The Impact of Firm and Industry Specific Risk on Outside Director Contracts

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Abstract

This paper uses the principal-agent framework to determine the optimal outside director contract offered by a shareholder to a potential director to serve on the board of a corporation. It is found that firms with more inherent risk in their operations must provide directors with a larger salary for a given level of insurance coverage to make them indifferent between serving on the board of a high risk or low risk corporation when the lawsuit is treated as endogenous. The model uses the assumption of a risk averse principal (shareholder) seeking to employ a risk averse agent (outside director). The optimal contract which is offered to the outside director includes a combination of both a salary and a D&O liability insurance policy. It is determined that the shareholders purchase D&O insurance for the dual role of enticing a director to accept an employment contract, but also to smooth shareholder earnings across different states of the world. The latter conclusion provides rationale for the purchase of a D&O insurance policy when the lawsuit is treated as endogenous in the model.