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Controlling-minority shareholder incentive conflicts and directors' and officers' liability insurance: Evidence from China

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ABSTRACT

This paper examines the demand for directors' and officers' liability insurance (D&O insurance) by Chinese listed companies where controlling-minority shareholder incentive conflicts are acute due to the concentrated and split ownership structure. We hypothesize and find evidence that the incidence of seeking D&O insurance is positively related to the extent of controlling-minority shareholder incentive conflicts – a finding not previously documented in the literature. Using an event study, we find that the announcements of D&O insurance decisions in firms that engage in earnings management, and/or are controlled by a local government (such firms tend to have stronger incentives to tunnel), seem to have a negative wealth effect. In addition, the incidence of the D&O insurance decision is positively related to the proportion of independent directors and several litigation risk proxies. Therefore, the breakthrough in corporate governance and judicial reforms has created non-negligible perceived securities litigation risks in China.

1. Introduction

This paper investigates why some listed Chinese companies recently considered the purchase of directors' and officers' liability insurance (since 2000) (hereafter referred to as "D&O insurance"). In particular, we explore the effect of China's concentrated ownership structure on D&O insurance decisions and test whether the purchase of D&O insurance is related to litigation risks arising from the incentive conflicts between controlling shareholders and minority investors. This is an issue not hitherto examined by prior D&O insurance studies conducted in jurisdictions such as the United States (US) and the United Kingdom (UK) where the ownership structure is dispersed and owner–manager agency incentive conflicts are a major agency problem.

D&O insurance is purchased by a company to cover all directors and managers for legal liability arising from their professional activities on behalf of the company and its use is common for listed companies in common-law jurisdictions, such as Canada, the US and the UK.[1] D&O insurance is an important corporate governance issue because it may change the liability risk profile of company directors and managers and thereby affect their incentives in business decisions. Core (1997) argues that demand for D&O insurance may arise from three main sources: (a) the demand for personal coverage by risk-averse directors; (b) the demand for D&O corporate coverage arising from an efficient corporate insurance decision (and thereby it mirrors the determinants of other insurance purchases);[2] and (c) the demand for D&O insurance arising from mana-

[1] A typical D&O policy provides both corporate and personal coverage. The former reimburses the company when it indemnifies directors or officers for legal costs or compensation payments awarded against them. The latter provides direct payment to directors or officers when the company is not able to indemnify them for legal reasons or due to financial distress. Traditionally, D&O insurers will pay claims arising from shareholder suits if the directors and officers have acted honestly and in good faith. As long as the directors and officers do not admit to dishonesty, however, insurance coverage may be retained (Ferris et al., 2007).

[2] Mayers and Smith (1982), among others, theorize that in a world with frictions (e.g., bankruptcy costs, contracting costs, and taxes), ownership structure, leverage, firm size, growth opportunities, managerial compensation, tax and regulatory status are important determinants of corporate use of insurance.

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gerial entrenchment. While there has been a longstanding interest in understanding the determinants of corporate use of D&O insurance, the number of empirical studies has been limited due to the difficulty in obtaining D&O insurance data.

Three studies (Core, 1997; O'Sullivan, 1997; Chalmers et al., 2002) have investigated the use of D&O insurance in Canada, the UK and the US, respectively. For example, Core (1997) examined 222 Canadian companies in 1993 and found some support for all the three sources of D&O insurance demand mentioned above. Using a sample of London-listed companies in 1991, O'Sullivan (1997) found that large companies with a higher proportion of outside directors and a lower level of managerial share ownership were more likely to purchase D&O insurance. Using a sample of 72 IPOs in the US, Chalmers et al. (2002) found that the three-year post-IPO stock returns are negatively related to the amount of D&O insurance purchased at the time of the IPO. They conclude that managerial self-interest plays a key role in D&O insurance decisions, as managers seemed to have incorporated their private information regarding the overpricing of the IPO (and thereby the litigation risks induced by subsequent price decreases) in D&O insurance decisions.

These studies share two common features. First, they are carried out in litigious common-law jurisdictions, and, secondly, they are based on companies with a diffuse ownership structure where a major agency problem is related to the incentive conflicts between shareholders and managers. As directors and managers in these countries are under no obligation to seek shareholders' approval for purchasing insurance (Core, 1997, p. 68), directors and managers are more likely to purchase D&O insurance to serve their self-interests.

China – a large and dynamic economy with a unique institutional background – now provides a good opportunity for us to further test and/or refine the above theories on D&O insurance purchases that were primarily developed in western countries. China serves as an interesting setting for the current study for at least two reasons.

First, China's listed firms have a concentrated ownership structure that is often dominated by a large (state-owned) shareholder. According to recent "law and finance" literature, a central agency problem under a concentrated ownership structure is the expropriation of minority interests by controlling shareholders. The conflicts of interest between controlling and minority shareholders are further exacerbated in China because the ownership structure of Chinese listed firms is also split into non-tradable shares held by controlling shareholders and tradable shares held by minority shareholders (though both types of shares have the same cash flow and voting rights). This unique split share structure can lead to divergent interests between tradable and non-tradable shareholders and has long been recognized as the source of many corporate governance problems (e.g., financial frauds and tunneling) in China. As a result, managers/directors of listed companies are often involved in helping the controlling shareholder to expropriate minority shareholders, thereby facing litigation risks. Whether or not the purchase of D&O insurance is related to the incentive conflicts between controlling and minority shareholders and expropriation-related litigation risks is a question that cannot be effectively answered by studies focusing on countries where companies have a diffuse ownership structure. Our investigation is possible because directors and managers in China are required by the China Securities Regulatory Commission (CSRC) to seek the approval of shareholders' meetings for the purchase of D&O insurance. Therefore, any observed D&O insurance approval by shareholders' meetings in China can be assumed to be in line with the interests of controlling shareholders because otherwise they can veto the proposed purchase. Therefore, D&O insurance decisions in China are more likely to be dictated by controlling shareholders' interests rather than by managerial entrenchment.

Second, as we explain in detail in Section 2, although recent legal reforms mean that private securities litigation (PSL) against listed companies and their directors and managers is now possible in China, it has yet to be seen how the relevant judicial agencies will apply the new laws. Indeed, Chen (2003) reports that very few cases brought to the Chinese courts have been ruled in favor of defrauded investors. As a result, the risk of litigation in China that exists in principle may appear less real in practice. Therefore, investigating the purchase of D&O insurance also provides an opportunity to evaluate whether or not the recent changes to the legal codes that aimed to strengthen investor protection have had any noticeable effect on managerial behaviors in China. This is clearly of interest to both policymakers and investors (including international investors).

We hypothesize that firms with more acute controlling-minority shareholder incentive conflicts are more likely to consider purchasing D&O insurance than other firms. Using a sample of 53 first-time approvals of the purchase of D&O insurance by shareholders' meetings over the period 2000–2004 and a matched control sample, we find support for the hypothesis. For example, firms with more board seats occupied by representatives of large shareholders, engaging in earnings management, and/or more tunneling related-party transactions (RPTs) are more likely to seek D&O insurance coverage. These results suggest that D&O insurance can be opportunistically purchased to protect controlling shareholders and their agents (company directors and managers) against the litigation risks arising from the expropriation of minority interests. Using an event study, we found that the announcements of D&O insurance decisions in firms that engage in earnings management, and/or are controlled by a local government (such firms tend to have stronger incentives to tunnel), seem to have a negative wealth effect. We believe that the above evidence constitutes a useful extension to the D&O insurance literature. Since concentrated ownership structures are common in many countries around the world, and particularly in East Asia (Claessens et al., 2000), our results also have implications for these economies. Ferris et al. (2007) demonstrate that the incidence of derivative lawsuits is higher for firms with a greater propensity to (owner-management) agency conflicts. Our study complements theirs in that we show that firms with a greater propensity to controlling-minority shareholder agency conflicts are associated with a higher (perceived) risk of litigation.

In addition, we found that the incidence of the decision to take out D&O insurance is positively related to the proportion of independent directors on the board and to some litigation risk proxies (e.g., prior record of law violation, leverage, the number of shareholders, and the proportion of foreign investors). Interestingly, these results (from a country where the legal and political environment is still not conducive to PSL) are comparable to the findings of prior D&O insurance studies conducted in jurisdictions with litigious common-law traditions. One explanation is that the recent breakthrough in corporate governance and legal reforms seem to have created a non-negligible level of perceived securities litigation risk in China.

The remainder of this paper is structured as follows. Section 2 reviews the institutional background and formulates the research hypothesis. Section 3 presents the research design, including the model and variables used, and data description. Section 4 discusses the findings and the results of sensitivity tests, while Section 5 concludes the paper.