

Assessing Demand for Directors' and Officers' Insurance Using Public Information

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One of the most important duties of a corporate director is look after the financial wellbeing of the firm's stakeholders, and in particular of the firm's shareholders. Independently of the directors' behavior, talent and effort, shareholders may still suffer a financial loss because of a director's mistake. When asked to intervene, it is the forensic accountant's task to separate the mistake, for which the director is liable, from the unfortunate business decision, for which the director is not. Although directors are technically personally accountable for such mistakes, many require protection from lawsuits so that their personal assets are not expropriated. The goal of this article is to assess why corporations purchase directors' and officers' liability insurance (D&O), and how the contract parameters are chosen. Using publicly available information from Canadian corporations, I find that the decision to insure as well as the amount of coverage purchased (policy limit and deductible) are mostly driven by the previous year's decision and unobservable firm characteristics. In fact, apart from the directors' total compensation, a corporation's fundamentals (either financial and or governance-related) do not appear to have much impact on the decision to purchase directors' and officers' insurance nor on the amount of insurance to purchase.

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1 INTRODUCTION AND MOTIVATION

As representative of the corporation directors and officers are liable for actions committed by the corporation. More importantly, they are *personally responsible* for actions taken in the name of the corporation. This means that their personal wealth is at risk in the event of a lawsuit against the corporation and its management. One way for a corporate director to protect his personal wealth is to have the corporation buy insurance on his behalf. This insurance is known as directors' and officers' (D&O) liability insurance.

Directors argue that this insurance is essential for them to accept to sit on the firm's board. One reason is that they may be caught up in events that are out of their control. Forensic