THE ENVIRONMENT FOR DIRECTORS’ AND OFFICERS’ LIABILITY: EVIDENCE FROM 2009 TO PRESENT

by

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Honors Thesis

Appalachian State University

Submitted to the Department of Finance, Banking, and Insurance
and The Honors College
in partial fulfillment of the requirements for the degree of

Bachelor of Science in Business Administration

May 2019

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Abstract

Directors’ and officers’ (D&O) liability is a legal topic that is increasingly publicized and talked about. People can sue upper management of a company to hold them liable for not fulfilling their fiduciary duty to shareholders. As a result of an increasing number of these suits being filed, companies are purchasing D&O insurance to protect the individual when sued as a director or officer. As more D&O liability lawsuits arose after the financial crisis of 2009, there was a connection between D&O insurance premiums and executive compensation, which has also been increasing in recent years. Corporations may be relying too heavily on D&O insurance to mitigate risk that should not exist initially. The insurance market for D&O may be transitioning from “soft” to “hard” in the near future because of these changes.

Introduction

Every corporation has a Board of Directors, a group of people who ultimately control the company at the most strategic level. The Board may be comprised of major stockholders, other stakeholders (such as key members of company management or retirees), and business leaders. The Board of Directors selects the executive officers of the company, also known as the C-suite or upper management. These directors and officers create the strategy for the company and make the large decisions; however, this tremendous responsibility include risks (The Institutes, 11.3). Shareholders frequently disagree with directors’ and officers’ (D&O) decisions. This could be because the shareholder believes the corporation is not fulfilling its fiduciary duty or duty of diligence to shareholders, is behaving unethically, or any one of myriad other reasons. Such a disagreement does not itself constitute a liability issue for the
company. Some shareholders (or other entities), however, do sue company leadership when they believe they have suffered damages resulting from strategic company decisions. This creates risk for corporations not only because a court award or settlement to shareholder(s) could be of high magnitude, but also because litigation is time-consuming and expensive (even if the director(s)/officer(s) prevails in the end). To protect against the risk, a company can purchase Director’s and Officer’s Liability Insurance on behalf of its Board members and executive management team to cover defense costs and potential direct losses in the event of such a lawsuit. Most companies also have extensive risk management programs and specific mitigation strategies to combat reputation loss (The Institutes, 11.9).

**Background & Evolution of D&O Liability through 2009**

D&O Liability Insurance is used to protect board members and upper management of firms from exposing their personal wealth to litigation and scandals. Litigation could otherwise bankrupt an individual, and the exposure could be sufficient to scare most individuals away from serving a company in a leadership capacity. Most corporations carry D&O insurance to prevent executives from taking on this personal liability, with the insurance policies tailored to the extent possible to the specific directors’ and company’s risks. In addition to the direct protection D&O Insurance affords Ds&Os, it can also indirectly protect shareholders since it serves as a hedge for their investment risks (Boyer). So the existence of D&O insurance smooths the labor market for executives and strategic leaders, while it simultaneously diversifies investor risk.

While the protective effect of D&O insurance on individuals benefits the labor and investment markets, the effects of D&O liabilities are largely shouldered by a specialty
insurance market that at times appears to struggle to keep up with the dynamics of corporate scandal and corruption. *The Shocking Impact of Corporate Scandal on Directors’ and Officers’ Liability* explores the impact of scandals on the insurance market. The property-casualty insurance market, of which D&O insurance is a part, runs in cycles rather than in a consistently balanced state. Key indicators include premium levels and capacity. The cycle for a line of insurance business (such as D&O Liability Insurance) typically begins in an environment of conservative premium levels and capacity, with few insurers willing to write policies (low capacity) and high, relatively non-negotiable pricing (high premium levels). If under these arrangements, the line of business proves profitable, capacity may rise and prices may fall. In the absence of major loss events, additional insurers likely enter the market, putting downward pressure on prices and liberalizing contract terms. Tight competition for risks tends to result in a soft market, in which pricing may be suppressed and contract terms may be customized for the buyer (favoring policyholder needs). Once a catastrophic loss (or string of near-catastrophe losses) occurs, the market tends to swing to a hard status, with higher prices and stricter contract terms (Mansfield, et. al., 228-229).

When Sarbanes-Oxley (SOX) created more personal liability for corporate executives, D&O insurance purchases increased dramatically. Linck et. al also found that Sarbanes-Oxley changed the corporate executive landscape by increasing director pay and the demand for leadership positions in firms. When the Financial Crisis struck late in the first decade of this century, the market for D&O liability insurance had reached a soft state, largely because insurers saw the benefit in having large corporate customers (paying large corporate insurance premiums), even if technically the prices charged for the insurance may
later prove inadequate for the risk. Mansfield, et. al. argues that even with the increased frequency of corporate scandals preceding the Financial Crisis the market for D&O insurance remained relatively soft.

Liability can lie with the directors and officers of a corporation through lawsuits, where shareholders place blame on leaders for loss (Mansfield, et. al., 215). One would expect that the threat of these lawsuits would deter corporate leadership from wrongdoing related to the company, all else the same. Since the introduction of SOX there are increasing numbers of shareholders filing suit against directors and officers for their failures of business judgment, thus increasing the liability that those leaders take on by serving in leadership roles (Mansfield, et. al., 221).

Although D&O insurance was first created in the 1930s, it did not become common until the 1970s. Now, almost all publicly traded companies have D&O insurance (Mansfield, et. al., 222). Despite this, there is little standard for writing D&O insurance contracts. Risks are priced using largely proprietary (and possibly arbitrary) methods, with some insurers asking for changes to corporate governance in exchange for a policy to be written, while others ask only for a list of Board members and officers who will be included as “named insureds,” with an attached affidavit that “no prior losses” exist (224).

Corporate scandals shocked the market by disrupting its cycle. This started with the Enron fraud case in 2001 when they went bankrupt from risky investments and secretive (and corrupt) financial practices (230). There have been many scandals since then involving corporations stealing money. SOX was enacted in an attempt to curb such crimes, adding liability to directors and officers of companies that commit wrongdoings (232). As a result,
there was a hard market for D&O insurance, quickly followed by a soft market. The hard market occurred when corporations were first shocked by the scandals and the new policy, causing an uptick in demand and higher premiums. Then, as more insurers took advantage of the demand and created a more competitive landscape, coverage increased and premiums decreased (234).

There have also been broader economic turns since the first of these corporate scandals that share characteristics. During recessions, or times of financial uncertainty, industries that have more scandals purchased more D&O insurance (Mansfield, et. al., 236). This includes 2001 and 2008. It seems that D&O insurance and corporate scandals have different relationships depending on the financial climate of the time and the abundance of scandals within each industry.

Mansfield, et. al. noticed that securities class action lawsuits by shareholders against corporations increased in monetary size throughout 2008 and 2009. These are lawsuits where a group of people is represented, often shareholders of a company (textbook, 11.7).

These suits impacted the D&O insurance market because the insurance policies cover settlements up to the agreed amount. In 2009, there was a court ruling that corporate governors can be found liable if they have a “showing of bad faith and intentional misconduct” (238). An example is American International Group, Inc, which was found to have at least two leaders who knew about the financial wrongdoing that misled shareholders (239). Other examples include shareholders accusing CitiGroup of not responsibly handling money that was used in subprime mortgage lending, when Bear Stearns managers were sued for lying about taking large risks, and when MF Global Holdings Ltd. used customers’
money to cover up bankruptcy (241-243).

**Relationship between Compensation, Management Liability and D&O Liability Insurance**

The existing literature makes a clear connection between regulation, demand for directors, director compensation and D&O insurance premiums (Linck, Netter and Yang, 2009). Executive compensation is a particularly interesting tie-in among these separate elements of the management liability environment. This thesis asserts that amounts paid to executives (company management and Directors) for their services are both directly and indirectly connected to costs within the D&O liability marketplace.

*Executive compensation as exposure.* The direct relationship between D&O liability insurance premiums and executive compensation has been adequately established by prior research (citations). Indeed, executive compensation is treated as the de facto primary exposure being insured with D&O liability insurance policies. Thus, the higher the compensation, the higher the premiums to insure, all else the same (Risk & Insurance Knowledge Group, 2018).

*Executive compensation as hazard.* D&O lawsuits and insurance claims have increased in frequency in recent years, and prior research has linked executive compensation to the frequency of these insurance claims, not just to the severity (Citations). While claim severity may be explained by the contribution of executive compensation to loss exposure (as described above), claim frequency can only be explainable as the effect of executive compensation as a signal to shareholders (and their attorneys) of possible corruption and/or of possible deep pockets as lawsuit targets.
Executive compensation increases with the increased demand for directors and the increased corporate value demands placed on executives, as a matter of basic supply and demand. Pay studies clearly indicate these increases over time, with the exception of periods of economic crisis (such as during the Great Depression and the 2009 Financial Crisis). For instance, statistics reveal that CEO pay rebounded 31% in 2010 after -9% and -13% decreases in 2008 and 2009, during the Financial Crisis. 2010 was followed by moderate compensation increases (2-6% range) during 2011-16, followed by stronger increases of 11-13% in 2017-18 resulting from strong earnings growth and a tightened executive labor market. (Bout, Cruz and Wilby, 2019). (See Figure 1).

Figure 1: S&P 500 CEO Median Pay

Over the same period of years, litigation surrounding management wrongdoing has increased as well. For instance, class action securities litigation grew in number of cases by more than 50% from 2016 to 2017, and has remained consistently high in 2018 and the first
quarter of 2019 so far (McCollister, 2019). Although a full ordinary least squares regression analysis is not yet possible due to lack of data, t-testing reveals a significantly higher mean annual number of lawsuits between the period 2010-2018 than in 2002-2009, despite the relatively high prevalence of management liability media attention in 2002-2003 (e.g., Enron).¹

While D&O insurance premiums can be difficult to track formally, anecdotal data indicate premium amounts have followed the claims trend, by increasing in recent years. The following section details changes in the market seen since 2009.

**Evolution of the Market 2010-Present**

2009-10 saw relatively high numbers of securities lawsuits (largely due to the Financial Crisis), and the number of securities lawsuit filings has increased each year following a dip in 2011 on the heels of the 2009-10 activity. Most recently, there were a total of 412 and 403 securities class action lawsuit filings in 2017 and 2018, with 2017 seeing the highest annual number of securities lawsuit filings in any year except 2001.² Using the number of public traded companies as of the end of a prior year for purposes of calculating an estimated litigation rate, the 2017 and 2018 litigation rates appear to be approximately 9% and 11%, respectively, if all securities suit filings are taken into account (or about 4.8% and 8.5% if only the traditional securities suit filings are considered). These rates represent historical highs.

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¹ Mean difference = 58 suits, significant at the 0.01 level. Data taken from Westlaw, and retrieved April 5, 2019.
² The 2017 filing figures were inflated by a substantial number of federal court merger objection lawsuits. Nevertheless, even if the federal court merger-related lawsuit filings are deleted from the data, the traditional securities class action lawsuit filings alone during 2017 represent the highest annual number of securities suit filings since 2004.
The 2017 and 2018 litigation rates are also far above the 1996-2016 average annual litigation rate of 2.8%. Even if merger objection lawsuits are disregarded, the chances of a U.S.-listed company being hit with a traditional securities lawsuit in 2017 and 2018 was about 70% higher than the long-term 1996-2016 historical average, respectively. The total of traditional securities lawsuit filings during 2018 is nearly 13% above the 1996-2016 annual average total number of all filings. The number of traditional filings in 2018 is in fact the highest annual number of traditional filings at least since 2008.

A classic D&O case trigger is financial misstatements. These were traditionally the “bread and butter” cases for D&O plaintiff attorneys to pursue, although such cases have been most often dismissed or ruled in favor of defendant(s) (after often protracted periods, the result of which attorney compensation can be quite high). In Morello v. McGee (2014) insurance company shareholders brought a derivative suit against the insurance company’s board members for misstatement in financial statements for life insurance. Board members moved to dismiss. Directors were indemnified from personal liability. They would not likely face personal liability for false financial statements. The motion was granted, so the case was dismissed.

This shows how shareholders are carefully reading company information. Financial statements can be manipulated and misleading. During and immediately following the Financial Crisis, as more people became aware of how companies can cause harm, they noticed it more (or public sentiment against corporations was stronger, or both).

While the number of securities lawsuit filings has increased every year for the last seven or eight years, lawsuits based on alleged financial misrepresentations – once the
stereotypical source of such suits – are becoming increasingly rare. There are fewer financial restatements now than in the past, and with fewer financial restatements to target, plaintiffs’ attorneys have shifted their focus away from company financials and toward adverse developments in company operations. Event-driven lawsuits have been a significant factor in the increase in the frequency of securities suit filings in recent years.

An example of this kind of lawsuit is the suit filed against Arconic in the wake of the tragic 2016 Grenfell Tower fire in London (Westlaw). It is hardly surprising that litigation arose out of Arconic’s manufacturing of the metal cladding used on the apartment tower. What is surprising among the litigation arising in the wake of the building fire was a securities class action lawsuit filed, and filed in the U.S. by U.S. shareholders no less. In July, 2017, plaintiffs’ attorneys filed a complaint in the Southern District of New York against Arconic and certain of its Ds & Os, alleging: “(i) Arconic knowingly supplied its highly flammable Reynobond PE (polyethylene) cladding panels for use in construction; (ii) the foregoing conduct significantly increased the risk of property damage, injury and/or death in buildings constructed with Arconic’s Reynobond PE panels; and (iii) as a result of the foregoing, Arconic’s public statements were material false and misleading at all relevant times.”

Several companies have also been sued in securities lawsuits since 2016 following news reports that the company had been it with a data breach or other cyber securities incident. The highest profile case among these suits is the set of securities class action lawsuits filed in September 2017 against Equifax and certain of its Ds&Os in the wake of the
company’s announcement that it had sustained a data breach involving credit records of over 143 million its customers (Westlaw).

During 2017, the #MeToo movement and appalling revelations that leading politicians, entertainers, political candidates, and others engaged in sexual harassment, assault, and even worse misconduct surfaced. As the accounts of misconduct emerged, a dynamic has developed in which the victims come forward with their stories and seek to hold the wrongdoers accountable. A blockbuster settlement entered in November 2017 now suggests that this dynamic may not be limited just to attempting to hold individuals to account but could also involve efforts to hold the wrongdoers’ companies’ executives accountable for allowing the misconduct or for turning a blind eye.

In what is one of the largest shareholder derivative settlements ever, senior officials of 21st Century Fox have agreed to a $90 million settlement (to be funded entirely by insurance) of allegations the company’s management permitted a culture of sexual and racial harassment to permeate the company, ultimately resulting in financial and reputational harm to the company. The settlement included provisions for governance and compliance enhancements, including the creation of a Workplace Professionalism and Inclusion Council (Stempel, 2017).

Furthermore, two of the lawsuits women filed against Harvey Weinstein alleging his sexual misconduct have also named as a defendant The Weinstein Company itself; for example one of the lawsuits places blame on the company’s “executives, officers, directors, managing agents and employees,” alleging they had “actual knowledge of Weinstein’s repeated acts of sexual misconduct with women.”
These D&O lawsuits represent a substantial statement that the ongoing revelations of sexual misconduct will mean not only that the individual bad actors will be held accountable, but also that corporate executives and company officials who permitted the behavior or turned a blind eye may also be called to account as well. The magnitude of the 21st Century Fox settlement – which by my reckoning is one of the top ten largest derivative lawsuit settlements ever – underscores the seriousness of these issues and the potential threat they represent in terms of management liability exposure.

There are additional causes of liability exposure in the years since the Financial Crisis as well. Notable cases and their triggers are outlined below.

**Triggered by Bankruptcy: Federal Deposit Insurance Corporation v. Loudermilk (2019)**

FDIC sued Ds&Os of a bank in Georgia for approving ten commercial real-estate loans, saying they were grossly negligent, and awarded in excess of $5 million to the plaintiff. The case eventually reached the Supreme Court, which upheld the original ruling. This case seems to be a result both of the 2008 Financial Crisis, when subprime mortgages played a large role in bringing down the global economy, as well as of the trend in event-based suits.


The drilling contractor sued insurer for breach of contract, bad faith, and unfair settlement practices. The judge granted summary judgement on coverage and deductible, other claims were decided by jury. Summary judgement is when the judge makes a decision without taking the case to a jury. The case went to the court of appeals.
Originally the case was DeNucci v. Matthews, which was a derivative suit against the president and other officer for fraud and breach of fiduciary duties. The judge ruled partial summary judgement for fraud and the jury decided on claims for fiduciary duties and declaratory relief. The defendants appealed.

In this case, shareholders claimed the company breached their fiduciary duty involving a buy-back agreement. This case was distinguished by another where there was an agreement between the contractor and insurance company that they claimed did not settle the insurance correctly. This implies that the result of one case can trigger more litigation.

Triggered by Merger-Acquisition Activity: Central Laborers’ Pension Fund v. McAfee, Inc. (2017)

McAfee acquired a security company. Former security company shareholders filed a class action lawsuit against McAfee, the security company, and its directors and officers for breach of fiduciary duties and aiding and abetting. This is due to shareholders believing they were not adequately compensated for their stock in the security company. A California court granted defendants summary judgement and they appealed.

Mergers and acquisitions have been increasing as companies look to consolidate. These transactions have the potential to cause harm to shareholders and any other people involved in the company. The economic climate supports this flux of merger and acquisition activity. Shareholders of the company that was acquired brought this case to say they were not treated well in this time of transition. Companies must be careful and follow regulations when writing contracts for acquisitions.
Triggered by Shareholder-to-Shareholder Suit: Green v. Freeman (2013)

Investors sued a shareholder and officers of Piedmont Capital Holding of NC, Inc. In superior court, the judge granted the shareholder partial summary judgement and the jury ruled in favor of the investors. The shareholder appealed and the investors cross-appealed with the same judgment. Then, the shareholder appealed again and the judge ruled that the investors were not shareholders, the shareholder did not owe the investors individually, and there was no personal injury for breach of fiduciary duty against the shareholder. The case was reversed and remanded, which means that they went against the opinion of the lower court and sent the case back to the lower court for further review.

In the original lower court case, investors sued members of the corporation who were also directors and officers for breach of fiduciary duty. The judge granted summary judgement and the jury voted in favor of the investors. Member appealed and investors cross-appealed.

This case focuses on the rights of the shareholders, which implies more activism of shareholders having control of the company. The case mentions piercing the corporate veil to treat corporate decisions as the responsibilities of the Ds&Os. This case has many levels to it in terms of appeals.

Many of these event-based lawsuits are being filed by “emerging” law firms; that is, law firms that were not responsible for significant amounts of securities lawsuit filings in the past but that have a significant share of securities lawsuits now. At the annual Professional Liability Underwriting Society (PLUS) International Conference in 2018 a partner from one
of these emerging law firms expressly acknowledged that their firm had expanded its consideration of what constitutes fraud sufficient to support a securities lawsuit.\(^3\)

Although there have been many cases involving corporate scandal in court, there is no standard for how these cases are handled. It seems that each case creates a precedent that is so specific that future litigation decisions cannot be based on them. There are so many different types of scandals that a new case must be made for each.

**Insurance Implications**

The possibility of these kinds of cases arising is of course a problem for the companies involved, but it is also a problem for the companies’ D&O insurers. The risk exposure that these kinds of claims represent is not necessarily conducive to objective underwriting (that differentiates meaningfully between customers bringing differing levels of risk exposure to the insurance pool). Maybe even worse, the exposure may not respond to risk-based underwriting even when such underwriting is feasible. It is difficult to reduce the possibility that a company might experience this type of incident- or event-based claim to objective underwriting criteria that would allow risk segmentation and assist in risk selection.

Insurers actively underwriting D&O, especially primary (first-dollar-coverage) D&O, are exposed to these kinds of risk. Pricing must reflect this element of frequency exposure, as the premium has to reflect the possibility of these kinds of claims. This all begs the question whether in the current D&O liability environment – with securities class action lawsuit filing

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\(^3\) PLUS is an insurance industry organization dedicated to advancements and education in the underwriting of management liability, employment practices liability, and errors and omissions liability insurance. Retrieved from http://plusweb.org/ on April 25, 2019.
levels at historically high levels – and in the current “soft” insurance market environment, whether the pricing charge adequately accounts for the risk exposure.

The abundance of D&O insurance may be having the opposite effect of the original intent of insurers. Corporations may be relying too heavily on the insurance to protect leaders, thus giving them leeway to act in a way that is not in the best interest of the shareholders. Thus, the very industry that is known for reducing risks (insurance) may be contributing to the behavioral hazards, and thus may in some ways increase rather than reduce the underlying risks of D&O liability.

Conditions in the business environment indicate that the D&O market may be transitioning back to a hard status because of the number of sexual abuse scandals exposed, political tensions rising, and the economy’s anticipation of a recession. The D&O insurance industry could suffer if it continues to be soft because demand is increasing and losses could rise.

*The Shocking Impact of Corporate Scandal on Directors’ and Officers’ Liability* provokes questions about how D&O insurance has evolved in recent years. The public seems to be increasingly concerned with how corporations approach social responsibility, social justice, and equality. With the rise in members of the public standing up to those in power, companies face more liability risk to their directors and officers than ever before. This begs questions about how companies may finance these risks while still encouraging their leaders to avoid wrongdoing. Also, as regulation tightens and loosens with changing lawmakers, how does that impact the D&O insurance market? With time comes change, and as time goes on, we must update our understanding of the relationship between corporate scandals and D&O
Corporations that have recently filed their initial public offerings are especially likely to be targets for class action lawsuits. Despite this increase in claims and award amounts, the market for D&O insurance seems to be soft. Prices are not increasing with the number of claims as they usually do partially due to abundant supply in the reinsurance industry, which essentially is insurance for insurance companies. D&O insurance has not experienced several consecutive years of not being profitable, which allows capital markets to continue competing for market share in the D&O insurance space. Competition can keep prices low. There is also incentive for attorneys to file D&O liability suits because the insurance payouts largely go to defense costs. This can easily make up 80 to 90% of the payout, depending on how long the case is drawn out before a conclusion is reached (McCollister).

With the constantly changing political landscape, it is difficult to predict how public policy will impact D&O insurance as well. As pointed out before, D&O activity seems to increase during times of economic turmoil, but public policy tends to be slow to catch up, waiting until there have been many scandals and damage done.

Conclusions

As evidenced of recent court cases, litigation involving D&O liability is increasing, in frequency as well as severity. This implies that the need for D&O insurance is also increasing. With the rise of environmental, social, and governance awareness, shareholders are paying more attention to how companies are run; therefore, there is more litigation surrounding corporate governance and events (as opposed to merely financial (mis)statements). Also, after the financial crisis of 2008, regulation has become more
stringent and the general public is more aware of what corporations are doing and their abilities to cause harm. With the easy access to technology and information, news about these cases and corporations is readily available and easy to find. As more people are aware of D&O liability cases, more have been involved in litigation involving D&O liability.

Public company D&O insurers face a challenging claims environment. Record numbers of securities class action lawsuits and new threatening areas of potential future claims present the carriers with a negative claims outlook. Whether and to what extent the D&O insurers actually achieve rate increases across the marketplace will depend to a large extent on the level of competition. The fact is that despite the adverse D&O claims environment, the D&O insurance marketplace remains competitive, at least for many accounts, particularly for excess coverage. The end result, at least for now, seems to be that even where the primary insurers are able to hold the line or even secure a rate increase, continuing competition at the excess levels means that many D&O insurance buyers’ overall insurance costs are stable – and in some cases even continuing to decline. It could be some time before the increases in risk exposure make their way into the pricing of management liability insurance.

The most disconcerting element of the market’s current status is that because more D&O cases are occurring, the need (demand) for D&O insurance is increased, and companies are relying more heavily on D&O insurance when these cases arise. The market for this type of insurance could be suppressed as a result for some time to come, and potentially result in a new Liability Insurance Crisis, as not seen since the Liability Insurance Crisis of the 1980s.
References


