and other investor protection goals are optimized is unclear.[99]

Also unclear is exactly how efficient any claims process using FSI would be. In his FSI proposal, Dr. Ronen sketches a claims-settlement process of the most attractive kind. It differs markedly from standard securities law litigation, as well as from existing insurance-claim processes. At the outset in Dr. Ronen's model (presumably as part of the FSI policy itself), the insurer and insured "cooperatively select a fiduciary organization."[100] This "fiduciary organization" is unspecified,[101] but its tasks are to assess claims, notify the insurer of claims, and represent investor interests.[102]

The claims-settlement process begins when losses are claimed (that is, when financial misstatements are alleged). Dr. Ronen does not describe how shareholders (or other security holders) solve collective action and rational

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1933 Act rationale was less to provide compensation than "to stimulate diligence on the part of those persons who are actually responsible for the preparation of registration statements"). *See generally* 17 C.F.R. § 229.510 (2003) (stating current SEC policy, including requiring registrants to disclose in registration statements that they have been advised of this policy).

98. Part II gives numerous examples of provisions that federal securities law permitting FSI likely would require to be contained in FSI policies in order for them to qualify as legitimate alternatives to FSA. *See also* Cunningham, *supra* note 5.

99. *See* David L. Gilbertson & Steven D. Avila, *The Plaintiffs' Decision to Sue Auditors in Securities Litigation: Private Enforcement or Opportunism?*, 24 J. CORP. L. 681 (1999); *see also* ADAM C. PRITCHARD, SHOULD CONGRESS REPEAL SECURITIES CLASS ACTION REFORM? 12–14 (CATO Inst. Policy Analysis No. 471, 2003), *available at* http://www.cato.org/pubs/pas/pa-471es.html; Jill E. Fisch, *Class Action Reform: Lessons From Securities Regulation*, 39 ARIZ. L. REV. 533 (1997).

100. Ronen, *Post-Enron Reform*, *supra* note 4, at 51.

101. This concept historically was used to describe mutual funds and certain other kinds of institutional investors. *See* ADOLF A. BERLE, JR., POWER WITHOUT PROPERTY: A NEW DEVELOPMENT IN AMERICAN POLITICAL ECONOMY 59 (1959). No doubt this would assume a different meaning in the FSI context, though Dr. Ronen does not specify its meaning or illustrate candidates. Presumably they could be created. *Cf.* Elizabeth C. Price, *The Evolution of Health Care Decision-Making: The Political Paradigm and Beyond*, 65 TENN. L. REV. 619, 641 (1998) (proposing creation of fiduciary organizations to assist consumers with healthcare insurance claims and disputes).

102. Ronen, *Post-Enron Reform*, *supra* note 4, at 51.

apathy problems in bringing a claim. Presumably, the process follows the traditional securities law model, with large investors acting or class action lawyers rounding up claimants. In any event, in Dr. Ronen's model, the fiduciary organization becomes aware of the potential claim and notifies the insurer. At this point, Dr. Ronen indicates that the insurer and the fiduciary would "mutually select an independent expert" to determine the claim's validity and amount.[103] Then, Dr. Ronen concludes, "Within a short time after receiving the expert's report, the FSI carrier compensates the fiduciary up to the face amount of the policy for the damages."[104]

Dr. Ronen obviously intends to provide a thumbnail sketch of the claims process, hinting at perceived limitations in existing securities law litigation. In suggesting the alternative, however, major differences between the proposed model and standard principles of insurance law and practice appear. Insurance practice, by custom and contract, follows a fairly rigid pattern. In the traditional pattern, the insured must notify the insurer of a claim; the insurer then investigates; the insurer becomes liable only when the insured is held liable; the insurer typically defends the claim; and settlements are reached or the case goes to trial. Whether FSI could be streamlined using Dr. Ronen's approach or be constrained to follow this traditional insurance claim model is uncertain. Issues raised are considered in the next part, along with other advanced insurance law and practice matters necessary to complete this evaluation of FSI's efficacy and its appeal compared to FSA.

II. FSI AS SUI GENERIS

If the foregoing structural analysis suggests that FSI may be appealing, additional intricacies of insurance law remain to be considered to confirm this appeal. The starting point for analyzing the insurance law aspects of FSI is to recognize that it is unlike any existing type of insurance—it is sui generis.[105] This may enhance its appeal, since its contours may be written

103. *Id.* (providing that insurer and fiduciary organization "mutually select an independent expert to render a report as to whether there was an omission or misrepresentation and whether it did give rise to the amount of losses that resulted").

104. *Id.*

105. FSI is sui generis in the denotative sense of being something new under the sun, though not necessarily in the etymological sense of being self-generating or self-sustaining. *See* BALLENTINE'S LAW DICTIONARY 1236 (3d ed. 1969) (sui generis means "of its own kind, peculiar"); BARRON'S LAW DICTIONARY 495 (4th ed. 1996) (sui generis is "of its own kind"); BLACK'S LAW DICTIONARY 1434 (6th ed. 1990) (sui generis defined as "of its own kind or class").

more nearly on a clean slate, though with lettering formed by a variety of existing insurance law principles, as well as by insurance market practices.

The boundaries between types of insurance are sometimes blurry or overlapping.[106] Yet classifications pose significant consequences for policy terms and market expectations, so an effort to classify any insurance scheme is useful. This seems particularly true for FSI, since on the surface it bears kinship to D & O insurance, but on closer inspection critical differences appear.

In fact, to be effective, FSI would necessarily differ from D & O insurance policies (and related entity-level policies) in such key respects outlined below as interpreting insurance law's fortuity requirement (concerning the insurability of intentional acts), evaluating traditional insurance law problems such as application fraud, and defining policy type according to the insurance industry's distinction between claims-made and occurrence policies. Additional implications follow relating to the determination and meaning of insurance premiums and coverage bought (for example, as to requirements for self-insurance through deductibles and retentions) and for the claims-settlement process.

Part A below addresses the classification issue, beginning with a brief history of D & O and entity insurance, showing key ways in which FSI policies must differ. Parts B and C pursue the related implications concerning premium-coverage and claims processing, respectively, showing how practice and state insurance law must be molded to enable FSI to work in the federal securities law context. Each illustrates in different ways three tools for facilitating the interplay between state insurance law and insurance markets on the one hand and federal securities regulation on the other: contract, disclosure, and some judicial or regulatory adaptation. In each case, a federal regulatory overlay would be necessary to enable underlying insurance principles to facilitate federal securities regulation objectives.

A. Classification and Key Elements

D & O insurance is a form of casualty insurance; it is third-party insurance providing coverage for losses that insureds incur to others. It evolved out of professional malpractice liability insurance,[107] but is more complex. Its chief complexities are due to its coverage of fiduciaries for investors in a

106. *E.g.*, KIRK A. PASICH, CASUALTY AND LIABILITY INSURANCE §§ 1.01–.02 (LEXIS Bus. Law Monographs: Ins. Series, Release No. 75, 2003) (noting that the boundaries between casualty and property insurance often blur and that more useful analytical categories are first-party insurance versus third-party insurance).

107. *See* JERRY, *supra* note 38, at 415.

corporation rather than of professionals rendering services to clients.[108] In this context, it offers advantages over other resource mechanisms, such as indemnification, by providing an additional funding source apart from the corporation's own balance sheet. Entity coverage is a further extension of D & O insurance, picking up liabilities the corporation itself incurs to investors for various wrongs. Both forms of insurance are of recent vintage, and their history has been marked by significant volatility and change.

D & O insurance was first marketed in the late 1960s, when state corporation laws were amended specifically to authorize corporations to provide it.[109] It remained relatively rare before the 1980s, however, and then began to proliferate.[110] The proliferation was slowed somewhat by two cases where directors were held personally liable for staggering sums that their D & O insurance covered.[111] The market recovered from these shocks, in part by using more tailored contracts that expanded policy amounts and risks covered while more effectively managing risks. Protections against frivolous litigation provided by Congress in the late 1990s sustained market growth,[112] but a reversal occurred in the early 2000s amid a wave of large insurance settlements[113] and the September 11, 2001 terrorist attacks that shook all insurance markets. Readjustments followed, with premiums increasing, coverage decreasing, and various self-insurance requirements imposed.[114]

The entity-insurance variation of D & O insurance first appeared in 1996, during the growth period for this coverage.[115] These policies provide coverage for risks similar to those D & O policies cover but extend to liability incurred by the corporation itself. They are separate policies from D & O policies, carrying separate premiums. The two markets tend to move in similar fashion to each other, however, and the see-saw experience of the D & O market of the late 1990s and early 2000s applied equally to the entity insurance market. Thus, attractive policy options and terms appeared in the late 1990s

108. *See* OLSON ET AL., *supra* note 94, § 12:1, at 12-3.

109. *See id.* § 12:2, at 12-3 to 12-4 (citing Orvel Sebring, *Recent Legislative Changes in the Law of Indemnification of Directors, Officers and Others*, 23 BUS. LAW. 95, 106–07 (1967)).

110. *See* DIRECTORS AND OFFICERS LIABILITY INSURANCE DESKBOOK, at iii (David E. Bordon et al. eds., 1998).

111. *See* OLSON ET AL., *supra* note 94, § 12:2, at 12-4 to 12-5 (citing Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985) and Fox v. Chase Manhattan Corp., No. 8192-85, 1985 Del. Ch. LEXIS 518 (Dec. 6, 1985)).

112. *See id.* § 12:2, at 12-4 to 12-5 (discussing Private Securities Litigation Reform Act of 1994).

113. *See id.* § 12:2, at 12-6 n.19 (noting early 2000s payouts concerning Cendant ("in the billion dollar range"), 3Com ($259 million), Procter & Gamble ($49 million) and Rite-Aid ($200 million)).

114. *See id.* § 12:2, at 12-7.

115. *See id.* § 12:2, at 12-6 (noting also the availability of entity insurance to companies effecting initial public offerings).

(such as multiyear policies) and vanished in the early 2000s.[116] The policy options of the late 1990s included specific coverage for securities law claims, a feature traditionally specifically excluded from D & O policies.[117] Risks realized amid the general market downturn led insurers to substantially curtail coverage and require greater detail in risk assessment and exposure information before issuing policy coverage.[118]

Within the D & O and entity insurance markets, no specific product extends to cases of accounting irregularities or fraud that FSI would cover. Rather, issuers and auditors face liability, with auditors in turn using malpractice liability insurance on an umbrella basis to cover certain of their losses. Even those entity and D & O policies expressly covering securities law claims are not designed or suited to deal with accounting cases. They work in addressing conventional securities law class actions when defendants deny deliberate wrongdoing.[119] For accounting irregularities or fraud, such denials are often by definition untenable.[120] In addition, D & O and entity insurance policies cover claims made during a particular time period, whereas FSI insures a particular year's financial statements, with coverage extending to discoveries made in future periods. In insurance parlance, this means FSI is retroactive coverage, to be provided on an "occurrence" basis.

FSI's retroactive-coverage character suggests an affinity not to D & O insurance, but to title insurance (strange as this may seem at first). Title insurance is coverage concerning risks of defects in legal title to real property.[121] Home sellers represent ownership of title to buyers and, when transferring their interest, provide buyers with title insurance policies backstopping this representation. If the seller breaches this representation, the insurer defends the buyer's claim of title against third parties and pays the buyer's damages arising from the third party's successful assertion against the buyer's title.[122] FSI thus differs from title insurance, since title insurance is usually procured by a

116. *See id.* § 12:2, at 12-8 to 12-9.

117. *Cf.* DIRECTORS AND OFFICERS LIABILITY INSURANCE DESKBOOK, *supra* note 110, at 147 (citing cases interpreting the express securities claims exclusion provisions of D & O policies, including *Isroff v. Federal Insurance Company*, No. 93-3130, 1994 WL 253027 (6th Cir. June 8, 1994) (applying Ohio law); *Bendis v. Federal Insurance Company*, 958 F.2d 960 (10th Cir. 1991) (applying Kansas law); and *RHI Holdings, Inc. v. National Union Fire Insurance Company*, No. Civ. A. 93-4249, 1994 WL 167946 (E.D. Pa. May 4, 1994) (applying multiple state laws), *aff'd* 47 F.3d 1161 (3rd Cir. 1995)).

118. *See* OLSON ET AL., *supra* note 94, § 12:2, at 12-9.

119. *See* Ty R. Sagalow & Michael R. Young, *Dealing with the D&O Insurer*, *in* ACCOUNTING IRREGULARITIES AND FINANCIAL FRAUD 141, 156 (Michael R. Young ed., 2d ed. 2002).

120. *See id.*

121. *See* JERRY, *supra* note 38, at 48.

122. *See id.* at 48–49.

property seller, who buys the policy by naming the property buyer as the insured. Despite this methodological difference, FSI's other parallels to title insurance make this kinship stronger than FSI's kinship with D & O or entity insurance.

Title insurance is retroactive in character in the sense that it covers matters arising before the policy issuance date.[123] FSI operates identically, covering accounting irregularities reflected in financial statements covering a prior period. More conceptually, a key feature that FSI and title insurance have in common is that they both solve a problem of incomplete information: in the case of title insurance, the quality of the seller's title, and in the case of FSI, the quality of the company's financial statements. D & O and entity insurance are less about incomplete information than they are about behavioral and performance risks. They also concern prospective rather than historical matters.

FSI is also akin to title insurance in economic terms. Title insurance is unusual among insurance lines in that a substantial portion of premiums are dedicated to investigation rather than to expected payouts and profits.[124] The central activity in assessing risk involves particularized investigations concerning property and transaction character and research on filings, surveys, zonings, and permit examination.[125] This contrasts with most insurance underwriting exercises, where risks are classified using general actuarial tools rather than specific investigation. In the case of title insurance, the result is that associated losses and legal costs range as low as 3 percent to 7 percent of total operating income.[126] FSI can be expected to perform similarly, given the substantial investigation auditing entails and given that the audit condition must be met for an FSI policy to become effective.

This review of the conceptual kinship of FSI to other forms of insurance implies that general criticism applicable to D & O insurance does not automatically apply to FSI. For example, while D & O insurance may provide clues through premiums that serve as proxies for corporate governance quality,[127]

123. *See* JAMES L. GOSDIN, TITLE INSURANCE: A COMPREHENSIVE OVERVIEW 3–4 (2d ed. 2000) (noting that title insurance can also include post-policy matters).

124. *See id.* at 1 ("[A] substantial part of title insurance cost generally [is] allocated to search, evaluation/examination, or clearing underwriting objections.").

125. *See id.* at 2.

126. *See id.* at 3 (stating that "losses and attorneys' fees have been approximately 5.6%" for the last ten years).

127. *See* Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 54 n.337 (2002) (stating that premiums for D & O insurance accurately reflect governance quality (citing John E. Core, *The Directors' and Officers' Insurance Premium: An Outside Assessment of the Quality of Corporate Governance*, 16 J.L. ECON. & ORG. 449 (2000))). Professor Ribstein also states that premiums for defaults on debt correlate to issuer risk

critics observe that the D & O insurance market does not demonstrate that insurers have any monitoring incentives, since insurers do not condition policy issuance upon formal governance reviews or approvals.[128] Such D & O insurance limitations simply reflect a more attenuated relationship between corporate governance quality and related liability risks.[129]

In contrast, audit effectiveness and auditor performance bear directly on financial statement and reporting quality, and, under FSI, auditor review and opinions are integral monitoring functions. As a result, the insurer's FSI risk model will result from investigation, not pure abstraction. This method neutralizes concerns arising from the reliance such abstract models place on pooled risks. For example, insurance works when covered risks are substantially independent, so that coverage distributes risk across participants pooled according to similar circumstances.[130] If financial misstatement risk lacks characteristics of independence, the risk-pooling function diminishes. This can occur when financial misstatement risks multiply during particular economic climates, congregate in certain industries or cluster around certain innovations or practices.[131] However, since the FSI risk model will be based upon investigation, including the audit mechanism and audit condition, FSI risk models should not rely upon pooled-risk abstractions but on particular information generated.[132]

Moreover, FSI provides monitoring incentives on insurers that differ from those insurers face when underwriting auditor malpractice liability insurance for FSA. In the latter case, umbrella policies cover a broad range of auditor activities, including all its audit engagements. For FSI, each policy is tailored to a particular audit engagement with associated risk, premium, coverage, and other tailored policy terms.[133]

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factors. *Id.* at 54 n.338 (citing Henny Sender, *The Early-Warning Signal for Stock Trouble*, WALL ST. J., July 17, 2002, at C1).

128. *E.g.*, Grundfest, *supra* note 51, at 7 (questioning Ronen's FSI proposal on this basis).

129. *See* BLACK ET AL., *supra* note 1, at 43 (far more relevant to director and officer liability risk than corporate governance are a company's industry, stock price volatility and trading volume). While only a limited number of insurers may underwrite D & O insurance, moreover, this does not imply that only a limited number would underwrite FSI.

130. *See* Kahn & Lawson, *supra* note 51, at 428.

131. *See id.* (noting that financial misstatement claims may be more numerous in adverse compared to robust economic climates).

132. Analogous to information-particularization versus modular-abstraction are FSI policy terms using tailored versus standardized terms, discussed in Part II.B *infra*.

133. Thus criticisms of existing auditor limitations are likewise not transplantable as criticisms of FSI. *Cf.* Grundfest, *supra* note 51, at 7 (introducing the symposium where Dr. Ronen's paper appeared, opining that auditors should have incentives for high-quality audits given a desire to maintain a client relationship long-term, but audit failure suggests related myopia, and contending that Dr. Ronen does not explain how insurers will differ).

In addition to rendering criticism of D & O insurance inapt to FSI, this comparison also suggests a variety of market and legal differences between these types of policies, requiring specific attention both to make FSI efficacious and to evaluate its relative appeal compared to FSA.[134] As noted, the key elements discussed next, and those discussed in ensuing sections of this Article, can be addressed by a combination of three devices. As for contract and contract interpretation,[135] federal securities regulation permitting FSI as an alternative to FSA should require certain contractual provisions for a policy to qualify,

134. Three recently developed insurance products are analogous to FSI: Tax Insurance, Fiduciary Audit Insurance and Representations/Warranties Insurance. Tax Insurance covers professional opinions given to clients as to the tax treatment of transactions. For example, a company may wish to spin-off a subsidiary in a tax-free transaction. The company retains a tax lawyer to provide an opinion and that opinion is insured. Like FSI, a professional thus provides an opinion based upon investigation and the insurer backstops that work. The Treasury Department endorses this product in rules exempting from disclosure to the IRS putative tax-free transactions if backed by contractual protection, including Tax Insurance. *See* T.D. 9046, 2003-1 C.B. 614, ¶ 4 ("Section 6011—Transactions With Contractual Protection"); 26 C.F.R. §§ 1.6011-4(b)(4)(i) (2003) (exempting transactions from required reporting when covered by Tax Insurance).

Fiduciary Audit Insurance, a trademarked product developed by the law firm Greenberg Traurig, covers a pension plan's compliance with applicable regulations. An insurance policy is issued after an expert conducts a plan audit to assess compliance. The policy covers losses caused by corrections and penalties. *See* Greenberg Traurig LLP, Publications and Press Room, *at* http://www.gtlaw.com/pub/ (including memorandum summarizing terms of the audit as a condition to insurance eligibility).

Representations and Warranties Insurance (RWI) is used in acquisition agreements to allocate risks from breaches of representations or warranties. When covering seller's representations as to property title, RWI is akin to title insurance; when covering financial statement representations, it is akin to FSI. The RWI insurer's underwriting consists of reviewing the due diligence process, though not repeating it.

The existence of these insurance markets supports predicting FSI's commercial feasibility. For example, RWI premiums average 5–7 percent of maximum policy coverage, ranging as low as 4 percent when coverage backstops a party's indemnification obligation to 8 percent when coverage replaces the obligation. On the other hand, all are novel and all are used in narrower circumstances than FSI would be used. Lessons for FSI nevertheless appear in these products, including use of standard forms containing terms unsuitable for FSI (all of which are addressed in the coming sections). *See, e.g.*, CHUBB GROUP OF INS. CO., REPRESENTATIONS AND WARRANTIES INSURANCE POLICY (2000) (in contrast to FSI requirements discussed below, sample RWI policy (a) is claims-made not occurrence-based; (b) makes application fraud a defense to the insured's obligations; (c) expressly excludes coverage for deliberate or willful actions; and (d) requires insured-to-insurer notice of claims), *available at* http://www.chubb.com/products/pdf-files/r-wpol.pdf.

135. A significant part of insurance law is advanced contract law, in which judges apply general principles of contract law to insurance policies guided in their interpretation by the distinct purposes of this form of contract. Often this involves evaluating both the insurance policy contract as written and the broader purposive context of which it is a part. *See* Robert E. Keeton, *Insurance Law Rights at Variance With Policy Provisions*, 83 HARV. L. REV. 961 (1970); Peter Nash Swisher, *Judicial Interpretations of Insurance Contract Disputes: Toward a Realistic Middle Ground Approach*, 57 OHIO ST. L.J. 543 (1996); *see also* STEVEN SHAVELL, ON THE WRITING AND INTERPRETATION OF CONTRACTS (Nat'l Bureau of Econ. Research Working Paper 10094, 2003) (discussing the theory of contract interpretation specifying that a written contract is basis for argument in developing interpreted contract, which is the contract to be enforced), *available at* http://www.nber.org/papers/W10094.

analogous to the approach federal securities regulation uses in the Trust Indenture Act applicable to bond indentures.[136] As for disclosure, various contract terms influence the premium-coverage mix for given policies, and these factors are necessary to interpret FSI's premium-coverage signal. As for factors that cannot effectively be addressed by contract or disclosure, specific judicial and/or market approaches would be necessary to make FSI efficacious, as the following key examples show.

1. The Fortuity Requirement

A basic and ancient principle of insurance law holds that losses must be "fortuitous."[137] This doctrine excludes as uninsurable those losses that an insured party causes intentionally. Accounting cases covered by FSI would likely raise issues of intentionality. Interpretive issues arise that concern classifying conduct and specifying the mechanisms used to make the classification conclusive.

Specification of conduct type can be complex.[138] Federal securities law cases construing D & O and entity insurance policies recognize a public policy against insuring persons for losses arising from willful or criminal misconduct, as this would dilute the goals of securities law to deter such conduct and to promote diligence among persons subject to those laws.[139] Coverage is largely

136. Trust Indenture Act of 1939 §§ 305, 307, 15 U.S.C. §§ 77eee–77ggg (2000) (specifying a variety of provisions required to appear in a bond indenture for public debt securities in order for the agreement to qualify under federal securities laws).

137. As Dean Jerry summarizes:

> It is a fundamental requirement in insurance law that the insurer will not pay for a loss unless the loss is "fortuitous," meaning that the loss must be accidental in some sense. The public policy underlying the fortuity requirement is so strong that if the insurance policy itself does not expressly require that the loss be accidental courts will imply such a requirement. The fortuity principle is often expressed with reference to certainty: losses that are certain to occur, or which have already occurred, are not fortuitous. In some jurisdictions, the fortuity doctrine is codified.

JERRY, *supra* note 38, at 450–51 (citing CAL. INS. CODE § 22 (West 2001); N.Y. INS. LAW § 1101[a] (McKinney 2001); and Waller v. Truck Ins. Exch., 900 P.2d 619, 626 (Cal. 1995) ("This concept of fortuity is basic to insurance law.")).

138. *See* Sagalow & Young, *supra* note 119, at 157 (discussing D & O insurance, "[t]he starting point in assessing coverage in the wake of accounting irregularities is ordinarily the *deliberate fraudulent act exclusion*"). A typical policy provides: "The insurer shall not be liable to make any payment for Loss in connection with any Claim made against an Insured . . . arising out of, based upon or attributable to the committing in fact of any criminal or deliberate fraudulent act . . . ." *Id.* This therefore excludes criminal and deliberate fraud, but "*provides* coverage for fraud that arises out of recklessness." *Id.*

139. *See* OLSON ET AL., *supra* note 94, § 6:11, at 6-26. For example, the Investment Company Act of 1940, applicable to mutual funds and the like, prohibits covered entities from including in articles or bylaws or providing by contract any arrangements protecting directors and officers against liability resulting from willful misfeasance, bad faith, gross negligence, or reckless disregard of duties. *See* Investment Company Act of 1940 ch. 686, § 17, 15 U.S.C. § 80a-17(i) (2000).

limited to breach of duty, neglect, error, misstatement, and misleading statement, omission, or act.[140] Recklessness, residing in the median, is placed sometimes on the insurable and sometimes on the uninsurable side of this line.

On which side of the line accounting irregularities or fraud reside will influence FSI's efficacy and comparative appeal, since auditors under FSA are liable whether their conduct is reckless or more culpable. In general, claims concerning financial statement irregularities and fraud differ from typical securities law class actions contemplated by D & O and entity coverage.[141] The truth defense is unavailable when deliberate lies are afoot, triggering standard policy exclusions and public policy limitations.

A common fact pattern appears: Accounting irregularities are discovered—whether due to internal audit, external audit, or SEC pressure—and the company conducts a review and announces publicly an intention to restate financial statements for one or more accounting periods. In theory, this substantially negates mounting a truth defense and could render related conduct uninsurable, by virtue both of public policy's fortuity requirement as well as insurance policy exclusions expressing it.[142]

In each case, on the other hand, a mechanism is needed to determine the class of conduct involved.[143] Mechanisms range from a final adjudication to a determination by a company's directors independent from the issues

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140. Concerning public policy limitations on D & O coverage for a class of egregious conduct, see generally Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 33 n.205 (1999); Thomas A. D'Ambrosio et al., *Special Project: Director and Officer Liability* (pt. 2), 40 VAND. L. REV. 599, 777 n.16, 784 n.51 (1987); Francis J. Mootz, *Principles of Insurance Coverage: A Guide for the Employment Lawyer*, 18 W. NEW ENG. L. REV. 5, 37–44 (1996); Roberta Romano, *What Went Wrong With Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1 (1989).

141. *See* Sagalow & Young, *supra* note 119, at 141 ("[A]ccounting irregularities [do] not necessarily give rise to a conventional securities class action of the sort that D&O policies are specifically designed to address.").

142. *See id.* at 156. Sagalow and Young state:

> [D&O policies are] primarily intended to address a conventional securities class action [where defendants] do not admit they've deliberately said anything wrong. Where accounting irregularities have surfaced, that is by definition not the case. If the company has issued a press release admitting to irregularities, it has already gone a long way to conceding the existence of fraud. Even absent the admission of irregularities, the mere acknowledgement of need for an earnings restatement concedes that earlier numbers were incorrect.

Id.

143. *See id.* at 159 (explaining need for fact determination under typical policy provision that "limits an exclusion of coverage based on deliberate fraudulent acts to instances where there has been a *final adjudication* or other finding of fact"). "A typical provision may . . . exclude coverage . . . 'if a judgment or final adjudication adverse to the Insured(s) or an alternative dispute resolution proceeding establishes that such criminal or deliberate fraudulent act occurred.'" *Id.* Under such provisions, press releases and restatements would probably not be enough to trigger the exclusion. *Id.* at 159–60.

and persons involved.[144] In the case of D & O insurance, most states prohibit coverage only when an insured is convicted of fraud, though this varies across states. Such cases are uncommon. In fact, it is rare for any class action to go through trial to a final judgment, including claims for securities law disclosure violations and accounting irregularities or fraud.[145] To this extent, as a practical matter, insurance covers a wide range of culpable behavior despite contrary public policy or insurance policy exclusions.

Plaintiffs' lawyers further circumvent these public policy and insurance coverage exclusions for intentional misconduct by not pressing fraud claims that they fear will give insurers grounds to deny coverage.[146] When D & O insurance exists, for example, this leads plaintiffs to avoid alleging "actual intent to mislead" in order to keep coverage in place.[147] They try to meet the relevant culpability standard (negligence under the Securities Act of 1933 and scienter under the Securities Exchange Act of 1934), being careful not to proffer evidence of "intent or conscious knowledge."[148] An optimal FSI regime would not require such litigation gymnastics or rely on the absence of final adjudications of uninsurable conduct in order to provide coverage.

Avoiding such recourse for FSI may be achieved using judicial strategies that balance the fortuity requirement with other public policy goals. Courts sometimes interpret the fortuity requirement to vary depending on the viewpoint adopted (for liability policies, whether the viewpoint of an insured or a third party is adopted).[149] While liability insurance policies invariably

144. *E.g.*, Indemnification by Investment Companies, Investment Company Act Release No. 11,330, 20 SEC Docket 1342 (Sept. 4, 1980) (providing a framework for determining whether particular conduct arises from such causes, including through a judicial or quasi-judicial determination or by decision of a majority of a quorum of disinterested directors).

145. *See* Sagalow & Young, *supra* note 119, at 160 ("Virtually no class action litigation goes through trial to a final judgment.").

146. *See* BLACK ET AL., *supra* note 1, at 27.

147. *See id.*

148. Claim restraint of this sort becomes more difficult to do when more types of conduct are designated as criminal, including those so designated under SOX Sections 303 and 807. Section 303 makes it unlawful fraudulently to influence the conduct of audits. Sarbanes-Oxley Act of 2002 § 807, 18 U.S.C.A. 1348 (West Supp. 2004). Section 807 creates a class of criminal securities law violations for knowing execution (or attempts at execution) of schemes or artifices to defraud others or to profit using them in securities transactions. *Id.* (fines and imprisonment up to 25 years). The concepts of knowing and fraudulent in these statutes raise basic issues of statutory interpretation, and additional unknowns when considering their interplay with FSI. At minimum, the effect is probably to enlarge the population of conduct deemed criminal, potentially putting coverage further out of reach of insurance policies, whether D & O or FSI.

149. *See* Jeffrey W. Stempel, *Construing the Fortuity Requirement in Coverage for "Accident,"* 4 CONN. INS. L.J. 855 (discussing *Nationwide Mut. Fire Ins. Co. v. Pipher*, 140 F.3d 222 (3d Cir. 1998), where the court, applying Pennsylvania law, adopted the approach of analyzing the fortuity requirement and the related policy provision excluding intentional or expected acts using the insured's standpoint and finding coverage).

exclude coverage for damages the insured intentionally causes, using the third party's viewpoint permits coverage enforcement. Injury to the third party is seen as fortuitous (to the third party, injury is not certain), even though from the insured's viewpoint injury would not be fortuitous.[150] Maximizing FSI's acceptable scope of coverage could draw upon these judicial strategies focused on viewpoint variances.[151]

Justifying these judicial strategies requires two additional observations. The first concerns how reimbursing people for intentional, undesirable acts destroys a significant disincentive to engage in those undesirable acts.[152] For FSI, this concern can be offset by observing that FSI does not displace liability for officers, directors, attorneys, or underwriters; it only substitutes insurers for auditors and issuers. With these active agents facing liability risks—and insurers functionally backstopping auditor work—sufficient systemic deterrence should exist to permit enforcing FSI using an investor viewpoint to treat the fortuity requirement as met.[153]

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150. *See* JERRY, *supra* note 38, at 452. When the insured acts through others, as where corporations act through employees, the employer-insured's viewpoint renders their actions fortuitous as well. *See id.*

151. *See* DIRECTORS AND OFFICERS LIABILITY INSURANCE DESKBOOK, *supra* note 110, at 85 ("In some states, it is against public policy to afford coverage for certain misconduct. The state's public policy thus becomes a defense to coverage. . . . [S]ome policies exclude 'matters uninsurable under applicable law' from the definition of loss."). Related case law construing D & O policies is mixed, and may or may not be reconcilable. *Compare* Am. Guar. & Liab. Ins. Co. v. Shel-Ray Underwriters, Inc., 844 F. Supp. 325 (S.D. Tex. 1993) (insurer has no duty to defend antitrust claims based on alleged violation of penal statute), *and* Coit Drapery Cleaners, Inc. v. Sequoia Ins. Co., 18 Cal. Rptr. 2d 692 (Ct. App. 1993) (finding state statute forbids insuring loss caused by a willful act, an implied exclusion of all insurance policies), *with* Andover Newton Theological Sch., Inc. v. Cont'l Cas. Co., 930 F.2d 89 (1st Cir. 1991) (applying Massachusetts insurance law, and finding in the context of a jury verdict for violating an age discrimination statute, reckless conduct does not preclude coverage), *and* Atl. Permanent Fed. Sav. & Loan Ass'n v. Am. Cas. Co., 839 F.2d 212 (4th Cir. 1988) (applying Virginia law, and finding conduct that is volitional but not intended to cause injury is insurable). *See also* Blast Intermediate Unit 17 v. CNA Ins. Cos., 674 A.2d 687 (Pa. 1996) (holding that Pennsylvania public policy does not prevent coverage for negligent violation of federal law since this does not encourage intentional illegality).

152. *See* cases cited *supra* note 151.

153. A common contractual mechanism can be used to advance this objective. Insurance contracting distinguishes between all-risk and specified-risk liability policies. The choice is significant for burdens of proof in litigation. Under specified-risk policies, insureds bear the burden of proving not only that a loss occurred, but also that it is covered by an enumerated cause. *See* JERRY, *supra* note 38, at 411. Under all-risk policies, insureds need only prove that a loss occurred, whereupon the insurer bears the burden of proving that the loss was caused by an exception. *See id.* Allocation of the burden of proof can determine outcomes, making the all-risk versus specified-risk policy choice potentially pivotal. For FSI, therefore, all-risk policies would be indicated, and probably should be required by federal securities law to qualify FSI as an acceptable alternative to traditional FSA. *See supra* note 136 and accompanying text.

The second observation concerns the insurer's perspective. Insurers have an interest in excluding coverage for intentional acts. When premiums are based on probabilities of fortuitous loss, losses caused intentionally are neither contemplated nor accurately priced into the premium.[154] A partial response to this recognizes that the FSI model makes insurers central participants as monitors of auditors and must provide them related incentives. While this is an unorthodox insurer role for many insurance lines, including D & O policies, it is congruent with insurer roles in the title insurance line. The remaining solution to this insurer concern is for insurers to set FSI premiums in anticipation of this approach to the fortuity requirement.

2. Application Fraud

A conceptual cousin of the fortuity requirement is the application fraud defense. This permits insurers to deny coverage to insureds that provide information when applying for insurance constituting material misrepresentations on which insurers rely in issuing a policy. In some ways, FSI diminishes the significance of this defense, though several issues need to be addressed.

With any insurance, insurers lack perfect information as to risk. To minimize information risk, insurers require insureds to disclose requisite information in insurance applications, and also may conduct independent investigation. These steps enable the insurer to assess risk and decide whether to accept applications on an informed basis. The application is usually incorporated into the policy when issued, making its material accuracy a condition to the insured's obligations under the policy.

For D & O and entity insurance, applications are accompanied by financial statements, typically a company's most recent Annual Report on Form 10-K.[155] When subsequent financial statements are afflicted by accounting irregularities or fraud, chances are good that the application's financial statements were likewise infected.[156] If the misrepresentations are material and the insurer relied upon them in issuing the policy, state law permits it to deny coverage.[157] Otherwise, insurers become victims too.[158]

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154. *See* JERRY, *supra* note 38, at 479.

155. *See* Sagalow & Young, *supra* note 119, at 162.

156. *See id.* ("[W]here accounting irregularities have surfaced, the information given to the insurance carrier may in fact be false. The insurance application may be false, for example, insofar as it disclaims knowledge by any officer of circumstances that would give rise to a claim.").

157. *See id.* at 162–63 ("To the extent it can prove the misrepresentations were material and that the policy was issued in justifiable reliance upon them, the carrier may potentially have still another basis to deny coverage and, now, to rescind the policy."); DIRECTORS AND OFFICERS LIABILITY INSURANCE DESKBOOK, *supra* note 110, at 11 (materiality for application misrepresentations are those

FSI will operate differently, more akin to title insurance than to D & O or entity insurance. Applications will be required, but the information contained will be used only to make an initial determination of whether to investigate a proposed policy risk. No policy will issue until after the insurer's auditor completes a full financial statement audit and issues an unqualified opinion on financial statements.[159] This audit condition gives insurers access to information and enhances risk assessment capabilities. It thus negates the credibility of any subsequent insurer claim of reliance on managerial assertions. To this extent, application fraud risk functionally disappears in FSI.

On the other hand, misrepresentation risk may simply be moved back one step. Even an audit provides imperfect information, given inherent limits on auditing. Auditors under GAAS and as a matter of practice obtain additional assurance during the course of an audit, including a formal set of management representation letters, as part of concluding an audit.[160] These steps would not change under FSI. Accordingly, evaluating FSI's prospects requires attention to how misrepresentations in these letters will be treated. To make FSI work, these statements should probably not be accorded the same level of judicial protection as application fraud statements.[161]

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affecting the insurer's risk, decision, or premium). State law permits rescission, usually putting the burden on the insurer to show materiality and reliance (meaning it would not have issued the policy on the terms issued had it known the truth). *See* Harbor Ins. Co. v. Essman, 918 F.2d 734 (8th Cir. 1990) (applying Missouri law, and finding insurer's claim against accounting firm for negligent preparation of financial statements failed when insurer alleged only that the firm should have known it would rely on financial statements, rather than that (1) the firm prepared them to enable insurer to decide whether to issue D & O policy, (2) the firm knew insurer would receive statements, and (3) the insurer was within class of limited, foreseeable class of reliant parties); Tiffany Indus. Inc. v. Harbor Ins. Co., 536 F. Supp. 432, 434 (W.D. Mo. 1982) (applying Missouri law, and finding to the same effect, adding that firm must know insurer would rely and that financial statements were incorrect); *see, e.g.*, DIRECTORS AND OFFICERS LIABILITY INSURANCE DESKBOOK, *supra* note 110, at 14 (noting also that some states permit rescission for innocent misrepresentation while others require intent or bad faith).

158. Business and legal realities can limit an insurer's willingness to use application fraud to deny coverage, risking both its reputation and legal claims for bad-faith denial. Nevertheless, they sometimes do so. *See* BLACK ET AL., *supra* note 1, at 16 (noting that insurers invoked this defense in the D & O cases arising out of securities law claims against Adelphia, Enron, Sunbeam and Tyco, though in each case a court order or negotiation led to some coverage).

159. Unsatisfied audit conditions could lead to a renegotiation on new terms in certain circumstances, as discussed in Part I.C.2 *supra*.

160. *See* LAWRENCE A. CUNNINGHAM, INTRODUCTORY ACCOUNTING, FINANCE AND AUDITING FOR LAWYERS chs. 1, 15 (4th ed. 2004).

161. *See* L. William Caraccio, Comment, *Void Ab Initio: Application Fraud as Grounds for Avoiding Directors' and Officers' Liability Insurance Coverage*, 74 CAL. L. REV. 929 (1986) (making the case for construing application fraud defense narrowly in D & O insurance cases given limited reliability of related preexisting knowledge clauses).

This requires considering judicial techniques used to evaluate application fraud as a defense. A key interpretive issue is whether an assertion is treated as a warranty or a representation.[162] A warranty is usually an assertion of promise, the breach of which operates as a condition to the insurer's obligations, often whether or not the assertion is material to the insurer's decision to provide a policy. A representation is usually an assertion as to an existing state of affairs, the breach of which operates to limit an insurer's obligation, but not to excuse it unless the representation is material. The differential effects of these assertion types sometimes lead courts to characterize an assertion as a representation rather than a warranty in order to deny the insurer an excuse from coverage altogether.[163] State statutes have also been enacted to mitigate the stronger effects of breaches of representations and warranties. These could be made applicable to FSI.

Transplanting this mitigation policy to FSI can be justified using a general theoretical public policy perspective. Strict interpretation of representations permits insurers to take assertions at face value, facilitating more accurate risk assessments, and minimizing investigation costs.[164] The insured supplies the information rather than the insurer searching for it; when claims arise, investigation is made but since claims arise on only a small portion of a pool, overall costs are lower, benefiting all insureds as well as beneficiaries. Denying coverage when misrepresentations are discovered protects the insurer's risk-classification model and decision. In FSI, however, the audit condition entails investigation, neutralizing this public policy concern.

A misrepresented application means the insured was assigned to a lower risk tier than was appropriate, effectively seeking more coverage for less premium than otherwise available.[165] Rejecting or diluting the misrepresentation defense forces lower-risk insureds to fund the costs of covering higher-risk insureds. The tradeoff, therefore, is between protecting the insurer's risk-classification model and extending coverage to those not meeting it. For FSI, the balance tips in favor of limiting the application fraud defense. Given the insurer's full opportunity to investigate, risk classifications should be precisely tailored to that investigation. Accordingly, extending coverage to protect harmed investors

162. For an extensive discussion of warranties and representations and their judicial and statutory treatment, and an overall assessment of their operation, see JERRY, *supra* note 38, at 777–811; the accompanying discussion draws upon that discussion.

163. Another tool further distinguishes the concept of warranty between affirmative and promissory warranties, the former being treated more nearly as representations of present fact than of promises to continue a state of affairs. *See id.* at 784.

164. *See id.* at 818.

165. *See id.*

should neither impair the insurer's risk-classification methodology nor increase costs for other investors.

3. Occurrences, Not Claims-Made

Liability insurance can be either occurrence or claims-made.[166] Occurrence policies cover events occurring while a policy is in effect (independent of when the event manifests damages, is discovered, or notice is given to the insurer). They are used in title insurance policies. In contrast, claims-made policies cover damages discovered and notified to the insurer while a policy is in effect, such as in a given calendar year (independent of when the event occurred).[167] Claims-made policies dominate in professional malpractice insurance,[168] and for D & O and entity insurance.[169] A principal reason is that occurrence policies create long-tail risk of obligations arising for periods extending well into the future, a risk claims-made policies avoid.[170]

FSI will require occurrence policies, as in title insurance, not the claims-made policies used in D & O and entity insurance markets. There will invariably be a time lag between the event causing damages (a material financial misstatement) and the manifestation of those damages (revelation with value-destroying effects on securities). As retroactive coverage, FSI covers a particular year's financial statements, and extends coverage for numerous subsequent years. For example, FSI would be written for 2005 and the policy would provide coverage through 2007, 2008, or beyond. Assuming a three-year policy, in any event, if material misstatements are discovered in the years 2006, 2007 or 2008, they would be covered.[171]

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166. *See* Bob Works, *Excusing Nonoccurrence of Insurance Policy Conditions in Order to Avoid Disproportionate Forfeiture: Claims Made as a Test Case*, 5 CONN. INS. L.J. 505, 520–22 (1999) (noting that these are not the only possible types of policy triggers and that both often pose troublesome questions in application).

167. Policies may also pick up claims as to which notice of possible occurrence is made within a policy period, though the claim is actually made after the period. *See* Sagalow & Young, *supra* note 119, at 154.

168. *See* JERRY, *supra* note 38, at 530–31.

169. *See* DIRECTORS AND OFFICERS LIABILITY INSURANCE DESKBOOK, *supra* note 110, at 5.

170. *See id.* at 52. The handbook states:

> All modern D&O policies are claims made policies. Thus, a claim must be deemed made during the policy period to be covered under the policy. Such policies are designed to avoid the "long tail" effect experienced under "occurrence policies." Occurrence policies cover claims based on wrongful acts which occurred during the policy period. Such claims may be asserted long after the occurrence policy has expired.

Id.

171. To promote FSI congruence with federal securities regulation objectives, policy terms could be set to equal the relevant limitations on actions or of repose articulated in federal securities statutes or case law. For example, Section 13 of the Securities Act of 1933 provides a one year

The general disadvantage of the time lag between event and claim in occurrence policies is the resulting uncertainty, which can be considerable. The fact that FSI for fiscal year 2005 does not generate a claim until 2008 complicates the matching of premiums received with proceeds payable. Complexities arise from inflation effects as well as evolving or shifting liability theories, both covering the insured's behavior and coverage under the policy.[172] Claims-made policies overcome this disadvantage using probabilities extrapolated from the number and size of claims made in previous years to the likely number and amount in current and future years.[173] Ultimately, therefore, the premiums for these different kinds of policies differ materially.[174]

All FSI policies would necessarily be occurrence policies and federal securities law authorizing FSI as an alternative to FSA should so provide. Other policy provisions materially affecting the premium-coverage mix could be made mandatory or permit tailoring subject to appropriate disclosure, as discussed next.

B. Premium-Coverage Mix

Apart from estimated risk of financial misstatement/audit failure, FSI's premium-coverage mix will be affected by numerous secondary factors.[175] This is true of all insurance policies, because risks can only be managed, not eliminated. Insurers use a variety of tools to measure and allocate risk, all of which can be tailored for particular policies. Policy provisions that influence premium-coverage signals include self-insurance mechanisms, coverage exclusions, the nature and scope of the insurer's obligations, and the allocation of insurance

statute of limitations, *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 210 (1976), and Section 10(b) of the Securities Exchange Act of 1934 uses a statute extending two years from constructive knowledge, subject to a maximum five year period of repose. Sarbanes-Oxley Act of 2002 § 804(a)(2), 28 U.S.C.A. § 1658 (West Supp. 2004).

172. *See generally* JERRY, *supra* note 38, at 533.

173. *See id.* (citing, as providing useful historical discussion, Zuckerman v. Nat'l Union Fire Ins. Co., 495 A.2d 395 (N.J. 1985)).

174. *See id.* ("[I]f an occurrence-based liability policy is priced accurately, converting the basis of liability to claims-made should enable the premium to be reduced because the maximum tail exposure is limited to one year, unlike an occurrence policy that has theoretically unlimited tail exposure.").

175. In addition to those elaborated in the text, which are difficult, a more straightforward but still important factor is that premiums are distinguished into gross and net; net premiums are the portion paid associated directly with the risk covered; gross premiums include additional amounts associated with the insurer's administrative costs, overhead, and profit. *See id.* at 611. The latter can vary across insurers based on insurer-specific characteristics, including business model, firm structure and claims-paying capabilities. Companies would need to disclose these factors, to the extent material, in proxy statements proposing investor approval of FSI. Federal securities regulations may impose additional requirements. *See infra* Part III.

responsibility when multiple policies cover a given claim. As discussed below, all are likely to arise for FSI, in various combinations with standardized techniques.

In combination, insurers use tailored provisions and standardized grouping techniques to ideally relate premiums to risk. Grouping is performed as a preliminary mechanism to classify risks by type (high, medium, or low risk, for example). Contractual standardization follows. Standardized forms reduce costs of negotiation and disputation (including litigation) and enhance uniformity in judicial contract interpretation.

The drawback is rough, imperfect classifications. All insureds in the group pay the same premium, but present greater or lesser risk. The result, called adverse selection, is that within any group, a larger proportion of insureds will present greater rather than lesser risk because that subgroup receives a better deal.[176] Adverse selection costs are addressed using risk particularization and policy tailoring. Tools include the premium-coverage mix, but also various contractual devices.

The combination of standardization and tailoring used varies across insurance markets. In most insurance markets, including title insurance, standardization dominates;[177] in D & O and entity insurance, tailoring dominates.[178] FSI should aspire to maximum standardization to provide as much informational content to the premium-coverage mix as possible, while allowing for sufficient tailoring to maximize premium-risk accuracy (and requiring disclosure of material policy-tailoring). Leading issues for tailoring and disclosure include those discussed in the following sections, some of which would have to be mandated by federal securities laws in order for an FSI policy to qualify as a lawful alternative to FSA.[179]

1. Self-Insurance and Over-Insurance

FSI differs from both entity and D & O coverage (and the latter two differ from each other) concerning self-insurance. This refers to policy provisions imposing deductibles, retentions, and co-insurance on the insured, designed to address moral hazard, disincentives to take precautionary measures when resulting losses are paid by others. Notably, these provisions are usually higher for entity insurance than for D & O insurance.[180]

176. *See* JERRY, *supra* note 38, at 169.
177. *See id.* at 237.
178. *See supra* note 94.
179. Analogous to FSI policy terms using tailored versus standardized terms are information-particularization versus modular-abstraction, discussed in Part II.A *supra*.
180. *See* DIRECTORS AND OFFICERS LIABILITY INSURANCE DESKBOOK, *supra* note 110, at 8. Related provisions such as per-claim limits likewise vary in how they are construed to treat multiple

For D & O policies, self-insurance provisions were uncommon from the early 1990s through the late 1990s, but then became fairly standard.[181] Co-insurance neutralizes moral hazard by requiring the insured to bear a percentage of losses not covered by insurance. Deductibles impose a minimum specified dollar amount of losses on the insured, before the insurer becomes obligated to share. Deductibles encourage insureds to prevent small losses; co-insurance encourages insureds to buy more coverage.[182]

FSI raises issues unlikely to be addressable by self-insurance mechanisms. There are no agents whose conduct may be influenced.[183] Directors, officers, attorneys, and underwriters remain exposed to liability risks to the identical extent as under FSA. Insurers employ auditors and backstop the risk of audit failure, increasing auditor incentives compared to FSA; issuer liability is functionally independent of regimes, since its exposure is simply a derivative function of its agents. Accordingly, self-insurance provisions may be limited in FSI, though any use influences related premiums, requiring disclosure to make the premium-coverage signal meaningful and not misleading.[184]

A greater concern arises when companies procure more insurance than necessary or desirable. This could happen with FSI if greater credibility is signaled by high-coverage or low-premium policies. That could motivate managers to procure high coverage without regard to value, making coverage a function of managerial confidence rather than the probable magnitude of losses due to undetected financial misstatement. The device could also be abused to inflate stock price. For investors, on the downside the premium will be higher than necessary when coverage is greater than value (or in any event greater than is necessary); any potential windfall on the upside, moreover, may be unenforceable under insurance law.[185]

Over insurance issues in FSI can be addressed by drawing on a feature common to certain business policies. Many business policies let the premium-coverage mix vary with designated business metrics. A good example is insurance covering inventory values, which may fluctuate monthly. Coverage and premiums can be set to vary with inventory levels, which the insured calculates periodically and reports to the insurer. Coverage and premiums are adjusted.

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claims arising from the same events or facts as single or multiple occurrences/claims, subjecting them or not to the single retention and per-claim limit concepts. *See id.*

181. *See* OLSON ET AL., *supra* note 94, § 12:2, at 12-8.

182. *See generally* JERRY, *supra* note 38, at 680–85.

183. *See supra* Part II.A.1; text accompanying notes 152–153.

184. *Cf.* Kahn & Lawson, *supra* note 51, at 428–29 (suggesting this would be a key feature of FSI, diluting its efficacy).

185. *See* JERRY, *supra* note 38, at 686 n.46 (insurance policies producing windfalls can be voided as wagers).

The virtue to the insured is avoiding unnecessary premium costs given the value, and the virtue to the insurer is avoiding bearing risks proportionally greater than premiums charged.[186]

An analogous approach may be useful in FSI. Coverage and premiums could vary with a company's market capitalization or other metric for the year covered. For example, they could be set at a stated percentage of average market capitalization during that year. This would reflect risks that public market valuations based on reported financial statements are mistaken due to misstated financials. Coverage levels would thus differ year to year, driven by market valuation changes.[187] Since FSI is retroactive, covering a prior year, coverage can be based on known maximum risk, negotiated using known quantities. Federal securities laws may need to specify metrics establishing bands of minimum and maximum coverage, but a wide range in between would be permitted and accompanying disclosure would be required.[188]

2. Primary or Excess and Other-Insurance Clauses

Another significant factor affecting premiums relates to stacking, circumstances where particular claims are covered by overlapping insurance policies. Questions arise concerning which are primary and which, if any, cover only losses in excess of certain amounts or other coverage. To truncate related disputes ex ante, policies typically attempt to specify their rank in such overlapping insurance situations using various types of so-called other-insurance clauses.[189] For example, D & O policies usually contain excess clauses, meaning they apply only when and to the extent other applicable insurance is exhausted. Despite contracting efforts, disputes frequently arise when insurers facing

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186. *See id.* at 445–46.

187. This approach could also be called a valued policy, common in marine insurance, where the policy stipulates an insured value, but not common in any other policies. *See id.* at 635–36.

188. This approach to coverage levels echoes aspects of the warranty-auditing models discussed in Part I.B.2 *supra* by using a somewhat contractual (market-based) coverage determination with due concern for avoiding enforced windfall levels that would bankrupt compensation-providers and thus reduce antecedent risks of driving audit service providers to exit the auditing services market. *See supra* note 48.

189. Other-insurance clauses vary widely, typified by pro rata, excess, and escape clauses. Their interpretation by judges also varies widely. Pro rata apportions coverage across overlapping policies; excess makes one primary and others secondary, the secondary policies covering only losses not covered by the primary one; and escape clauses void coverage if other valid collectible insurance exists. For discussion of each, their use in combination, and judicial interpretation strategies, see JERRY, *supra* note 38, at 739–50, 752–57.

claims resist providing coverage by pointing to the existence of other policies to be drawn on first.[190]

Overlapping insurance would likely occur in FSI-coverage situations. D & O insurance would likely apply along with FSI, covering directors and officers participating in preparing or certifying misstated financials.[191] The interplay between policy types can affect premiums. If investors focus on FSI's premium-coverage mix, and not on D & O premium-coverage data, managers could obtain a superior FSI premium-coverage mix by making FSI excess while making D & O insurance primary, or pursue other combinations using other-insurance clauses that cloud the reliability of FSI's premium-coverage mix as a signaling device.

Given the central role FSI would play in financial reporting and securities trading, and the importance of the premium-coverage signal, FSI should probably be designated as primary, not excess, and not contain any other-insurance clauses. This would both avoid the uncertainties of outcomes common to overlapping policy disputes and prevent biases in the premium-coverage signal that would otherwise arise. Accordingly, it may be desirable for federal securities law authorizing FSI as an alternative to FSA to specify that qualifying FSI policies must contain a policy provision specifying primary coverage and omit any other-insurance clauses. In any event, requisite disclosure would be necessary.

3. Indemnity or Defense

A significant factor influencing premiums is whether a policy requires indemnity only or also requires defense. For liability insurance other than that limited to indemnification, policies impose on insurers a duty to defend

190. Courts attempt to construe overlapping policies to implement the intention of other-insurance clauses; sometimes they harmonize (as where all contain pro rata clauses) but not always (say all contain excess or escape clauses). When clauses are mutually repugnant, however, courts often treat them as canceling each other and impose pro rata coverage. *See* DIRECTORS AND OFFICERS LIABILITY INSURANCE DESKBOOK, *supra* note 110, at 111–12. The handbook states:

> Some courts have held that the insurers share liability in proportion to the limit of liability each policy bears in relation to the total available limits. Other courts have been critical of this rule since carriers whose policies have larger limits are obligated to share a greater percentage of liability for losses at lower limits. These courts require the concurrent insurers to share liability in equal amounts on a dollar for dollar basis until exhaustion of the limits of the policy with the lower limit of liability. Thereafter, the remaining insurer would pay 100% of the remaining liability, subject to its limits of liability.

Id. at 112.

191. Virtually all public companies buy D & O insurance policies. *See* TILLINGHAST TOWERS PERRIN, 2002 DIRECTORS AND OFFICERS LIABILITY SURVEY 17 (98 percent of US companies with more than 500 shareholders carry D & O insurance).

claims against the insured and on insureds a duty to cooperate in the defense.[192] The duty to defend is functionally equivalent to litigation insurance, providing that the insurer will shoulder the financial burdens of being sued. The duty arises as to all claims potentially within policy coverage, constituting an effectively broader duty than the duty to pay proceeds (actions are required even if no duty to pay proceeds ultimately exists).[193] The choice can thus substantially affect premiums.

Traditional D & O policies do not impose duties to defend, but duties to indemnify only. Most public companies possess requisite resources and expertise to mount effective defenses without the need for the insurer's resources. As a result, demand for FSI would probably be for indemnity-only policies. Federal securities law should be indifferent to this choice, however, permitting either but requiring appropriate disclosure to explain the effects of the defend versus indemnity-only policy term on the premium-coverage mix.

C. Claims

As noted in the conclusion of Part I, Dr. Ronen's FSI proposal sketches a streamlined claims-settlement process, intended to differ from traditional insurance processes using essentially private dispute resolution mechanisms.[194] Claims are reported either by the insured company or by its investors to a fiduciary organization jointly chosen by the company and the insurer to act on investors' behalf. This organization assesses claims, notifies claims to the insurer, and together with the insurer in turn selects a claims adjuster to determine whether a covered claim exists and the amount of covered loss. The claims adjuster reports to the insurer the covered amount and the insurer pays investors this amount. As noted, this arrangement has an appeal of swiftness and smoothness but raises numerous issues of adjudication of insurance law disputes. Addressed below are the most significant of these, along with suggestions for molding them into congruence with federal securities regulation objectives.

192. *See* JERRY, *supra* note 38, at 845–55 (Cooperation entails providing requisite information, attending proceedings and general good faith). Material and prejudicial noncooperation can justify an insurer in refusing coverage. *See infra* Part II.C.4.

193. *See* JERRY, *supra* note 38, at 855–56 (citing Ellen S. Pryor, *The Tort Liability Regime and the Duty to Defend*, 58 MD. L. REV. 1 (1999) and Susan Randall, *Redefining the Insurer's Duty to Defend*, 3 CONN. INS. L.J. 221 (1997)).

194. *See supra* Part I.C.4.

1. Liberal Notice Provisions

Most insurance policies impose strict notice requirements, making compliance with specified procedures a condition to an insurer's obligation to pay proceeds. Typical requirements include notice given by the insured being made promptly after an occurrence that might create covered liability. Courts enforce such provisions, holding that effective notice must be provided by the insured and that discovery by the insurer from investigation or from other sources is ineffective to meet the notice requirement.[195] The rationale is to provide the insurer with a basis and an opportunity to investigate.

Under Dr. Ronen's FSI proposal, notice would be provided to the insurer by the fiduciary organization.[196] It is at least as likely, however, that sources other than such an organization will be positioned to provide such notice. Candidates include the insurer's own auditor or management, as well as independent investigations by the SEC or securities lawyers. To the extent an insurer receives notice from sources providing it a basis and opportunity for investigation (certainly, for example, through its own auditor conducting a current FSI audit), this discovery should satisfy the notice requirement.[197] Accordingly, FSI policies should be required to include, or be construed as including, more liberal notice provisions than apply to other types of insurance.[198]

2. Limited No-Action Clauses

Insurers do not always promptly perform obligations, whether or not notice is properly made. When an insurer arguably fails, the issue becomes who is entitled to enforce its obligations. The insured has this right, but more important for FSI are the circumstances under which investors (or a relevant

195. *See* JERRY, *supra* note 38, at 629 (citing Am. Home Assurance Co. v. Republic Ins. Co., 984 F.2d 76 (2d Cir. 1993) and Ins. Co. of N. Am. v. Waldroup, 462 F. Supp. 161, 162–63 (M.D. Ga. 1978)).

196. *See supra* Part I.C.4.

197. The notice provisions would also need to be harmonized with varying applicable state laws. For example, some states, including New York, impose a strict notice rule. *See* JERRY, *supra* note 38, at 634 (citing Steinberg v. Paul Revere Life Ins. Co., 73 F. Supp. 2d 358 (S.D.N.Y. 1999), *aff'd* 210 F.3d 355 (2d Cir. 2000) and Gardner-Denver Co. v. Dic-Underhill Constr. Co., 416 F. Supp. 934 (S.D.N.Y. 1976)).

198. Given insurance practice requiring notice promptly after an occurrence, it would help FSI's efficacy to develop guidelines governing when an occurrence triggering the notice requirement arises. In general liability insurance policies, it is when an insured should reasonably believe a potentially covered loss has occurred. For FSI, this could occur as early as when senior management becomes aware of possible financial statement irregularities, by designated internal events, such as reporting by internal whistleblowers of these conditions or, at the other end of the spectrum, when a company receives indications from lawyers or institutional investors of a possible claim.

fiduciary organization engaged to act on their behalf) are so entitled. Most insurance policies contain no-action clauses, expressly denying third-party loss victims direct rights of action against insurers.[199]

No-action clauses specify that no action arises against the insurer until the insured's liability to third parties is established by final judgment or the insurer's agreement.[200] These clauses prevent beneficiaries from suing insurers; they must sue the insured. The theory, of course, is to prevent the insurer from defending a lawsuit in front of a jury.[201] For FSI to be effective, however, these clauses should be limited, at least to authorize the fiduciary organization or claims adjuster to sue on investors' behalf. Again, federal securities laws authorizing FSI as an alternative to FSA could so provide.

No-action clauses pose particular problems when the insured is bankrupt, which may be common in cases where losses arise under FSI policies. First, without a judgment against the insured, investors have no way to sue the insurer. Second, the Bankruptcy Code stays claims against debtors,[202] preventing investors from obtaining a judgment that would trigger liability under the policy. This undercuts the concept of the insurance and would pose significant limits on FSI's efficacy. FSI policies would therefore need to include provisions making the insured's bankruptcy or insolvency irrelevant to the insurer's obligations.[203] This will increase the likelihood, but not guarantee, that a bankruptcy court would lift the stay and allow the judgment (providing that any judgment not be executed against the debtor's assets but only against the insurer).[204]

199. *See* JERRY, *supra* note 38, at 655.

200. *See id.* (citing Dvorak v. Am. Family Mut. Ins. Co., 508 N.W.2d 329 (N.D. 1993) and Outboard Marine Corp. v. Liberty Mut. Ins. Co., 607 N.E.2d 1204 (Ill. 1992)).

201. *See id.*

202. 11 U.S.C. § 362 (2000).

203. *See* JERRY, *supra* note 38, at 655 (noting that "all modern liability policies provide that the bankruptcy or insolvency of the insured will not relieve the insurer of its obligations under the policy" and that some state statutes require including this language to address this problem, instancing Arkansas and Nebraska statutes).

204. *See id.* at 655–56. In contrast, a few state statutes explicitly provide for direct rights of action by policy beneficiaries against insurers. *See id.* at 656–57 (noting that the states are Louisiana, Rhode Island and Wisconsin, states known as "magnets for suits" against insurers, citing also WILLIAM E. YOUNG & ERIC M. HOLMES, CASES AND MATERIALS ON THE LAW OF INSURANCE 112 (2d ed. 1985)). These directly expose insurers to the loathed jury, creating conflicts with a different public policy, reflected in trial rules treating as prejudicial error disclosure of liability insurance when a defendant's negligence is at issue. For cases concerning direct action statutes, compare Quinlan v. Liberty Bank & Trust Co., 575 So. 2d 336 (La. 1990) (construing statute as permitting direct actions under liability policy but not under indemnity policy, and finding subject policy a liability policy), with Black v. First City Bank, 642 So. 2d 151 (La. 1994) (noting distinction should not be made between indemnity and liability policies for purposes of direct action statute). *See also* FDIC v. Duffy, 47 F.3d 146, 150 (5th Cir. 1995) (applying Louisiana law, and permitting direct action by the FDIC

3. Loss Payees

Under any insurance policy, numerous possible payees may exist. In general, the insured is the person whose loss obligates an insurer to pay proceeds.[205] In liability insurance contracts, the insured is the contract party, and losses are usually paid to it, though it is possible for the insured to assign the proceeds or to designate one or more loss payees. Liability insurance policies often name the insured (for instance, a company) and designate a class of persons having specified relationships to the insured.[206] For FSI, companies are the insured, and policies would name as loss payees those investors holding the company's securities during the reporting period for a set of covered financial statements.

Complex capital structures may pose apportionment issues. Some of these can be addressed ex ante, perhaps mirroring relevant voting rules determining FSI approval.[207] More difficult to resolve in advance are competing claims that seek to treat FSI as an asset of the insured, as insurance policies are typically treated. When losses occur, loss payees may face competition from other parties for claims on that asset. While an FSI policy's contract rights may accrue only to the insured and investors as loss payees, third parties may assert rights to the policy's value. Most state laws limit this maneuver, under so-called state exemption statutes that put insurance policies outside the reach of an insured's creditors.[208] These laws may be of limited utility for FSI policies naming both shareholders and debt holders as loss payees, however, leaving unresolved a competition between them as well as with other creditors.

Policies would therefore need to clearly identify intended loss payees, rank their priorities and provide mechanisms substantially as comprehensive as relevant bankruptcy rules addressing the relation between an insured and loss payees on the one hand and the insured's noncovered creditors on the other. Failure to adequately specify these matters can be addressed, ex post, using the interpleader procedure.[209] But evaluating FSI's efficacy must include

against a law firm and liability insurer arising out of federal banking regulation violations); FDIC v. MGIC Indem. Corp., 462 F. Supp. 759, 762 (E.D. Wis. 1978) (applying Wisconsin law, and permitting direct action by the FDIC against a D & O insurer for negligence).

205. *See* JERRY, *supra* note 38, at 335.

206. An example is insurance providing collateral for unsecured debt. *See id.*

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

208. *See* JERRY, *supra* note 38, at 358 (referencing 7 COLLIER ON BANKRUPTCY (15th rev. ed. 1996)). State exemption statutes do not necessarily prevent a creditor from attaching a policy's value or proceeds when the creditor's funds were misappropriated and used to pay policy premiums or when the policy formed part of a scheme to defraud creditors. *See id.* at 358–59.

209. *See id.* at 763–66.

these complex considerations, both as a regulatory matter to determine whether to permit it as an alternative to FSA and to investors if asked to choose between FSI and FSA. In the latter case, related disclosure would be necessary.

4. Limiting Defenses

An inherent limitation of third-party liability insurance policies is that the insurer's duty to pay proceeds is subject to the insured meeting various conditions, over which loss payees lack control. Insurers may be discharged from obligation when the insured makes misrepresentations, fails to give proper notice, fails to cooperate with the insurer, and so on. For many liability policies the problems are potentially significant, but not because of anything peculiar about the relation of the insured to the loss; for FSI, the insured's conduct will likely be central to the claims process. This is the case even if a fiduciary agent or other claims adjuster is designated in the policy as an investor representative. To minimize the adverse effects of this risk, related FSI insurer defenses should be strictly construed to protect investors, and policy premiums should be set in anticipation of this approach.

5. Altered Good Faith

Insurers face numerous decisions in any claims-making process, and FSI would be no exception, no matter how the claims process is structured. The FSI insurer's goal of minimizing claim-losses may align insurer-investor interests during audits,[210] but it poses conflicts during claims-settlement processes. Investors want to minimize claim losses arising from audit failure, but when insured audit failure occurs they want to maximize claim recoveries. In the latter case, insurers have opposite goals. This conflict in turn poses a conflict with traditional insurance law.

For third-party insurance, insurers are obliged to exhibit good faith towards the insured and may be subject to tort liability to insureds when acting in bad faith.[211] For FSI, good faith requirements are likely to be necessary not

210. *See* Ronen, *Post-Enron Reform*, *supra* note 4, at 52–53; *supra* Part I.C.2.

211. The paradigm case arises in connection with third-party claims offering settlements within policy limits that the insurer rejects, followed by judgments exceeding policy limits to which insureds must contribute. The classic cases in a trio are *Brown v. Guarantee Insurance Co.*, 319 P.2d 69 (Cal. Ct. App. 1957), *Comunale v. Traders & General Insurance Co.*, 328 P.2d 198 (Cal. App. 1958) and *Crisci v. Security Insurance Co.*, 426 P.2d 173 (Cal. 1967). *See also* Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113, 1117 (1990) (updating these classic cases and the standard fact

so much to the insured as to the loss payees, the investors. Enlisting insurers so directly in the auditing function under FSI requires imposing on them the public watchdog and investor protection burdens associated with traditional auditing. As with most, though not all, other provisions discussed in this part, federal securities law could require such good faith provisions to appear in FSI policies in order for them to qualify as a lawful alternative to FSA (or simply deem them to be present whether or not they are actually included).[212] The meaning of such provisions and remaining potential conflicts can likewise be provided in public disclosure.

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To recapitulate this part's discussion and analysis of approaches to insurance matters necessary to make FSI efficacious as a matter of securities regulation: (1) insurance law's fortuity requirement limiting lawful insurance coverage to nonintentional acts would require massaged application of the viewpoint concept to permit a broad scope of coverage; (2) insurance law's application-fraud defense excusing insurers from payment obligations must and can be narrowly limited by relying upon FSI's audit condition and associated insurer investigation; and (3) FSI must be occurrence based, not claims-made based, so that a policy covers a year's financial statements but extends for occurrences arising from that year's financial statements for future years.

Factors affecting FSI's premium-coverage signal driven by policy tailoring instead of standardization would require: (1) disclosing self-insurance levels (deductibles, retentions, and co-insurance), which are likely to be limited, and coverage-determinations related to average market capitalization, which might be bounded and appropriate disclosure required; (2) making FSI primary, not excess coverage, and excluding other-insurance clauses, or disclosing; and (3) disclosing whether a policy is indemnity-only coverage or also obligates insurers to defend claims, and the related effect on the premium-coverage mix.

Concerning the claims-settlement process: (1) liberal notice provisions should apply, with notice deemed given when insurers receive it from any reliable source; (2) investors should be afforded limited direct rights of action against insurers, at least through their fiduciary-organization agent or similar party; (3) loss payee clauses must address complex capital structures to contend

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pattern in analysis showing that "settlement behavior in tort cases is a product of the interaction between liability insurance and the law and procedure of tort litigation").

212. *Compare* Francis Mootz, *The Sounds of Silence: Waiting for Courts to Acknowledge That Public Policy Justifies Awarding Damages to Third-Party Claimants When Liability Insurers Deal With Them in Bad Faith*, 2 NEV. L.J. 443 (2002) (making the case for good faith obligations of insurers to third parties generally).

with a variety of priority issues, including those arising as a result of an insured's bankruptcy; (4) traditional insurer defenses against insureds should be strictly construed; and (5) traditional insurer duties of good faith should run to investors, not insureds.[213]

In sum, FSI's efficacy depends upon relating the foregoing insurance matters to securities regulation goals, largely achievable using a combination of contract, disclosure, and some judicial or regulatory interpretation or methodology. While the foregoing major topics can likely be addressed with modest

213. To summarize graphically, the issues and approaches are:

Issue	*Contract*	*Disclosure*	*Judicial/Regulatory*
Fortuity			Expansive coverage using investor view
Application fraud			Narrowly construe, given audit condition
Occurrence, not claims-made	Require occurrence policies		
Self-insurance		Disclose levels and effect on premium-coverage	
Coverage level	Specify bounded maximum/minimum	Disclose level and relation to relevant metric such as average market capitalization during covered year	
Primary not excess; no other-insurance clauses	Require primary; forbid other-insurance clauses		
Indemnity-only or defend also		Disclose choice/effect on premium-coverage	
Notice	Define liberally	Disclose process	Construe liberally
No-action	Restrict	Disclose process	Facilitate
Loss payees	Address complex capital structures and bankruptcy situations	Disclose	Bankruptcy court issues arise
Insurer defenses	Limit those due to insured's conduct		
Insurer good faith	Runs to investors	Disclose concept/limits	

federal overlays, a somewhat larger final issue concerning insurer solvency and systemic stability is considered in the following brief part.

III. REGULATORY COORDINATION

The intricacies of insurance practice and law indicate that a broad range of issues need to be addressed to make FSI workable. For FSI to be effective, it must concord with the goals of federal securities regulation. Part II highlighted the most significant harmonization challenges, shown to be manageable using a modest federal overlay. In addition to applying existing disclosure laws to compel descriptions of material policy terms and their effects on the premium-coverage mix, a federal statute akin to the Trust Indenture Act governing debt instruments can be developed to require qualifying FSI policies to contain specified contractual provisions.[214]

Justification for so amending the federal securities laws depends, however, on confidence that relevant state insurance law will be broadly applied to FSI in ways designed to facilitate federal securities regulation objectives. This invites a somewhat more general perspective on this level of policy formulation and practice evolution before reaching an ultimate conclusion concerning FSI's efficacy and appeal.

Much existing federal securities regulation depends on the integrity of various state laws, especially, of course, state corporation law. A prominent example is the interplay between shareholder voting rules under state corporation law and federal disclosure policy. Current debate concerning shareholder access to proxy statements illuminates how the interplay sometimes produces tensions requiring federal resolution.[215] More general illustrations are discussions surrounding the numerous accounting scandals of the late 1990s and early 2000s and accompanying federal reform of corporate governance traditionally handled by states.[216]

Unlike corporation law, however, which has long been a subject facing indirect pressure from federal securities regulation,[217] insurance law is primarily

214. *See* Cunningham, *supra* note 5; *supra* note 136 and accompanying text; *supra* note 212 and accompanying text.

215. *See* Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003).

216. *See* Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625 (2004).

217. *See* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859 (2003). Such pressure is documented in debates dating to the 1930s, led by Justice Brandeis and Professors Berle and Means, continued through the 1970s in a noted exchange between SEC Chairman Cary and Judge Winter, and endured through

state law strongly insulated from federal oversight and influence.[218] Achieving the requisite interplay and coordination between federal securities regulation objectives and insurance law applicable to FSI could require adjustments to this model. In addition to certain matters discussed in Part II that are not readily susceptible to handling by mandatory disclosure or mandatory FSI policy terms,[219] larger responsibility sharing may arise because permitting FSI as an alternative to FSA would depend critically and ultimately upon justifiable confidence in the solvency of the insurance industry, and of particular carriers underwriting FSI policies.[220]

Insurer solvency is a central concern of all insurance law, with state law generally providing the mechanisms to promote it. But since FSI would form a central part of the federalized enterprise of securities regulation, additional coordination efforts might be necessary. Traditionally, state insurance law defers to markets for efficient and fair insurance products, pricing, and operation, with regulatory intervention requiring a specific justification.

The most common justification relevant to FSI concerns risks of excessive competition among insurers yielding low premiums, leading to loss payouts exceeding aggregate premium volume, and producing industry insolvencies.[221] Historically, states regulated premiums to minimize insurance industry insolvency

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the 1990s and today with scores of articles devoted to numerous aspects of the subject. For a range of contributions, see ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992); Jones, *supra* note 216.

218. The chief federal statute concerning insurance is the McCarran-Ferguson Act, 15 U.S.C. §§ 1011–1015, a Congressional renunciation of federal dominion over insurance, directing that states, not Congress, regulate insurance. *See* Barnett-Bank v. Nelson, 517 U.S. 25 (1996). Thus while various federal statutes apply—including the Sherman Act, various labor statutes, and of course tax laws—direct regulation of insurance when Congress has not directly regulated it is a state matter. *See* Jonathan R. Macey & Geoffrey P. Miller, *The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 N.Y.U. L. REV. 13 (1993) (reviewing history and policy of the Act in contemporary context and prescribing continuing the existing antitrust exemption, leaving solvency regulation to states, and letting insurance rates be set by market forces).

219. These are chiefly the fortuity requirement and application fraud, as well as certain matters arising in the bankruptcy context involving disputes between loss payees and other claimants against the insured. *See supra* note 212 and accompanying text.

220. Insurer bankruptcy is a potentially acute issue, as the 2001 bankruptcy of Reliance Group Holdings, Inc. attests. For aspects of the related complex and protracted litigation, see Koken v. Reliance Group Holdings, Inc. (*In re* Reliance Group Holdings, Inc.), 273 B.R. 374 (Bankr. E.D. Pa. 2002).

221. *See* JERRY, *supra* note 38, at 69. Others, less likely relevant to FSI, are: (1) inadequate information, with complex policy provisions, regulated principally by requiring clear language (and judicial construction against insurers); (2) bargaining imparity, somewhat addressed, mostly by judicial tilts construing against insurers; (3) paternalism, protecting irrational people from themselves; and (4) social objectives, like anti-discrimination. *See id.* at 70–72.

risk,[222] though they increasingly defer to insurer competition.[223] Insurer solvency is instead promoted primarily through capital adequacy and annual reporting, as well as through auditing mechanisms.[224]

It is uncertain whether these state approaches provide sufficient comfort to federal lawmakers and regulators to justify placing FSI at the center of the financial reporting and capital market processes.[225] A federal role, at least in an oversight capacity, may likely be necessary at the outset and on a continuing basis to permit FSI. Although a federal role in insurance law would entail modifying federal-state responsibilities concerning insurance, such a modification is not impossible. At both a general and specific level of policy development, there is a basis for anticipating that such a modification would be politically feasible.[226]

Consider generally the recent removal of regulatory walls separating the three key aspects of the financial services industry: banking, securities, and insurance. From the 1930s until 1999, the three fields were held distinct by federal law (the Glass-Steagal Act), with banking and securities regulated primarily at the federal level and insurance regulated primarily at the state level. The Gramm-Leach-Bliley Act of 1999 removes those barriers.[227] No doubt the federal regulation of banking and securities will not devolve to states; less certain is whether traditional state regulation of insurance will revolve up to the federal level or not.[228] Some insurance companies might prefer a federal approach, some having lobbied for a federal chartering and licensing option.[229] The emergence of FSI could add substantial weight to this position, in turn enhancing FSI's efficacy.[230]

222. *See id.* at 114–17.

223. *See* Macey & Miller, *supra* note 218; JERRY, *supra* note 38, at 117.

224. *See* JERRY, *supra* note 38, at 118–19.

225. Parallels exist in prevalent auditor regulation. States nominally regulate auditors through licensing requirements applied to certified public accountants, but for SEC registrants, auditor independence rules are essentially federal. *See* text accompanying *supra* notes 18–19.

226. *See* Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 625 (1999) (noting need for centralized and uniform regulation and analyzing how to achieve this while respecting traditional state-based approaches to insurance law).

227. Gramm-Leach-Bliley Act of 1999, 12 U.S.C. 1811 (2000); *see* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation and Increased Risks*, 2002 U. ILL. L. REV. 215.

228. *See* JERRY, *supra* note 38, at 131.

229. *See id.* at 132; Danielle F. Waterfield, *Insurers Jump on Train for Federal Insurance Regulation: Is it Really What They Want or Need?*, 9 CONN. INS. L.J. 283 (2003) (including historical review, current options, and ultimate prescription for optional federal chartering creating a two-tiered system).

230. Federal law authorizing FSI as an alternative would likely contain requirements relating to the qualifications of insurers eligible to underwrite FSI, including a requirement that the insurer be independent of the insured, much as the Trust Indenture Act of 1939 relating to contracts governing

Consider more specifically the nature of the limited role federal authorities have assumed in insurance markets. This role is usually reserved for providing reinsurance mechanisms or programs to stimulate insurance coverage for extraordinary matters of national public policy. The main historical examples of such a federal role in insurance regulation are: (1) insurance covering nuclear reactors;[231] (2) reinsurance for damages to urban property damaged by riot or civil disorder;[232] (3) promoting political risk insurance covering private business investment in developing countries;[233] and (4) funding a national flood insurance program.[234]

Most recently, the federal government has developed a federal reinsurance approach to terrorism insurance.[235] The Terrorism Reinsurance Act (TRIA),[236] adopted in late 2002 in response to the terrorist attacks of September 11, 2001, establishes a loss-sharing insurance model between the federal government and the insurance industry for commercial property and casualty damages arising from defined terrorist attacks.[237] TRIA refrains from dictating the manner of state rate regulation, but it preempts state insurance law relating to policy exclusions concerning terrorist acts by effectively requiring insurers to offer terrorism insurance coverage, and also confers exclusive federal jurisdiction for litigation arising from terrorist acts.

These schemes show that federal involvement in insurance regulation always attempts to narrow any preemption of related state insurance law. The incursions focus on promoting insurer solvency through reinsurance schemes. FSI could comfortably follow this approach of state insurance law supremacy,

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public debt securities requires trustee independence. Under both frameworks, such independence was more readily achievable before the Gramm-Leach-Bliley Act passed, but is still manageable.

231. Atomic Energy Damages Act, Pub. L. No. 85-256, 71 Stat. 576 (1957) (codified as amended in scattered sections of 42 U.S.C.) (requiring nuclear reactor operators to carry private insurance at maximum available levels and capitalizing a secondary insurance fund).

232. Housing and Urban Development Act of 1968, Pub. L. No. 90-448, 82 Stat. 476 (codified as amended in scattered sections of 5, 12, 15, 18, 31, 38, 40, 42, 49 U.S.C.). This was in effect from 1968 to 1984.

233. Overseas Private Investment Corporations Amendments Act of 1974, 22 U.S.C. §§ 2191–2200a (2000) (establishing federal Overseas Private Investment Corporation).

234. National Flood Insurance Act of 1968, Pub. L. No. 90-448, 82 Stat. 572 (codified as amended in scattered sections of 42 U.S.C.).

235. Fraud and terrorism pose more kindred systemic challenges than one might suppose. *See* Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, 29 J. CORP. L. 267 (2004).

236. Terrorism Risk Insurance Act of 2002, Pub. L. 107-297, 116 Stat. 2322 (2002).

237. *See* Lucien J. Dhooge, *A Previously Unimaginable Risk Potential: September 11 and the Insurance Industry*, 40 AM. BUS. L.J. 687 (2003); Lucien J. Dhooge, *The Terrorism Insurance Market After September 11: The Case for Limited Federal Intervention*, 34 MCGEORGE L. REV. 27 (2002). TRIA uses specified deductible and co-insurance provisions along with a federal reinsurance program on a temporary basis. It contains a sunset provision for automatic expiration on the last day of 2005.

applying features such as a federal equivalent of the Trust Indenture Act and disclosure policy to respect these boundaries.[238] Any needed federal role concerning solvency risk or reinsurance schemes would entail inquiry replicating more general debates concerning federal versus state insurance regulation. Ultimately this would require deciding whether financial reporting is more akin to major national issues like nuclear power, riot, flood, and terrorism, where meaningful federal intervention has occurred; or more akin to traditional insurance markets such as automobile, life, fire, accident, disability, and health, where it has not.

It is not necessary to pursue this larger debate in this Article, but it may be useful before concluding to identify one potentially significant factor in the debate. It concerns tools that the FSI industry would likely use to manage solvency risks in markets. For example, Dr. Ronen suggests using financial derivative instruments to hedge and distribute risks of FSI loss. Insurers would buy tailored put options on insured-company securities with durations matching the FSI policy period.[239] Puts would be exercisable when securities prices fall due to financial misstatements, spreading risk.[240] Apart from practical issues, such as determining causation and settling claims, such risk distribution carries both advantages and drawbacks of systemic significance that may bear on the relative need for a federal role in any FSI market.[241]

Risk distribution across the broader financial community beyond the insurance industry should reduce overall risks of insurer insolvency. When risks are realized, however, it likewise can cause systemic breakdown through cascade effects. Similarly, such capital-market reinsurance reduces risks of

238. For example, the Trust Indenture Act requires issuers to propose indentures for qualification, with the SEC empowered to issue stop orders against qualification in cases where the proposed trustee lacks requisite regulatory supervision, financial capacity, and independence. Functionally equivalent requirements and procedures could be included in a Financial Statement Insurance Act. *See* Cunningham, *supra* note 5.

239. *See* Ronen, *Post-Enron Reform*, *supra* note 4, at 54.

240. *See id.* (noting that puts become "exercisable upon a stock price decline of the insured that was determined to have resulted from misrepresentations or omissions in the insured's financial statements").

241. For a sampling of the legal literature concerning financial derivative instruments used to hedge various risks and exploring various aspects of the accompanying textual assertion, see Symposium, *Derivative Securities*, 21 J. CORP. L. 1 (1995) (containing articles by Henry T.C. Hu, Lynn A. Stout, Jonathan R. Macey, and Brandon Becker and Francois-Ihor Mazur); Kimberly D. Krawiec, *More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives*, 23 IOWA J. CORP. L. 1 (1997); Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. CORP. L. 211 (1997); Frank Partnoy, *The Shifting Contours of Global Derivatives Regulation*, 22 U. PA. J. INT'L ECON. L. 421 (2001); Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701 (1999).

unraveling the market for auditing services, but could increase unraveling risks when insurance markets contract (a commonplace occurrence in insurance markets, as the history sketched above concerning D & O and entity insurance indicates).[242] Whether markets alone can shoulder such burdens is hotly debated.[243] The question of a federal role in FSI insurer solvency would generate similar intensity, and the terms of that debate would influence FSI's efficacy.

Even if a federal role promoting insurer solvency would likely be feasible or necessary to facilitate FSI, some uncertainty would remain as to FSI's overall stability and utility. Federal regulation, after all, cannot assure these qualities (dramatically attested by the savings & loan industry insolvency and bailouts of the late 1980s).[244] Accordingly, setting aside uncertainties associated with the appropriate federal-state regulatory overlay to promote FSI insurer solvency, requisite mechanisms for other regulatory coordination appear available to mold FSI to achieve federal securities regulatory objectives. As a result, a preliminary conclusion of FSI's efficacy seems justified.

CONCLUSION

The history of insurance shows product and coverage proliferation in proportion to society's wealth.[245] In poor societies, risks of loss are real, but without discretionary wealth, pooling risks by transfer and distribution is not feasible. In affluent societies, the risk of loss increases (more is at stake) and resources are available to meet the costs of transferring and distributing it. Modern U.S. history follows this path. The twentieth century witnessed

242. *See supra* Part II.A; text accompanying notes 109–118.

243. *Compare* J. Robert Hunter, *Rate Suppression and Its Consequences: A Critique*, 11 J. INS. REG. 333 (1993) (defending insurance-rate regulation), *with* Macey & Miller, *supra* note 218, at 19 (urging market insurance rate-setting).

244. *See* Macey & Miller, *supra* note 218, at 18.

245. Crude forms of insurance emerged among the Babylonians and in the Code of Hammurabi (around 2250 B.C.), with similar mutual aid programs developed in ancient cultures of the Egyptians, Chinese, Greeks, and others. Modern admiralty law traces its roots to these mechanisms, which blossomed in seventeenth century England in the practices of transferring and distributing (mostly maritime) risks among underwriters at Lloyd's Coffee House on London's Tower Street. Insurance for other risks developed more slowly than for maritime risks, beginning with fire (in the early 1700s), then life (later that century), and accident (1849). *See* JERRY, *supra* note 38, at 20–23.

In the United States, maritime insurers emerged in port cities, including Philadelphia and New York, in the 1790s and early 1800s. Accident insurance came later (and life insurance after that), when railroad travel both increased these risks and generated resources to fund transferring and distributing them. Liability insurance emerged after the industrial revolution, likewise concomitant upon the expansion of both wealth and risk of losing it. Disability insurance followed at the turn of the twentieth century, with health insurance proliferation a phenomenon of the second half of that century. *See id.*

unprecedented increases in both wealth and risk of loss, and parallel increases in insurance.[246] Insured risks extend far beyond the concept's ancient maritime origins, and far beyond more modern innovations concerning fire, life, accident, disability, health, and liability.[247] Well-known examples include insurance covering homeowners, mortgages, and flood; more arcane examples are viatical settlements[248] and insurance covering risks of political expropriation, business interruption, and—increasingly—terrorism.[249] Lesser known recent innovations akin to FSI are insurance covering tax opinions, pension plan compliance and representations and warranties made in business acquisitions.[250]

With the United States enjoying unprecedented wealth, and stock market capitalization ranging around $10 trillion, it is tempting to see financial statement insurance as not far off. FSI is a potentially useful mechanism to address fundamental limitations of the traditional auditing model, removing conflict and capture risks to provide financial statement audits of superior reliability compared to traditional financial statement auditing. Offsetting difficulties include a range of administrative complexities and a need to relate state insurance law to the objectives of federal securities regulation. As shown, these issues are probably surmountable.

This Article highlights major structural and public policy issues posed by FSI, without undertaking a comprehensive evaluation. The issues evaluated and solutions suggested are necessarily preliminary. Other issues, and alternative

246. Dean Jerry provides staggering data. As of the late 1990s, the U.S. insurance industry commanded nearly $4 trillion in assets, provided 2.4 million jobs, boasted premium volume of $735 billion, sold insurance to almost all homeowners and one-third of renters and about two-thirds of all persons had life and health insurance. *Id.* at 24.

247. For a short essay outlining key aspects of this history in relation to risk management and behavioral economics, see ROBERT J. SHILLER, RADICAL FINANCIAL INNOVATION (Cowles Found. for Research in Econ. Discussion Paper No. 1416, 2004), *available at* http://cowles.econ.yale.edu/P/cd/d14b/d1461.pdf.

248. *See, e.g.*, Fiona M. Jones, Note, *The Viatical Settlement Industry: The Regulatory Scheme and Its Implications for the Future of the Industry*, 6 CONN. INS. L.J. 477 (2000); *see also* Gander v. Livoti, 250 F.3d 606, 607 n.2 (8th Cir. 2001). *Gander* states:

> A viatical settlement is an agreement under which an insured sells a life insurance policy for an immediate payment approximating the discounted face value of the policy. An investor acquires an interest in a life insurance policy of a terminally ill person at a discount, depending upon the insured's life expectancy.

Id.

249. *See* GOSDIN, *supra* note 123, at 2 (insurance can be procured for nearly any type of risk including: liability, worker's compensation, burglary and theft, personal property, boiler and machinery, leakage and fire extinguishing equipment, malpractice, vehicle, disability, elevator, water leakage and pipe breakage, credit, livestock, marine, and congenital defects).

250. *See supra* note 134.

solutions to those discussed, are likely.[251] Overall, however, the analysis justifies concluding that FSI's theoretical promise certainly warrants further examination.[252] It may even warrant implementation, at least on a partial and experimental basis.[253] A first step would be to develop a regulatory framework to justify confidence in allowing companies to propose to investors using FSI as an alternative to traditional financial statement auditing.[254] The resulting experience would shortly reveal FSI's efficacy and appeal in practice.

251. For example, the Article concentrates on comparative dimensions of financial statement insurance versus traditional financial statement auditing, examined principally through lenses of the existing auditing model and its limits, securities regulation, and insurance law principles. Additional attention would focus more internally on the intrinsic appeal and limits of liability insurance mechanisms as risk distribution and loss sharing devices. *See, e.g.*, Kent D. Syverud, *On the Demand for Liability Insurance*, 72 TEX. L. REV. 1629 (1994) (advancing the thesis that demand for liability insurance is driven by attorneys and insurers, which generates liability, requiring more insurance, spiraling without end or means for halting it). *But see* Randall R. Bovbjerg, *Liability and Liability Insurance: Chicken and Egg, Destructive Spiral, or Risk and Reaction?*, 72 TEX. L. REV. 1655 (1994) (commenting on the foregoing paper by Dean Syverud, contending that its picture is drawn narrowly and incompletely).

252. *See* Cunningham, *supra* note 16. Despite recent financial-reporting reforms, continuing development of alternatives is desirable for possible use amid future manifestations of systemic deficiencies in the financial-reporting process.

253. Limited-basis experimentation is sometimes used in developing various accounting and auditing innovations. For example, during the rampant price inflation of the 1970s, the Financial Accounting Standards Board (FASB) adopted principles requiring large companies to provide inflation accounting disclosure in their SEC filings. Experience with the project, along with a general decline in price inflation, led FASB to repeal the rules. *See* FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 89, FINANCIAL REPORTING AND CHANGING PRICES (1986); *see also* CUNNINGHAM, *supra* note 160, ch. 5; ABA Fed. Sec. Regulation Subcomm. on Annual Review, *Significant 1986 Regulatory and Legislative Developments*, 42 BUS. LAW. 827, 871–72 (1987) (noting 1986 repeal of FASB inflation accounting statement in effect during the latter 1970s and adjustments to related SEC rules formerly requiring certain large public companies to provide supplementary financial information on the impact of inflation).

254. In addition to requiring an investor vote to permit companies to opt for financial statement insurance rather than using traditional financial statement auditing, the alternative could be limited to companies of a certain size or type, an approach commonly used in dealing with a variety of accounting and auditing challenges. *E.g.*, Abraham Stanger & Samuel P. Gunther, *'Big GAAP-Little GAAP': Should There Be Different Financial Reporting for Small Business?*, 56 N.Y.U. L. REV. 1209 (1981); Bryan P. Robertson, *SEC Adopts Auditor Independence Rule That Affects Business Valuations*, 4 VALUATION STRATEGIES 37 (2001) (discussing how such a bifurcation concept might apply to recently adopted auditor independence rules, *see supra* note 19 and accompanying text), *available at* 2001 WL 1194731.

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