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Is corporate governance risk valued? Evidence from directors' and officers' insurance

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ABSTRACT

We find that common equity firms pay lower D&O insurance premiums than income trusts, an alternative and riskier ownership form. This result has wide-ranging implications for investors insofar as the information provided by D&O insurers provides investors with an unbiased signal of the firm's governance risk. The signal is unbiased because it comes from an entity (i.e. the insurer) that has a direct financial incentive to correctly assess an organization's governance risk, in contrast to other *ad hoc* governance measures and indices.

1. Introduction

We study the impact of an organizational form on the D&O insurance contract at the time of the IPO to evaluate the extent to which insurers assess the income trusts' potential cost of litigation due to their riskier governance structure. If they are indeed riskier, then, *ceteris paribus*, income trusts should pay more for the same D&O insurance protection. This controlled experiment allows us to test whether D&O insurers charge common equity and income trust companies different premiums based on their ownership structure only.

In line with the corporate governance risk hypothesis, our results show that income trusts pay higher D&O insurance premiums than firms incorporated under a common equity structure. This higher premium remains significant even after controlling for many of the firms' aspects that have been hypothesized in the literature as having an impact on D&O insurance premiums. This result suggests that insurance companies perceive income trusts as riskier than common equity companies, which implies that D&O insurance contracts reveal some litigation and governance risk information to the market.

A corporate director's duty goes beyond a simple firm value maximizing paradigm to include a fiduciary duty, a duty of loyalty and a duty of care. If they fail in those duties, the definitions of which are in constant flux, corporate directors and officers become personally liable for damages caused by their actions or absence thereof. According to the different annual surveys conducted by

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Tillinghast Towers-Perrin[1] (1999 through 2006), around 20% of firms had at least one lawsuit brought against their directors in the previous ten years, and about 50% of claims made against public companies arise from shareholders.[2] This exposure to liability risk prompts directors and officers to request insurance coverage to protect their personal wealth in the event a lawsuit is brought against them as representatives of the corporation.[3] This insurance, known as directors' and officers' liability insurance (D&O insurance hereinafter), is extremely common in public corporations.[4] Moreover, Link et al. (2009) show that following the Sarbanes–Oxley Act of 2002, directors are busier, meet more often and also assume more responsibilities and risk than before. Consequently, they report that D&O insurance premiums have doubled after the adoption of the Sarbanes–Oxley Act.

Corporate governance and its impact on the risk and return of corporations have been increasingly under the scrutiny of investors. Many governance indices have emerged to fulfill the need for governance risk assessment, but these indices are themselves criticized by academics and practitioners. As underlined in Rose (2007) and Bebchuk and Hamdani (2009), governance indices suffer from many different methodological shortcomings (see Bebchuk et al., 2009, for a recent survey of governance indices). As some governance factors are neither adequately specified nor publicly available (see Baker and Griffith, 2007), one has to wonder how much remains unknown. Bhagat and Bolton (2008) highlight the necessity to account for the endogeneous relationship between governance and performance, which is overlooked by governance indices. Moreover, they also judiciously point out that indices suffer from non-trivial measurement error. Adams et al. (2010) argue that the firm is confronted to myriad of governance related problems and that its governance structure emerges as its best response to those problems. Hence, given the heterogeneity of governance issues faced by the firm, it is unlikely that a unique governance policy is best for all firms. For instance, director independence is not necessarily a desirable feature of a board. As noted in Bebchuk and Weisbach (2010), researchers have a hard time finding a relationship between board independence and performance. Ravina and Sapienza (2009) show that when investing in the firm, independent directors earn abnormal returns of the same order of magnitude as the firm's managers. Independent directors thus benefit from an informational advantage and are close to management, which makes their independent status questionable. Recent work by Wintoki et al. (2011) uses a dynamic panel GMM estimator to tackle the endogeneity problem and examines the board structure and performance relationship. The authors find no causal relationship between the structure of the board of directors and firm performance. These various papers illustrate the faulty methodology employed by governance indices.

We argue in this paper that armed with private information and powerful incentives, insurers should be more apt than governance indices to decipher the adequacy of a firm's governance structure. Indeed, an alternative to using ad hoc corporate governance indices is to use the revealed preferences of corporations that have taken it upon themselves to indirectly obtain a corporate governance assessment when purchasing liability insurance on behalf of their directors and officers. Indeed, because of their direct financial involvement in paying for claims arising against directors and officers, insurers have had to develop appropriate technologies that transform a policyholder's observable characteristics into risk measures which yield an appropriate insurance premium. This is true for any type of coverage, including D&O insurance coverage. As a result, insurance companies that provide liability insurance protection to corporate directors and officers face a strong monetary incentive to correctly measure the potential cost of litigation. To assess this risk, insurers conduct a thorough investigation of the risk faced by firms seeking an insurance policy for their directors and officers.[5] The outcome of this analysis is integrated in the insurance contract.

As litigation against a firm's directors and officers is one of the unfortunate consequences of governance risk, and since insurers have the appropriate incentives to correctly measure the potential cost of litigation against the insured firm's directors and officers, one can thus imagine that the structure of a D&O insurance contract is an unbiased measure of a firm's governance risk, one that does not suffer from measurement error. Indeed, Baker and Griffith (2008) mention that the main risk directors and officers face is associated with shareholder litigation, and the major liability exposure is securities litigation on the basis of misrepresentation. We therefore expect D&O insurance premiums to be closely linked to the firm's governance risk, at least inasmuch as insurers use the correct technology to transform observable characteristics into an insurance premium. The insurance contract therefore provides information on the firm's financial perspectives, the quality of its management team and its “deep governance” features (i.e. its *culture* and *character* as highlighted in Baker and Griffith, 2007).

To test the prediction that insurers are able to measure the potential cost of litigation against a corporation's directors and officers, we would like to gain access to a large database of firm characteristics and control for all that is observable by the insurer, including governance risk. Although D&O insurance characteristics are not publicly available for U.S. firms, a close proxy is to use Canadian data as in Core (1997, 2000), Boyer (2006) and Park Wynn (2008) because Canadian firms typically disclose the D&O insurance protection they purchase to protect their managers.

But this still leaves open the question of whether insurers have the ability to measure governance risk and its impact on the potential cost of litigation. To answer this question, we limit our dataset to Canadian companies that went public[6] through an

[1] The Tillinghast Towers-Perrin surveys report trends in average D&O claims and premiums as well as patterns in insurance purchasing habits for North American firms. Although these surveys are not exempt of selection biases, there is no other consistent information on D&O insurance data. These surveys are now conducted by Towers Watson.

[2] McTier and Wald (2011) show that class action lawsuits prompt firms to significantly reduce agency problems.

[3] Having insurance does not mean that directors are immune to out-of-pocket payments. According to Adams et al. (2010), Enron directors were mandated to pay 13 million dollars (not covered by insurance). The bill for Worldcom directors was $18 million.

[4] According to different Tillinghast Towers-Perrin surveys, approximately 95% of public corporations in the United States and 75% of public corporations in Canada provide such insurance to their managers.

[5] See Knepper and Bailey (1998), Blades (2006) and Baker and Griffith (2007).

[6] Chalmers et al. (2002) also analyzed the demand for D&O insurance by firms that went public through an IPO. They obtained their data for 72 American firms that went public between 1992 and 1996 from a proprietary database.