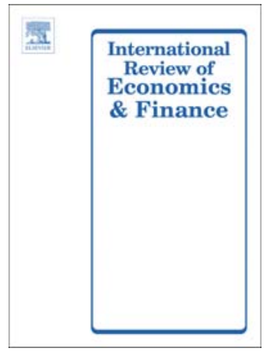

Directors' and Officers' Liability Insurance and the Sensitivity of Directors' Compensation to Firm Performance

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ABSTRACT

The fundamental idea of directors' and officers' (D&O) liability insurance is to provide liability protection to boards of directors and executive officers against accusations of wrongful acts in their capacity. This paper shows that although directors' compensation and firm performance are positively correlated, D&O insurance significantly weakens this positive relationship. Therefore, instead of providing positive incentive to boards of directors, D&O insurance may actually worsen the agency problem, which is very different from the essential idea and purpose of implementing this insurance. Specifically, with 5,619 firm-year observations of 1,236 listed firms in Taiwan during the period from 2008 to 2012, we show that D&O insurance reduces the sensitivity of directors' compensation to firm performance by approximately 42 percent for the insured firms. As a result, instead of alleviating agency problem, D&O insurance actually increases firms' agency costs. Our results are robust to alternative measures of directors' compensation, alternative measures of D&O insurance, firms' corporate governance quality, firm size, firm risk, industry characteristics, CEO's power, and different sample selections.

Keywords: Directors' and officers' liability insurance, D&O insurance, Pay-performance sensitivity, Agency costs, Directors' compensation, Shareholder wealth, Taiwan