ABSTRACT

One interesting but little explored research area—primarily due to limited data availability—is the link between managerial opportunism and Directors' and Officers' (hereafter D&O) liability insurance. Using an original Canadian database built from scratch, this dissertation contains three chapters investigating this relation in an unexplored market: The equity offerings in the secondary market.

In the first chapter, we present the corporate insurance theory as a background for the study of D&O insurance as well as the rationale behind D&O insurance. We also describe in details the basic features of D&O insurance such as the policy structure, the market, and the premium assessment. Finally, we discuss the major differences of legal environments between Canada and the U.S with regard to D&O insurance.

In the second chapter, we test the managerial opportunism hypothesis in a new context: The purchase of D&O insurance around the time when Canadian firms are getting ready to proceed with their seasoned equity offerings (SEOs). The Canadian context is interesting mainly because the reporting of D&O insurance details is mandatory. We examine whether informed managers *modify* their behavior regarding the purchase of D&O insurance when their firm are about to sell SEOs. After controlling for other cross-sectional determinants of D&O insurance coverage, we find a significant negative relation between the amount of D&O insurance purchased and subsequent firm performance. This result is surprising because the imposition of a public disclosure is supposed to make the D&O insurance purchases a useless tool for extracting private benefits from private information. As a further test of managerial opportunism, we investigate the premiums paid around the announcement date. If the insurers are able to distinguish managerial opportunism from genuine coverage, they will be able to charge larger insurance premiums on managers that try to cover themselves from the misfortunes of issuing overvalued stocks. The empirical evidence shows that D&O insurers are unable (or do not attempt) to charge more expensive premiums to firms that

exploit private information or that abnormally increase their insurance coverage for whatever reason. However, when we use a three-stage least squares (3SLS) model to control for the potential simultaneous determination between D&O insurance coverage and premium, we find results that support our expectation of a negative relation between D&O insurance premium and abnormal future performance. Finally, we do not find any support to the prediction that lower D&O insurance premiums are associated with good corporate governance quality. One major implication of this essay is that the imposition of a mandatory reporting does not alleviate the opportunistic behavior of managers through the purchase of D&O insurance.

In the third essay, we investigate whether D&O insurance influences earnings management practices undertaken by managers around SEO announcement dates. It is plausible to expect that managers are more willing to engage in opportunistic behavior by adopting aggressive earnings management strategies when they are covered by relatively higher D&O insurance limit. Our study examines whether D&O insurance coverage predicts the cross-sectional variation in earnings management measures. However, using the standard approach to test the relation between D&O insurance and earnings management practices can be misspecified, because D&O insurance coverage can be also purchased in anticipation of opportunistic behavior. In this paper, we take into account the endogenous nature between earnings management and coverage in the particular context of secondary equity offerings. Moreover, we investigate to what degree are insurers able to price the risk of opportunistic earnings management in accounting choice around offering date in their premiums charged to firms issuing equity offerings. We find a reliable association between D&O insurance and earnings management practices. We also find that D&O insurers detect managerial opportunistic behavior, and price it accordingly in the premiums charged to insured firms. Furthermore, we address some hypotheses that are not tackled in the existing literature: (a) We examine the impact of the inclusion of provincial CDRP on the opportunistic earnings management and on D&O insurance premiums. We find that the provincial CDRP adoption is ineffective in alleviating opportunistic earnings management, but contribute to the D&O premium

reduction. (b) We investigate the effect of the D&O insurance market cycles on the managerial opportunism. The empirical evidence shows that neither the managerial opportunism in accounting choice, nor the pricing of D&O premiums is affected by the D&O insurance market cycles.

KEYWORDS: Directors' and Officers' liability insurance, managerial opportunism, seasoned equity offerings, long-term performance, earnings management, mandatory disclosure.