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Research Report

The materiality of directors' and officers' insurance information: Case for disclosure

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A B S T R A C T

This paper advocates for the regulation of the disclosure of the information contained in directors' and officers' liability insurance policies. To prove the merit of the argument, it is demonstrated that this information meets the disclosure criteria identified in both the SEC Staff "Report on Public Company Disclosure" (2013) and the SEC disclosure concept release "Business and Financial Disclosure Required by Regulation S-K" (2016).

Introduction

In the aftermath of the devastating 2008 crisis, the Securities and Exchange Commission (SEC) attempted to enhance investors' confidence in capital markets by modernizing the U.S. disclosure regime. Specifically, they addressed the insufficiency of publicly available information on corporate risk factors, as the latter were blamed for the 2008 economic crisis (Shareholders Bill of Rights Act, 2009).[1] During last several years, consistent with the Disclosure Initiative,[2] SEC has been conducting a review of Regulation S-K to determine how to streamline disclosure requirements. In compliance with this regulation, on December 20, 2013 the SEC issued the "SEC Staff Report on Public Company Disclosure" (SEC Staff Report hereafter) to Congress, and on April 13, 2016 it issued the concept release "Business and Financial Disclosure Required by Regulation S-K" (SEC Disclosure Concept Release hereafter), which outlines the main objectives and conditions for information disclosure (Securities and Exchange Commission (SEC), 2013, 2016). SEC Disclosure Concept Release affirms that the most effective disclosures are clear, concise, and focused on matters that are both material to investors and specific to the company. It charges management with the responsibility to disclose all material transactions and events as defined and framed by principles-based framework substantive objectives. Altogether, a regime grounded in a principles-based framework aims to foster disclosures that facilitate investors' grasp of a company's present circumstances and future prospects. As such, it is more adaptable over time than one that addresses shifting market demands by adopting prescriptive requirements that run the risk of becoming archaic. Consistent with its "objective-oriented" approach, the SEC classifies materiality as one of the main conditions for disclosure and, as a general rule, defines *materiality* as attribute that could influence the investment decisions of a reasonable investor.[3] To this end, this paper seeks to demonstrate that the information contained in

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[1] The Shareholder Bill of Rights Act (2009) is designed to amend the Securities Exchange Act of 1934 and related rules to impose a number of far-reaching CG mandates, available at http://www.law.du.edu/documents/corporate-governance/legislation/bill-text-shareholders-bill-of-rights-act-of-2009.pdf (retrieved on February 5, 2017).

[2] https://www.sec.gov/disclosureinitiative

[3] For more details on the objective-oriented approach, refer to the Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System issued by the SEC on July 25, 2003. Available at https://www.sec.gov/news/studies/principlesbasedstand.htm (retrieved on August 17, 2016)

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directors' and officers' liability insurance (D&O insurance hereafter) informs investors about a company governance risk, and, thus can be defined as material according to the framework laid down by the SEC (SEC Disclosure Concept Release, 2016). Accordingly, several D&O information features consistent with latest SEC substantive objectives have been identified as principles to inspire a modernized disclosure regime; namely context, credibility, and comparability.

Two parties-in-interest are involved in each D&O insurance transaction, with financial risk and economic uncertainty allocated on both sides: an insurer and a policyholder. D&O insurance operates as a contractual mechanism that spreads the risk of potential shareholder litigation.[4] On the policyholder side, it moves the risk away from individual directors and officers with the ultimate result that they are almost never encumbered with personal liability for corporate losses.[5] In other words, the D&O liability insurance practice is the set of controls and procedures that makes litigation and loss less likely, and, in case the litigation occurs, it reduces the severity of a loss.[6] In this context, D&O insurance can be considered a corporate governance (CG hereafter) feature that can be used as a proxy to measure the level of litigation risk associated with a company. Consistently with the latter statement, Core (2000) argues that D&O premium is higher for the firms with weaker governance quality because they have greater litigation risk.[7] Therefore, the information on insurance provisions is relevant to investors' evaluations of a company's financial position, including potential litigation costs, which is not a trivial issue.[8]

Several potential contra-arguments need to be recognized here. First, some scholars suggest that by mitigating managers' financial responsibility for their wrong-doing, this insurance has a potential to give rise to managerial opportunism, manifesting itself as a moral hazard (Egger, Radulescu, & Rees, 2015). So, it is argued that the disclosure of D&O insurance could be accompanied by an increase in non-meritorious security litigation (Donelson, Hopkins, & Yust, 2015; New York Legislature, 1969). The evidence for this is inconclusive, and the prospect of additional litigation costs remains hypothetical. Moreover, the specialized law firms that drive shareholder litigation have independent methods for evaluation of this information (Griffith, 2006). A second contra-argument is that there are costs to companies associated with additional disclosure (Fogel, El-Khatib, Feng, & Torres-Spellicsy, 2015). However, this study advocates for the disclosure of already available data included in the existing insurance policy; thus, the cost of such additional disclosure should not be insignificant. Finally, the case for additional disclosure could be seen as conflicting with the SEC's current attempt to streamline the amount of disclosure reported by companies (Disclosure Effectiveness Initiative). In response, a couple of important points can be made. First, the importance of the CG information for investors has been demonstrated in the literature that reports the market reaction to CG disclosure (Irani & Karamanou, 2004). Also, despite the lengthy "Risk Factors" disclosure in the initial offering documents and annual reports, it is still challenging to extract the firm-specific information associated with CG features.[9] Therefore, the disclosure of D&O insurance data, which are derived from assessments of CG, will significantly reduce the costs of the search for private information in the capital market.

The rest of the paper is structured as follows. The second section discusses the D&O insurance relevance to company risk. The third and fourth sections respectively establish the credibility and comparability of the information presented in the D&O insurance. To make an argument for the materiality of this information for the investors, the fifth section examines the shielding function of D&O liability insurance and explains its association with managerial opportunism. The sixth section discusses additional corporate motivations to purchase D&O insurance. Lastly, this study concludes with a discussion of the results and their implications for stakeholders in the capital market.

The D&O information disclosure context

To support the efficacy of D&O information disclosure, this section provides sufficient context to understand the importance of this disclosure. Particularly, it demonstrates the relevance of this information to understanding a company's financial position and risk.

A corporation insures directors and officers for potential legal expenses associated with a settled lawsuit, when a bad faith was neither admitted by a director or an officer, nor found by the court of law, if a lawsuit went to court (Romano 1991; Boyer & Tennyson, 2015). The firms purchase D&O insurance coverage to reimburse directors' and officers' defense costs and settlement, which arise from a litigation that are not allowed to be indemnified by a corporation (e.g., certain shareholder derivative lawsuits) or, when a corporation is unable to indemnify (e.g., a corpo-

[4] Overall, a key purpose of D&O insurance is to fill the financial vacuum, if indemnification is unavailable or a corporation is unable to insure directors and officers for the costs associated with litigation (Gibson, Dunn & Crutcher 2013; Cao & Narayanamoorthy, 2014; Boyer & Tennyson, 2015; Romano 1991). For instance, indemnification may not be available in case of a derivative suit, because of the so called circular transfer of funds that violates public policy (Gibson, Dunn & Crutcher 2013). Circular transfer of funds is the situation when a corporation ends up paying out amounts recovered by or on the behalf of the corporation, but actually paid by the same corporation.

[5] It should be noted that according to recent studies directors can also suffer enormous loss of personal wealth from stockholders litigation in cases where they did not act in good faith. For example, the information related to the infamous Enron and WorldCom cases suggests that the directors in each company paid $13 million and $24.75 million in out-of-pocket costs, respectively (Alles, Datar, & Friedland, 2005; Bradley & Chen, 2011).

[6] https://wsandco.com/do-notebook/sec-corporate-governance-disclosure-social-policy/.

[7] Core (2000) performs two-phase empirical test to support his argument that D&O premium contains information pertinent to governance structure quality. He reports that excess of the CEO compensation is significantly higher for the firms with higher D&O premiums relative to their business risk. Overall, he "provides confirmatory evidence that the D&O premium reflects the quality of the firm's CG (p. 249)."

[8] See the reports on the litigation costs in Towers Watson (2013) survey (NYSE, NASDAQ: TW); Tillinghast-Towers Perrin (2005, 2006, 2007).

[9] Available at https://www.sec.gov/news/speech/chair-white-icgn-speech.html#_ftn4, retrieved on August 17, 2016.

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