Pacific-Basin Finance Journal 29 (2014) 18–34

Contents lists available at ScienceDirect

Pacific-Basin Finance Journal

journal homepage: www.elsevier.com/locate/pacfin

Directors' and officers' liability insurance and investment efficiency: Evidence from Taiwan

Kuei-Fu Li [1], Yi-Ping Liao *

Department of Accounting, Ming-Chuan University, 250 Zhong Shan N. Rd., Sec. 5, Taipei 111, Taiwan

ARTICLE INFO

Article history:
Received 12 June 2013
Accepted 3 March 2014
Available online 12 March 2014

JEL classification:
G22
G31
G32

Keywords:
Directors' and officers' (D&O) insurance
Corporate governance
Insurance companies
Investment efficiency
Managerial opportunism

ABSTRACT

Prior studies suggest that directors' and officers' (D&O) insurance induces moral hazard and reduces incentives on behalf of stockholders. As a result, we argue that purchasing D&O insurance exhibits lower investment efficiency. Using data from Taiwan between 2008 and 2010, which is mandatorily disclosed and thus serves as an ideal sample, we test for an adverse relation between D&O insurance and investment efficiency and explore factors that affect the magnitude of that adverse relation. The results show that the level of D&O insurance coverage is positively associated with over-investment. Further analyses suggest that the positive association is more pronounced in firms with lower levels of director ownership or institutional holdings and weakened when firms purchase from domestic rather than foreign insurers. Overall, we conclude that D&O insurance has an impact on corporate investment decisions, especially in terms of over-investment, and that better corporate governance mechanisms help mitigate the inefficiency problems caused by D&O insurance.

1. Introduction

The use of directors' and officers' (hereafter D&O) insurance is now widespread in North America, Western Europe, and Asia, and this market around the world, estimated by Allianz Global Corporate & Specialty, is worth $10 billion in written premiums.[2] D&O insurance policies offer liability cover for executives to protect them from claims that may arise from the decisions made and actions taken within the scope of their regular duties. Thus, D&O insurance helps in recruiting and retaining excellent directors and allows directors and officers to take appropriate actions for the benefit of shareholders. However,

* Corresponding author. Tel.: +886 2 28824564x2157.
E-mail addresses: kfli@mail.mcu.edu.tw (K.-F. Li), ypliao@mail.mcu.edu.tw (Y.-P. Liao).
[1] Tel.: +886 2 28824564x2166.
[2] Refer to http://www.agcs.allianz.com/assets/PDFs/risk%20insights/AGCS-DO-infopaper.pdf.

http://dx.doi.org/10.1016/j.pacfin.2014.03.001
0927-538X/

giant Berkshire Hathaway, the eighth largest public enterprise in the world, does not provide liability insurance for its own directors. Warren Buffett, the company's chairperson and CEO, stated, “We do not provide them directors and officers liability insurance, a given at almost every other large public company. If they mess up with your money, they will lose their money as well.”[3]

Recent studies have responded to Buffett's statement and provided valuable insights into the role of D&O insurance. They have examined the association between D&O insurance and (1) post-IPO stock performance, (2) stock performance following merger and acquisition (M&A) acquisition announcements, and (3) financial reporting decisions and suggested that D&O insurance causes managers to engage in excessive risk-taking at the expense of the firm or to report financial performance aggressively because the managers' expected legal liability is reduced via D&O insurance (Chalmers and Harford, 2002; Chung and Wynn, 2008; Lin et al., 2011; Wynn, 2008). In addition, investors perceive D&O insurance negatively, and firms with high D&O insurance coverage experience high capital costs (Chen et al., 2012; Lin et al., 2013). While most studies have indicated that D&O insurance induces severe moral hazard from the investors' perspective, little is known about whether D&O insurance has an adverse effect on internal corporate decisions. Accordingly, this study extends this research stream to capital investment decisions and provides the first empirical evidence on three important research questions: (1) whether an association between D&O insurance coverage and investment efficiency exists; (2) whether a positive association between D&O insurance coverage level and investment inefficiency exists and whether that association is more pronounced for firms with a low level of director ownership or institutional holdings; and (3) whether the characteristics of insurers affect the association between investment efficiency and D&O insurance.

These research questions are important on several grounds. First, we focus on investment efficiency because prior studies argue that agency problems may cause managers to implement inefficient investment decisions (e.g., Jensen, 1986; Lambert et al., 2007; Myers and Majluf, 1984). In addition, firm value is enhanced by investing efficiently in productive assets (Stulz, 2000). Managerial opportunism in investment decisions encompasses over-investment and under-investment; the former refers to a situation in which some positive net present value projects are foregone, and over-investment is a situation in which some negative net present value projects are undertaken. This study will provide evidence of both.

Second, although prior studies have argued that D&O insurance enhances opportunistic managerial behavior, it remains unresolved whether there exists a disciplinary measure to mitigate such moral hazard. We fill this gap by focusing on the internal corporate governance mechanism represented by ownership, which is generally contended to affect corporate investment efficiency. More specifically, it is well-documented that the agency problem that arises when executives hold only a fraction of the ownership shares of the firm (Jensen and Meckling, 1976) can be alleviated by increasing directors' ownership to align the interests of managers with those of shareholders (Jensen and Meckling, 1976; Ferreira and Matos, 2008; Francis and Smith, 1995; Richardson, 2006),or enhancing shareholders' monitoring function, a role that is usually played by institutional investors (e.g., Agrawal and Mandelker, 1990, 1992; Bushee, 1998; Shleifer and Vishny, 1986). In combination, we investigate how the ownership structure affects the relation between D&O insurance and investment efficiency.

Third, two competing hypotheses about D&O insurance have been studied in the literature. The first is the opportunism hypothesis, which posits that directors and officers do not behave in the interests of shareholders since their potential liability can be covered by D&O insurance. The second one is the monitoring hypothesis, which argues that firms buying D&O insurance are screened thoroughly by insurers, and as a result, D&O insurance helps ensure that directors pursue the interests of shareholders (Holderness, 1990; O'Sullivan, 1997). Most empirical studies have been supportive of the opportunism hypothesis. However, this does not refute the existence of the monitoring role of D&O insurance. Baker and Griffith (2006) argue that the absence of monitoring is due to a lack of adequate knowledge and experience on the part of the insured. Otherwise, compared to local insurers, foreign insurers take low pricing strategies instead of a product differentiation strategy to increase market share (Choi and Elyasiani, 2011). This study, therefore, informs the debate by providing a deeper analysis of the question of whether the monitoring effect is merely theory-oriented or is driven by the characteristics of insurers.

We focus on firms listed on the Taiwan Stock Exchange (TWSE) and the GreTai Securities Market (GTSM) between 2008 and 2010 because disclosures of D&O insurance have been publicly available since

[3] Refer to http://www.insurancejournal.com/news/national/2011/02/28/188339.htm.