

The effect of D&O insurance on managerial risk taking

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VALORISATION

1. Introduction

Pursuant to article 23 of the 2013 Regulation governing the attainment of doctoral degrees of Maastricht University an addendum shall be added to the dissertation about valorisation.

Regarding appendix 4 of the 2013 Regulation, valorisation is defined as *“the process of creating value from knowledge, by making knowledge suitable and/or available for social (and/or economic) use and by making knowledge suitable for translation into competitive products, services, processes and new commercial activities.”* It stipulates that *“examples include ... co-publications with social and/or economic stakeholders, publications in journals and newspapers, non-academic publications, appearances in the media, contributions to public debates, advice for social organisations or companies, projects for the SME portal, policy recommendations for governments, training programmes for professionals, ... spin-offs and start-up companies...”*

Appendix 4 lists questions that shall serve as a guideline, which are: What is the social (and/or economic) relevance of your research? To whom other than researchers are your research results of interest? Into which concrete products, services, processes, activities or commercial activities will your results be translated and shaped? To what degree can your results be called innovative in respect to the existing range of products, services, processes, activities and commercial activities? How will this/these plan(s) for valorisation be shaped?

The following will briefly address these questions with respect to my research.

2. What is the social (and/or economic) relevance of your research?

The research question of my thesis is how D&O insurance affects managerial risk taking. Risk taking of managers is considered paramount to a well-functioning economy and the development of society. The EU seeks to promote entrepreneurship and is currently working on a new framework on how to deal with the stigma of bankruptcy. Yet, as the case of Lehman Brothers has shown, excessive risk taking is associated with corporate failure and even economic crises.

The economy has to carefully balance these effects. According to law and economics theory, liability of managers could deter managers from taking excessive risks. In this context, countries such as the Netherlands consider implementing further criminal liability rules to discipline the manager. The USA and Germany are already one step ahead. In the USA, holding the manager liable on the basis of securities class actions is common practise. In Germany, criminal liability rules during bankruptcy proceedings against the manager are far reaching.

Still, the thesis argues, in line with numerous scholars, that complex (and possibly harsh) liability rules may chill the manager's willingness to seize risks that are beneficial to society. In this regard, the regulatory practices mentioned above would be counter-productive, if these countries want to promote entrepreneurship and innovation.

This thesis outlines how far insurance for managerial liability (called Directors' & Officers' insurance or D&O insurance), the less prominent affiliate to liability, may be equipped with the necessary tools to both prevent opportunism and promote efficient risk taking of the manager. In fact, a properly functioning D&O insurance system may more elegantly incentivize adequate managerial risk-taking than for example, direct regulation of managerial activity (e.g. disqualification) or the adoption of harsher liability rules.

This thesis argues that the D&O insurance seems to alter the risk taking of the manager. Yet, a change of risk taking does not necessarily mean that managers take excessive risks. Some observations actually suggest that an insured manager rather takes into account creditors' interests.

In this context, this thesis provides an insight into how D&O insurance influences managerial risk taking and in how far that could benefit society and the economy.

3. To whom other than researchers are your research results of interest?

Policy makers should be interested in the outcome. The thesis advocates three aspects to them. First, law makers should refrain from further regulating the liability system as it seems to chill the manager. The thesis suggests that managers exposed to higher liability risks take fewer business risks. However, the society needs managers that take the right amount of risks. Further regulation on liability endangers the effective risk taking of managers.

Secondly, this thesis demonstrates that the nature of national bankruptcy laws tends to prohibit effective D&O insurance for smaller corporations. Yet, empirical evidence suggests that, in times of financial instability, D&O insurance should be desired over other compensation measures in order to safeguard firm performance. This raises questions as to what extent the effect of current bankruptcy law is socially desirable and whether D&O insurance should be made compulsory for smaller corporations. The policy maker is called to evaluate whether a change of current bankruptcy laws

and/or compulsion of the D&O insurance for smaller corporations is desirable and feasible.

Thirdly, D&O insurance can also signal an IPO over-evaluation and empire building of the manager. In this regard, this thesis advocates that some basic, but not all, information on D&O insurance should be published in the USA, the UK, the Netherlands and Germany to publicly show this signal. The policy maker has the task of proposing relevant legislation in this respect.

Other parties, besides the law maker may also benefit from the research. Generally, parties involved in the market of D&O insurance may apply some of the arguments and findings to their everyday practice. Managers could apply some of the arguments to convince the shareholders and/or the supervisory board, why D&O insurance is a valuable expense.

Corporations may find the effect of D&O insurance on managerial risk taking beneficial. By purchasing D&O insurance and publishing the relevant data on it, corporations could show their approval of the general movement of transparency, accountability and corporate governance quality.

Insurers, not yet offering D&O insurance policies, could use the findings as a starting point to make the necessary calculations and draw up the relevant insurance contracts. As the thesis summarized a great deal of factors that correlate to the insured D&O risk, coverage limits, deductibles and premiums, insurers may have a simpler entry in a market that is very competitive. Moreover, the list of clauses commonly used in D&O insurance contracts and the explanations to these clauses may save these insurers time and effort, when entering into negotiations with the relevant insured party.

Financial institutions such as banks and investors have been suspicious with respect to D&O insurance. Many associate it with moral hazard and the manager's lack of accountability. While some of these assertions are correct (i.e. the effect of D&O insurance on IPO evaluations and empire building), this thesis also demonstrates the benefits of D&O insurance. Especially banks seem to profit from D&O insurance and offer insured corporations a favourable interest rate, provided that the coverage limit is average. Also investors may profit from D&O insurance in the long run. Some empirical evidence suggests that the decision-making of the manager with respect to value enhancing projects increases when the manager is insured and the corporation is under high competitive pressure.

In general, the findings of the thesis suggest that, under some conditions, stakeholders, such as creditors, victims and the public in general are better off with D&O insurance than without it. Yet, this thesis also argues that the desirability of the common settlement practice of D&O insurers should be further scrutinized. Settling may be effective. Still, it remains questionable whether the undisclosed resolution of conflicts by settlements

could impede the necessary dialogue between society and managers about managerial duties and risk taking.

Into which concrete products, services, processes, activities or commercial activities will your results be translated and shaped. To what degree can your results be called innovative in respect to the existing range of products, services, processes, activities and commercial activities?

I believe that the effect of D&O insurance has a particular resonance to it that makes it certainly fit for publications in journals, newspapers or in other forms of the non-fiction genre.

I am sure that the research provides a great insight to the benefit of SMEs. It can serve as a foundation with regards to policy recommendations for governments. As mentioned above, this thesis offers issues to the policy maker that should be tackled in the near future. As argued, widening the legal possibilities to indemnify a manager and promote D&O insurance could foster the sustainability of start-ups.

4. How will this/these plan(s) for valorisation be shaped?

The thesis raises issues that have the potential to create value from knowledge. I am happy to take part to put into practice any of these topics.

First, this thesis argues that insurance for the indemnification risk may be socially desirable. A market of insurance for the indemnification risk seems to exist. The knowledge of this thesis for increasing the effectiveness of managerial risk taking can benefit many parties involved (corporations, shareholders, creditors, managers, insurers, other stakeholders). On the basis of this knowledge, one could prepare promising new business models.

Secondly, this thesis argues that society would benefit from D&O insurance. In this regard, the thesis presents the foundation for a more effective, educated and cultivated approach towards D&O insurance. On the basis of this thesis, transnational and empirical studies could be conducted (i) into what extent the effect of bankruptcy law on D&O insurance is socially desirable, (ii) whether D&O insurance should be made compulsory for judgement-proof corporations, and (iii) whether new technology effectively encourages re-insurance.

Thirdly, this thesis argues that the publication of the D&O insurance data should be stimulated. One could market the identified data sets to risk analysts. The data would enlarge their knowledge on the effect of D&O insurance and thus enhance the thoroughness of their analyses on corporate share value.

Fourthly, the thesis points to the question of to what extent the insurer's settlement practice is socially desirable. In this regard, events and conferences with experts, practitioners and representatives of society could be organised. The questions and suggestions of this thesis could serve as a foundation for revealing discussions during these events.