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Directors' and Officers' Liability Insurance, Managerial Compensation and Firm Performance

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A B S T R A C T

While the debate on whether directors' and officers' liability insurance (DOLI) enhances monitoring, corporate governance, and improves firm performance remains alive, existing research lacks consideration of the self-selection of firms' demand for DOLI, and thus incurs self-selection estimation bias. This research corrects for self-selection bias in estimating the linkage between a firm's DOLI coverage, managerial compensation and firm performance by applying Rubin's (1973, 1977) matching theory, and propensity score matching by Rosenbaum and Rubin (1983, 1985a,b). Four matching algorithms, Nearest Matching, Caliper Matching, Mahalanobis Distance Matching and Mahalanobis Distance Matching with Caliper are applied to match financial characteristic variables determining firms' demand for DOLI. Based on data of TWSE-listed nonfinancial companies covering the period of 2008~2010, empirical evidence shows that, before matching, firms with DOLI do not have superior profitability but have higher managerial pay. After matching, evidence shows that underperformance in profitability and higher managerial pay of firms with DOLI still prevails. The principal outcome is consistent with a negative view of DOLI, such that DOLI coverage incurs a moral hazard problem associated with managerial overpay and deteriorating firm performance.

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