

Governing kidnap for ransom: Lloyd's as a “private regime”

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Abstract

Kidnap for ransom raises significant governance challenges. In the absence of formal regulation and enforcement, insurers have created an effective private governance regime to facilitate smooth commercial resolutions. Controlling ransoms is paramount: “supernormal” profits for kidnapers create kidnapping booms and undermine the market for insurance. Ransom control requires cooperation, but there are high transactions costs in enforcing a collusive agreement. The Coasean prediction is that a single firm will form to internalize the externalities arising from lax insurance and mismanaged ransom negotiations—or a government must order the market. There is indeed a single source of kidnap insurance: Lloyd's of London. Yet, within the Lloyd's market several insurers compete for business. Lloyd's is a club providing private governance: Its members issue standard contracts, follow the same regime for kidnap resolution, and exchange information to stabilize ransoms. Lloyd's, therefore, combines aspects of Coase's “single firm” and “government” solution to the externalities problem.

1 | INTRODUCTION

The owner-manager of a Mexican company is abducted at gunpoint. A ransom of US\$1 million is demanded with a threat of mutilating the hostage. His kidnap for ransom insurance is activated. A crisis response consultant coordinates a crisis management team with the hostage's brother as the only point of contact with the kidnapers. The consultant advises that previous cases in this area have settled for around US\$100,000 and that “we have yet to actually receive an ear. . .” The brother makes an initial cash offer of US\$40,000 citing liquidity problems at the firm. This is progressively raised, but in decreasing increments. After 16 days the wife tearfully pawns her engagement and wedding rings to bring the total offer to US\$99,814. The kidnapers accept, the crisis responder manages the ransom drop, and the hostage is safely released (Interview IV).

An aid worker is kidnapped in Yemen. Unbeknownst to the family, the NGO's strategic risk management plan includes kidnap for ransom insurance. Within 24 hr, a crisis response specialist convenes

a crisis management team of senior staff to conduct the negotiation with the kidnappers. He personally assures the family that “. . . everything will be done to ensure the timely and safe return of the hostage.” The NGO is advised to negotiate, but to stall and reject the ransom demand of US\$500,000. A former SAS officer bases himself in war-torn Aden to open indirect negotiations with tribal elders. After 36 days, the local sheik indicates that the hostage could be released in exchange for a new generator for his village. The NGO agrees, the unharmed hostage is released, and the NGO operates undisturbed afterward (Interview IV).

Kidnapping is a major (if largely hidden) criminal market, with an estimated total turnover of up to US\$1.5 billion a year (Catlins, 2012; *The Economist*, 2013; *The Independent*, 2010).¹ Transnational kidnaps, where the victims are foreign tourists, high-net-worth local residents insured by multinational insurers, and the employees of foreign enterprises, are scary one-off events for almost all families and most firms. Ransoming hostages is beset with trust and enforcement problems. Kidnappers seek to maximize ransoms and can employ extreme violence to pressurize stakeholders to reveal their assets. Law enforcement may prepare rescue operations while families (pretend to) negotiate a ransom. Any sequential payment process is potentially problematic, but ransom drops can fail even if both parties act in good faith. Kidnappers need not release (live) hostages after payment and may demand multiple ransoms (Clutterbuck, 1987, Lopez, 2011; March, 1988). Yet, despite these considerable difficulties—and contrary to general perceptions based on newspaper headlines—the vast majority of transnational kidnap victims survive and most cases conclude relatively quickly (Control Risks, 2016). This indicates the existence of an effective governance regime.

Reliable, discreet, and orderly commercial kidnap resolutions underpin the rising global demand for kidnap insurance, which enables companies to operate in weakly or corruptly governed territories with high kidnap risks (*The Economist*, 2013; Fink & Pingle, 2014; Kenney, 2008). The case examples above, based on interviews conducted for this research, illustrate key aspects of how the trade in hostages is ordered. Professional crisis response consultants—retained by insurers—inform and coordinate the stakeholders’ response. They focus on the minimum ransom kidnappers will settle for rather than the maximum stakeholders can raise. They have an arsenal of strategies to slow down negotiations, manage kidnapper expectations, and counter threats of violence. However, it is not enough to order individual transactions on behalf of the insured. Premium ransom payments (while individually rational) have the potential of destabilizing the market for kidnap for ransom insurance. This externality needs to be internalized. This article uses Cosean reasoning and club theory to analyze how competing insurers cooperate to provide effective governance in this criminal market (Coase, 1960; Stringham, 2015).

There is a growing literature on private and self-governance in political science and related disciplines. Private governance is common where government and law enforcement are absent or uninterested in protecting private property rights. Alternatively, people may “opt out” of the legal process if it is too slow, too public, erratic, expensive, or unsophisticated to resolve disputes (Bernstein, 1992; Stringham, 2015; Williamson, 1996). Many scholars study private governance for trades and joint enterprise between legal entities. Cutler, Haufler, and Porter (1999a) provide an overview of a wide range of private governance regimes, where experts or firms cooperate to order and facilitate international and online transactions. Governments can only enforce laws domestically and agents creating effective private governance regimes reap the gains of greater efficiency or market dominance (Stringham, 2015). Bernstein (1992), Greif (1989), Leeson (2006, 2011), Munger (2010), and Stringham (2015) study how sophisticated institutions incentivize cooperation without government regulation, adjudication, and enforcement. The predominant strategy is to create a credible threat of excluding opportunistic and rogue traders from future transactions—or significantly reducing their profits from doing so. Conversely, there is the literature on the governance of criminal markets (reviewed in Varese,

2014). In the gray and illegal economy, the protection of property rights and contract enforcement is delivered by Mafias, prison gangs or armed militias (Gambetta, 1993; Leeson & Rogers, 2009; Shortland & Varese, 2016; Skarbek, 2011, 2014; Varese, 2001). Here, the credible threat of violence against rogue traders (largely) keeps opportunism in check.

This paper analyzes the ordering of trades between criminal enterprises and legal entities. Stolen assets may be valued most highly by their original owners—for example, hostages, hijacked ships, and art objects. Trade between criminals and original owners may thus be Pareto optimal and insurers may have an economic interest in facilitating it. A sophisticated insurance industry has developed in response to the risk of transnational kidnaps—related to the “political risk” insurance that underpins much of global commerce (Haufler, 1997, 1999). Risk-averse families, NGOs, and firms employing staff in complex and hostile environments often buy insurance to help resolve and defray the cost of kidnaps (Fink & Pingle, 2014; Kenney, 2008; Lobo-Guerrero 2007).

Legally, ransoms can only be insured for criminal kidnaps: It is illegal to pay, facilitate, or reimburse terrorist ransoms (Section 17A of UK Counter-Terrorism and Security Act 2015). However, 80% of reported global kidnaps in 2015 were considered criminal (Control Risks, 2016). Commercially, kidnap insurance is only viable under three (related) conditions. First, kidnaps should be nonviolent and detentions short—otherwise, individuals and firms withdraw from high-risk areas (Pshisva & Suarez, 2010; Rodriguez & Villa, 2012). Second, insurance premia must be affordable. Although insurance is only demanded if people are concerned about kidnapping, actual kidnaps must be rare, and ransoms affordable. Insurers struggle in kidnapping hotspots: High premia deter potential customers. *The Guardian* (2014) provides a ball-park figure of “. . . \$250,000 a year for multinational firms working in dangerous places.” Where the threat is severe—for example, Mali—firms may be charged as much as “\$1500 per day per employee.” The type of operation that can afford such insurance premia could also self-insure. Third, ransoms and kidnap volumes must be predictable and premium income must cover (expected) losses (Haufler, 2009). If kidnapping generates supernormal profits, more criminals enter the kidnap business. Premium ransoms quickly generate kidnapping booms (Hagedorn Auerbach, 1998; United Nations, 2013; Wright, 2009). Insurers, therefore, have a common interest in ordering transactions and preventing ransom inflation.

Section 2 shows that in many established kidnap hotspots, ransoms are indeed surprisingly low and stable. However, impatience and badly managed ransom negotiations can quickly undermine a low ransom equilibrium. Containing ransom payments is expensive. Offering a high ransom can result in a faster release, reducing negotiation costs and risks for the hostage (Ambrus, Chaney, & Salitskiy, 2014). But high returns to kidnapping may trigger a kidnapping boom and ever-rising ransom demands. Unlike other insurance markets, kidnap insurers cannot individually establish reputations for low settlements: Revealing their presence in negotiations raises kidnapper expectations (March, 1988). Premium ransoms thus create externalities—and managing them requires cooperation between competing firms.

To analyze how this cooperation may be achieved, Section 3 draws on the transaction cost literature (Williamson, 1989, 2002) and Coasean reasoning (Coase, 1960, 2012). Insurers might form a buyers’ cartel to set maximum prices for hostages. Indeed, “ransoming cartels” were formed to negotiate prisoner of war releases in the 17th and 18th centuries (Frey & Buhofer, 1988). However, contracts between insurers to limit ransoms would be unenforceable. It would be very costly to prove that a high ransom was paid because an insurer cut corners, leaving a cartel agreement vulnerable to “chiselling.” The most efficient market structure is therefore a single firm, which fully internalizes the externality, or a government that enforces cooperative behavior (Coase, 1960).

Section 4 takes a detailed look at the market for kidnap insurance to reveal that kidnap insurance is indeed controlled by a single enterprise: Lloyd’s of London. Yet within Lloyd’s there are around 20 international syndicates underwriting kidnap for ransom insurance. The syndicates compete for

business according to clear protocols regarding how insurance contracts are structured, how information is (discreetly) exchanged, and how ransom negotiations are conducted. Lloyd's is a "private regime" in the sense of Cutler, Haufler, and Porter (1999b, p. 13): a complex set of formal and informal institutions that provides the governance for a specific economic issue area. As the necessary rules and protocols cannot be easily codified and enforced through the legal system, Lloyd's operates as a "club" for the provision of private governance (Stringham, 2015). This solves the externalities problem while facilitating competition between insurers. Section 5 provides evidence how Lloyd's syndicates voraciously internalize externalities—including those arising from uninsured risks—to make kidnap for ransom insurable. However, this private regime is undermined by myopic, cash-rich governments paying multimillion dollar ransoms to terrorist organizations (*New York Times*, 2014).

Specialty insurance and kidnap resolution are by necessity discreet operations. If firms or individuals are known to have insurance, moral hazard problems arise; kidnapers might target insured individuals specifically and their ransoms expectations escalate (March, 1988; Ochoa, 2012). Specialty insurance is usually "bespoke": Prices vary according to who is insured, for what purposes, the number of people exposed to risk, the risk environment, risk mitigation measures, previous incidents, and so forth (Lobo-Guerrero, 2007; Merklung & Davis, 2001). This secrecy makes it infeasible to collect representative, quantitative data on who buys insurance from whom and at what price. Most of the evidence presented below is open source information from insurance companies and the Corporation of Lloyd's. Some ransom data were provided by the business risk consultancy Control Risks. In addition, I conducted 16 in-depth interviews of 1 to 3 hr with employees of different crisis response companies, victims, insurers, and lawyers involved in kidnap resolution—see the Appendix for details. Several individuals agreed to be reinterviewed or provided additional information by e-mail, allowing me to cross-check information and confirm the validity of my findings. As most informants chose to remain anonymous, I used open source information from the insurance sector, crisis response companies, governments, NGOs, memoirs of ransom negotiators, and newspaper articles to cross-reference the interview information.

2 | RANSOM DISCIPLINE

Insured transnational kidnap cases generally settle for surprisingly small amounts relative to the resources most firms and families could be expected mobilize to retrieve a hostage. Catlins—a major underwriter of kidnap risks—reports: "In land-based kidnapping . . . the ransom amounts are comparatively small . . . in the thousands or tens of thousands of dollars. Only a few cross the six-figure threshold, and still fewer exceed US\$1 million" (Catlins, 2012, p. 2). Data from the business risk consultancy Control Risks corroborate this assessment. Control Risks is retained by Hiscox—the world's largest underwriter of kidnap risks—and was involved in resolving more than 200 Nigerian kidnap cases in 2006 to 2014. For these, the median duration was 5 days and 75% of cases were resolved within 10 days.² Only one victim was detained for more than 50 days. Although Control Risks' involvement suggests that the targets were valuable, the median ransom was less than \$5,500 and 75% of cases were resolved for less than \$12,800 per person. Even for foreign nationals, the 75th percentile is below \$100,000. Victim stakeholders—likely to include major international oil companies—never paid close to US\$1 million. In Mexico (with a GDP per capita roughly 3 times that of Nigeria), Control Risks reports higher ransoms for more than 100 kidnap cases between 2008 and 2014: The median ransom was \$37,565 and the 75th percentile at \$137,700. The median duration was 3 days and 75% of cases were resolved within 5 days. Just 2 cases settled for more than \$1 million.

Managing and containing the expectations of kidnapers is essential. Kidnap insurance needs to be reasonably priced and detentions short. Ransoms are negotiated under asymmetric information:

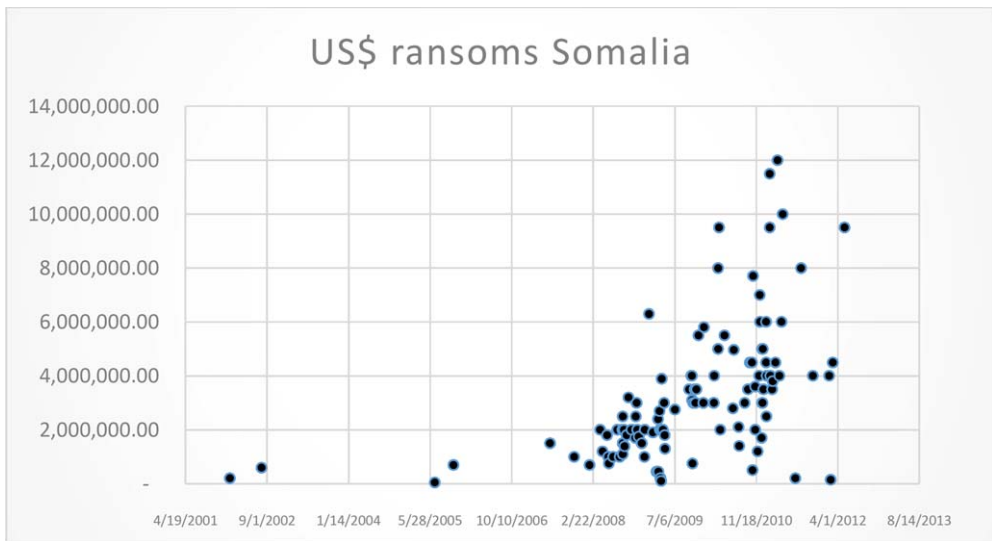


FIGURE 1 Pirate ransoms in Somalia by attack date (De Groot, Rablen, & Shortland, 2012)

kidnappers do not know who pays the ransom (family, firm, insurer, or government)—or the financial position of these entities. This is very different from the efficient plunder contracts studied by Leeson and Nowrasteh (2011), where the approximate market value of ships and cargoes was common knowledge. In the absence of detailed information, kidnappers base their ransom expectations for specific “victim types” on easily verifiable characteristics and past ransoms for that “type.”³ Interviews with professional ransom negotiators and victim stakeholders indicate that for most negotiations the “target settlement price” and negotiation duration are fairly clear from the outset (Interviews IV, V, X, XI; XIII, XIV; March, 1988).

However, if kidnappers receive an outlier ransom, concurrent, and future victims of that type are also tested at the new price (Interviews II, IV, V). News of large, easy ransoms—that is, supernormal profits—quickly spread through criminal communities. New gangs enter the market modeling their expectations on previously realized ransoms. A badly conducted ransom negotiation is, therefore, not just problematic for the insurer who reimburses the inflated ransom, but for the wider industry.

The evolution of hijack frequency and ransoms in Somalia illustrates this problem (Figure 1). Initially, few ships had hijack-for-ransom insurance and some ransoms were negotiated by myopic or inexperienced negotiators (including governments). These occasionally agreed record ransoms, which revealed valuable information about what Western ship owners would pay to retrieve their ships and crew. Price discipline collapsed and piracy exploded.

Somali pirates directly referred to a “market price” in their negotiations—meaning the price for recently released comparable ships. If news of a premium ransom arrived, this was included in ongoing and subsequent negotiations as the new “market price” (Interviews II, V, X, XI). As one pirate communicator⁴ explained to his counterparty:

There are some ships like [name withheld], they went back, they are at 1.5 [million US\$] now 1.7, and then 4 or 5 days ago another third ship got 1.8. Those are the kind of stuff they are looking at, so what I am saying is . . . it’s my opinion because these people they just like children you know. If you got that candy they want to have the same candy.⁵

Shipowners who resisted the new “market price” had their ships held for several further months (and sometimes years) to test their resolve. Well-off shipowners, therefore, generally accepted the

previous comparable settlement as the new reference value. As one shipowner explained to the pirate communicator:

... We can't go above the current market". "The [name withheld] is very similar to our ship. Ok ... why do we have to go through this nonsense when they know the [name withheld] was done at 1.7? Why do I have to waste my time at 1.9?"⁶

Premium ransoms can even influence cases in other geographic areas. The *New York Times* (2014) suggests that Al Qaida developed a common kidnapping protocol for the Islamic Maghreb, the Arabian Peninsula, and Somalia and that while "... in 2003 the kidnappers received around \$200,000 per hostage, now they are netting up to \$10 million." Every kidnap therefore has the potential of creating significant spillovers. If one agent's transaction changes prices for unrelated third parties, this is a "pecuniary externality." Usually, pecuniary externalities do not produce social costs, but transfer surplus between the counterparties of subsequent trades (Holcombe & Sobel, 2001). However, in this case there is a social cost: The "products" are hostages—some of whom die in the "production process"—the "producers" are criminals, and the "trade" is a forced transaction. If criminals underprice their "product," there is no economic efficiency argument to reveal that information. Any new equilibrium involves higher transfers to criminals and more crime.

Moreover, if ransoms and kidnaps escalate insurance markets can collapse. As insurance premia rise, some potential victims are priced out of buying insurance or only insure partially (Haufler, 2009). For example, the cost of war risk insurance for a journey through the Gulf of Aden shot up from US\$500 in 2007 to US\$20,000 in 2008 (Lloyd's List, 2008). If hostages are uninsured and stakeholders unable to afford the kidnappers' target ransom, they have to wait until the kidnappers adjust their expectations downward (or come under external pressure to release). Poor stakeholders signal their low valuation of the hostage by being patient (Ambrus et al., 2014, p. 2)—even when faced with physical violence to the hostage (e.g., *New York Times*, 1998). This signal would not be emulated by rich stakeholders. If everyone pays their reservation price, negotiations drag on as kidnappers probe stakeholders' valuation of the hostage—with threats and actual violence.

In such cases, companies avoid the high-risk area, generating economic inefficiencies and costs (World Bank, 2013). Many insurers incurred heavy losses on their hijack-for-ransom policies in Somalia and some withdrew from underwriting these risks (House of Commons, 2012 Ev3). The remainder lobbied for naval protection and compelled shipowners to adopt best management practice and employ private security guards (Shortland, 2015). The estimated cost of Somali piracy in 2013 of around 3–3.2 billion per annum (Oceans Beyond Piracy, 2013) vastly exceeded the pre-2008 cost of insuring ships and resolving the very occasional hijack for much less than US\$1 million. Managing externalities is therefore crucial for insurers—and highly desirable from a public policy point of view.

3 | INTERNALIZING EXTERNALITIES

Containing ransoms requires potentially lengthy bargaining with kidnappers while managing relations with the media, police, and relevant victim stakeholders. The process is usually led by a crisis management team of senior executives with the support of specialist consultants. Bargaining often involves threats of violence (Clutterbuck, 1987; Lopez, 2011; March, 1988). Given the high financial and psychological costs of negotiating, there is a temptation for hostage stakeholders to settle early and expensively.

Insurers that regularly reimburse (falsely or negligently) inflated claims have to charge higher premia and eventually price themselves out of business. Normally, insurers take a tough line on inflated claims and remain unaffected by their competitors' mistakes. However, in kidnap cases the knowledge

that victims are insured raises kidnappers' ransom expectations. The insurers therefore do not reveal themselves in the negotiation. If they did, kidnappers could blackmail them with violence and damaging media exposure—inviting litigation by hostage stakeholders. Insurers cannot therefore unilaterally prevent spillovers.

The pecuniary externality motivates the formation of a “buyers’ cartel,” setting maximum prices for hostages to extract seller surplus and internalize the externality. But could insurers enforce a cartel agreement? Coase (1960) argued that externalities are managed efficiently by the market if property rights are clearly assigned. If transaction costs are zero, it does not matter which party holds the property right: Either the party that is harmed can pay the producer of the externality to reduce the harmful activity, or the producer compensates those harmed by its activities (Allen, 2002, p. 5). However, if one wanted to contract over ransoms, transactions costs would be high. First, unlike Frey and Buhofer's (1988) government-led ransom cartels in the 17th and 18th centuries, insurers do not “own” the hostages. The negotiation is conducted by the insured's family or firm: All decisions are made by the victim stakeholders in the perceived best interest of the victim. The insurer can only limit the insurance cover and act in an advisory capacity.

Second, there are high information costs in verifying whether a “premium” ransom was paid. Allen (2002, p. 14) points out that acquiring information is costly when outcomes are both variable (by nature) and alterable (by man). Ransoms vary depending on the victim's financial position, the negotiating stakeholders' patience and personality, and the sophistication and expectations of the kidnapping gang. They also depend on the insurer's effort to steer the negotiation toward the appropriate settlement for the victim type and prevent an early, expensive conclusion.

If an outcome is both variable and alterable, cheating can occur without detection. Insurer “effort” in the ransom negotiation is not observable without full access to all aspects of the negotiation and briefings—plus detailed information on the victim's financial position and the kidnappers' sophistication. Kidnap victims would resist making this material public. Contracting between insurers is therefore neither enforceable nor self-enforcing (Williamson, 2002). Myopic insurers could cut short ransom negotiations to save themselves time, hassle, and cost and reimburse high ransoms without punishment.

We must, therefore, look for the most efficient assignment of the property right that confers externalities on others: underwriting the insurance contract. Coase (1960, p. 16, 17) predicted that in the presence of high transactions costs, externalities can be completely internalized by one firm owning all the activities that have external effects on each other. Alternatively, the problem could be resolved by a government that “. . . impose[s] regulations which state what people must or must not do and which have to be obeyed . . . [and] decree that certain methods of production should or should not be used . . .” (Coase, 1960, p. 17). We would, therefore, expect to see either a single insurer selling kidnap for ransom insurance or a regime governing the behavior of all kidnap insurers.

We should also observe that kidnap insurers voraciously internalize externalities arising from uninsured risks. It is in the interest of the insurer to insure as many cash-rich potential targets as possible and incentivize uninsured firms to use professional kidnap resolution services. If uninsured private individuals are kidnapped, their stakeholders might well offer their true reservation price to kidnappers. If stakeholders are unable/unwilling to hire professional support, one would expect insurers to provide relevant advice on a “pro bono” basis—though the family will still have to pay the ransom.

4 | ACHIEVING COOPERATION

4.1 | “A single enterprise orders the market . . .”

Prima facie, the kidnap insurance market appears highly competitive. A large number of insurance companies, boutique insurers, and brokers sell kidnap insurance. But on closer inspection, the risk is

borne by a small number of “specialty risk” insurance companies at Lloyd’s of London. Several insurers market specific Lloyd’s insurance products—for example, Zurich offers Hiscox policies.⁷ Others—such as DUAL—are Lloyd’s “coverholders,” meaning they are authorized to enter into contracts of insurance to be underwritten by specific Lloyd’s syndicates. Some use their own Lloyd’s brokerage (e.g., Aon with Aon Benfield). Brokers of kidnap insurance (e.g., A. J. Gallagher) also place the risk in the Lloyd’s market.

Other insurers use the Lloyd’s market to routinely reinsure their products—for example, Schinnerer uses Hiscox. This also applies to major insurers that do not advertise kidnap insurance (e.g., Allianz), but as a “one stop shop” will provide cover for their corporate and high net worth clients. Such cover is usually arranged through a broker, but if an insurer includes “free” kidnap cover in a bigger insurance package, they usually reinsure 60% to 90% of the risks, rather than keeping this on their books (Interviews XIV, XVI). Lloyd’s is a major reinsurance market: Any significant insurance written on a direct basis has a reasonable chance of being reinsured or retroceded back into the Lloyd’s market (Interview XVI). This is especially the case for “specialist” kidnap insurance: Lloyd’s is “. . . the leading market for companies that need . . . (re)insurance coverage for large, complex or bespoke risks” (London Market Group, 2014, p. 8). As reinsurers, Lloyd’s specialty insurers take on the role of coordination services firms, setting standards for how this type of risk is insured (Cutler et al., 1999b; Haufler, 1999).

To check whether there are any kidnap insurers outside Lloyd’s, the industry insiders interviewed for this project were asked to name all the kidnap insurers they had ever used, worked for, or had knowledge of. Table 1 alphabetically lists the insurers mentioned. The market is fluid with occasional mergers, entries, and exits, and the table reflects the status quo in July 2015.

All the insurers and brokers state on their websites who underwrites their kidnap insurance contracts. In all but one case, the companies referred either to Lloyd’s generally or to a specific syndicate (or syndicates) within Lloyd’s, where each syndicate is known by a unique number. Where the information was not precise I used the list published by the Bank of England of “Lloyd’s Managing Agents and Syndicates” to check how exactly the insurers were linked to Lloyd’s. The list from January 1, 2015 showed that—with one exception discussed below—kidnapping risks are either underwritten by specific Lloyd’s syndicates or are placed in the Lloyd’s market through Lloyd’s brokers.

The exception to the rule appeared to be American International Group (AIG). AIG does not advertise or mention a Lloyd’s connection on its website and no Lloyd’s syndicate is registered with the AIG brand name. However, the annual statement of Lloyd’s Syndicate 1414 “Ascot Underwriting Limited” states:

The only related parties that have transacted with Syndicate 1414 are companies within the AIG group of companies. (p. 21) and “The ultimate parent company and controlling party of the Syndicate’s main corporate member, ACNL, is American International Group Inc. (“AIG”)” (Lloyd’s Syndicate 1414 Annual Report & Accounts 2013, p. 22)

There are no kidnap insurance products marketed directly by Ascot. AIG clearly does not value the Lloyd’s brand and yet underwrites insurance at Lloyd’s via Ascot. By incurring the considerable cost of maintaining a syndicate at Lloyd’s (see *The Economist*, 2004), AIG signals that it is invested in kidnap insurance in the long term. This is analogous to patient traders in informal economies making valuable gifts to local chieftains to distinguish themselves from opportunistic traders (Leeson, 2006). As an insider, AIG is able to access relevant case information. There is, therefore, evidence in favor of Coase’s prediction of a “single-firm” solution to the externalities problem in kidnap for ransom insurance. Yet, Lloyd’s is not a “firm” in the sense of Coase (1937): It is a market in which independent firms (the syndicates) compete for business. How do they collaborate to control ransom inflation?

TABLE 1 Insurers, underwriters, and crisis responders

| Insurers | Underwriters | Crisis responder(s) |
|----------------------------|-----------------------------------------------------------------------------------|----------------------------------------------|
| ACE | Lloyd's Syndicate 2488 | Red 24 |
| AIG | American International Group | Neil Young Associates |
| ANV | Lloyd's Syndicates 779, 1861, 1969, and 5820 | MS Risk |
| AON (AON Benfield) | Specialist insurer founded by Lloyd's brokers | Neil Young Associates |
| Ascot | Lloyd's Syndicate 1414 | MS Risk |
| Aspen | Lloyd's Syndicate 4711 | AKE, Aegis Response, Henderson Risk |
| Beazley Furlonge | Lloyd's Syndicates 623, 2623, 3623, 362, and 6107 | MAST |
| Canopus | Lloyd's Syndicates 958 and 4444 | "Supported by expert crisis consultants" |
| Chubb | Lloyd's Syndicate 1882 | Ackermann |
| CV Starr | Lloyd's Syndicate 1919 | Neil Young Associates |
| DUAL | Lloyd's coverholder | MS Risk |
| Griffin | "Griffin Underwriting Ltd is reinsured 100% with certain Underwriters at Lloyd's" | Security Exchange |
| Hiscox | Lloyd's Syndicate 33 | Control Risks |
| Houston Casualty | Lloyd's Syndicate 4141 | Unity Resources |
| Ironshore | Lloyd's Syndicates 4000 and 2014 | Hazelwood |
| Liberty | Lloyd's Syndicate 4472 | Unity Resources |
| Tokio Marine Kiln | Lloyd's Syndicates 510, 557, 1880 | "In-house" response team |
| Travelers | Lloyd's Syndicate 5000 | Olive |
| QBE | Lloyd's Syndicates 386 and 2999 | Red 24 |
| XL Catlin (merged in 2015) | Lloyd's Syndicate 2003 | Terra Firma, Red 24, Compass Risk Management |

4.1.1 | Insurance at Lloyd's

In the Lloyd's market, independent insurance underwriters join together in syndicates (HMRC, 2016). Lloyd's members (individual "names," limited partnerships, or corporations) provide the capital supporting the syndicate's underwriting business. Legally, membership in a syndicate lasts only for 1 year at a time. Most syndicates' core capital is provided by the same members for many years, so that syndicates function as permanent insurance operations.

Transactions are conducted face-to-face in the underwriting room between the underwriters and the Lloyd's brokers or coverholders. Most syndicates offering kidnap insurance have their desks (called "boxes") in a large open-plan area on the ground floor of Lloyd's (Figure 2). Each syndicate has one or two kidnap specialists, who develop great expertise in this "boy-to-man" profession (Interview XVI). The brokers also specialize in particular areas of risk. They negotiate competitive terms for their clients within the market, walking from box to box to obtain quotes from different underwriters (Lloyd's, 2016).



FIGURE 2 Ground-floor underwriters' room at Lloyd's (Lloyd's, 2015)

In this small community, information flows without compromising client confidentiality. *The Economist* (2004) cites Mr. Hiscox of the eponymous underwriting business about the Lloyd's market: "... we all see each other's risks. ... It's wonderfully gossipy." Underwriters discuss ransoms paid, negotiation durations, and the performance of crisis response consultants "over lunch" (Interview V). This information flow is crucial to the functioning of the market. To price their product and conduct efficient ransom negotiations, insurers need information of relevant past cases. However, most kidnaps are resolved very discreetly. Families and firms rarely wish to advertise how much they paid a kidnapper—even if there are no legal issues surrounding abetting crime by paying a ransom. Open source information is, therefore, scant and unreliable (*The Guardian*, 2014). Significant underreporting is the norm and ransom information is often contradictory. The availability of information within Lloyd's and the high cost of acquiring it outside creates a significant barrier to entry into the market.⁸ Mutually beneficial information sharing could also be organized by trade associations. For example, the International Union of Maritime Insurers' Facts and Figures Committee disseminates "risk data to improve the decision making processes in risk pricing and risk transfer." However, the Lloyd's regime goes far beyond this.

4.1.2 | Club governance

The Corporation of Lloyd's—via its governing body the Council of Lloyd's—sets the framework and rules under which the syndicates compete. It is a "private regime": Although independent, all syndicates operate according to Lloyd's by-laws. The Corporation of Lloyd's oversees and governs the market and sets the required capital levels for its members. It also sets commercial standards to ensure that "underwriters operate in a way that benefits the whole market" (HMRC, 2016). The Corporation holds the syndicates' assets and members' funds in trust, so they are available to cover the insured risks. To cover catastrophic losses exceeding the funds of individual syndicates there is the "Central Fund"—consisting of mutual assets held by the Corporation and the ability to call on all members to make additional subscriptions if needed. This fund can be used to meet any member's insurance liabilities. Lloyd's strong international credit rating—often referenced by the insurers—is based on this "Chain of Security" (Lloyd's, 2011).

Syndicates trading under the Lloyd's brand, therefore, benefit from and contribute to Lloyd's central resources. The Lloyd's brand and its credit rating are extremely valuable to smaller insurers. In return, syndicates operate under the Council's watchful eye: "... the Corporation reviews and agrees business plans, monitors compliance against Lloyd's minimum standards and monitors syndicates' performance. . . . Lloyd's can take a range of actions, including, as a last resort, requiring a syndicate to cease underwriting" (Lloyd's, 2011, p. 8).

The wording here (and elsewhere) seems surprisingly vague: What exactly is a transgression against "minimum standards"? The lack of strict criteria is the very strength of Lloyd's, which effectively still operates as a "private club" (Stringham, 2015). Under its by-laws, Lloyd's can exclude syndicates that destabilize the market without hard evidence of malpractice. Members are unlikely to risk their club membership in pursuit of short-term profits. Indeed, in practice the "Corporation" usually only intervenes in the "Market" to provide guidance and information (Interview XVI). The Lloyd's setup of "Corporation" and "Market" therefore enables both cooperation (to control ransoms) and competition (for business). So what constitutes "good practice" in kidnap for ransom insurance?

4.1.3 | The Lloyd's "regime" for kidnap insurance and resolution

Kidnap insurance is "bespoke": The insurance premium depends on the risk exposure and the mitigation practices adopted by the company or family (Lobo-Guerrero, 2007). Part of the insurance premium is used for security briefings, staff training, and security checks on premises (Business Insurance, 2008). The insurance contracts are extremely similar in the coverage they provide and in their approach to resolving incidents (Interviews III, IV, V; Marsh, 2011). The maximum cover is limited to the ransom the client (corporate or family) can raise themselves. The ransom is reimbursed after payment and the insurance contract cannot be used as collateral—meaning the victim stakeholders actually have to raise the ransom themselves initially. Employers are not allowed to discuss the insurance with their employees—doing so invalidates the insurance cover (Lobo-Guerrero, 2007; Marsh, 2011). All these stipulations serve to reduce moral hazard among the insured.

In the event of a kidnap, the insurance contracts provide unlimited (free) access to a crisis response company (see Table 1). Experienced crisis response consultants arrive within 24 hr of the kidnap to advise stakeholders. They convey information about the kidnapping gang's previous conduct (including advice on whether to involve the police) and to inform stakeholders of the target settlement price and expected ransom duration. They reassure stakeholders during threats and advise them on their negotiation strategy (*Financial Times*, 2011; Hiscox, 2014, p. 19). Moral suasion is used to avoid early premium settlements by cash-rich victim stakeholders, alerting them to their responsibilities vis-à-vis future victims and the risk of a "revised" demand if too much is offered too quickly (Interviews V, X, XI; March, 1988). Consultants remain assigned to the case until it is resolved or the victim is proven dead (Interview IV; Hiscox, 2014, p. 19).

Although the consultants are paid by the insurer, this is an arm's length relationship: The consultants are not instructed how to handle individual cases or when to terminate them. Instead, consultants operate in a highly competitive environment, with different consultancies seeking to be the "named" responder on particular policies (Interview V). Only the biggest kidnap insurers retain full-time consultants; the rest are employed on a case-by-case basis (Interviews IV, V, VI). Consultants build reputations for good settlements and expertise in particular areas. News of "botched" negotiations quickly spread in the community of insurers and response companies.

4.2 | A private regime

The Corporation of Lloyd's looks like Coase's "government" solution to the externalities problem with high transaction costs. It is a "private regime" because the international hostage trade is beyond the reach

of formal legislation and law enforcement. Governments do not govern extraterritorially or order and facilitate transactions with (foreign) criminals. The official policy objective is to eliminate crime rather than pragmatically manage its impact (Snyder & Duran-Martinez, 2009, discuss some exceptions). Yet, Western governments have a political interest in facilitating their citizens' participation in foreign direct investment, international trade, humanitarian relief efforts, travel, and journalism—including in countries that have kidnapping problems. Foreign nationals are a small minority of total kidnaps: 6% in Africa, 2% in Asia, and 4% in Latin America (Control Risks, 2016). Insurance and effective kidnap resolution services are, therefore, invaluable. Lloyd's was granted sufficient powers to enable it to provide club governance for its member syndicates. Lloyd's sets the rules for what is insurable, how it is insured, and how claims are handled. Transgressors lose the benefits of club membership (Stringham, 2015).

5 | VORACIOUS INTERNALIZING

Firms and families who are not properly advised may well pay outlier ransoms. As insurers do not reveal themselves in insured cases, any premium ransom has the potential of raising kidnapper expectations. There is, therefore, a strong incentive to internalize externalities from uninsured cases as well.

5.1 | Preventing spillovers from self-insurance

For many companies, a significant one-off ransom is not problematic. One interviewee quoted a customer in the oil sector faced with a million-dollar ransom demand: "Why don't we just give them a million dollars? We spill more than that in a day . . ." (Interview IV). Yet, according to *The Guardian* (2014) ". . . at least 75% of Fortune 500 companies hold K&R insurance policies. . . ." Why do these companies insure kidnap risks?

Mayers and Smith (1982) argue that insurers have a comparative advantage in providing services related to claims management and in monitoring compliance with risk mitigation guidelines. Indeed, kidnap insurers foreground the specialist services of crisis response companies in risk mitigation, negotiating, and delivering ransoms. They also insure employers for legal liability arising from kidnap cases (Business Insurance Online, 2012). Corporations fear litigation unless they have demonstrably followed "best practice." Kidnap specialists use part of the insurance premium to provide training and security advice for the companies' staff and security checks of the premises of their overseas operations (Business Insurance, 2008). Thereby, companies cannot be accused of not trying to prevent abductions in the first place. If a kidnap occurs, the insurer's experienced crisis consultants reduce the likelihood of a bad outcome (Merkling & Davis, 2001) and the probability of an employer being found negligent. Kidnap insurance is therefore attractive even to companies that could theoretically self-insure. Major companies that do self-insure have direct contracts with the risk consultancies to prevent and resolve kidnap cases.⁹

Voracious internalizing is also likely to be behind the inclusion of kidnap cover in the "Gap Year Insurance" sold by Hiscox. This prevents well-off families from self-negotiating and inadvertently changing kidnapper expectations. Because the insured party knows that insurance was purchased, a low ransom limit is used to reduce moral hazard. Effectively, it is a "claims-only" contract of the type described by Mayers and Smith (1982, p. 285), where the insurer provides the claims management services, but the insured pays the claim.

5.2 | "Pro bono" services to promote market stability

Sometimes uninsured people are taken hostage. If the incident can create spillovers, kidnap insurers seek to control these negotiations. The snatching of Judith Tebbutt from a Kenyan beach resort and the

hijack of the Chandler couple from their private yacht by Somali pirates illustrates this. Had these kidnaps been profitable they might have broadened the targets of Somali pirates. The families were therefore offered pro bono advice and coached in how to conduct the negotiation (House of Commons, 2012, Ev 71).

The cost of staging the Chandler kidnap and the extended negotiation period were considerable. World Bank (2013) estimated the start-up cost of a piracy team at just below US\$80,000, on which investors would expect a financial return in the region of 430%. The *New York Times* (2011) reports an estimated cost of US\$250,000 in food and guards' wages over the nearly 13-month negotiation. A host of local power brokers expected protection money (Shortland & Varese, 2016). Yet, the House of Commons (2012) reports a final ransom of just US\$440,000, meaning that the Chandler kidnap resulted in a large number of disappointed investors, pirates, guards, local suppliers, and protectors. The case of Judith Tebbutt appears to have been resolved on a similar basis (*The Guardian*, 2012).

Although pro bono advice is given on "humanitarian" grounds, the approach in cases with clear scope for considerable externalities contrasts sharply with that of the "forgotten mariners" in Somalia. Here, the victims are from poor countries, the shipowners have abandoned them and their families have nothing substantial to offer. Indeed, commercial involvement in these cases is limited (*The Telegraph* March 26, 2015).

6 | CONCLUSIONS

The market for kidnap insurance is characterized by externalities: Cash-rich victim stakeholders can increase kidnappers' ransom expectations and encourage new kidnappings. Insurers need to prevent quick payments of premium ransoms, but can only do so at a cost. The private short-term benefits from containing ransoms are less than the benefits to the sector as a whole—myopic stakeholders are tempted to cut corners. For the market to be stable and risks to be calculable, this externality needs to be managed. Given the impossibility of enforcing "proper" ransom negotiations through contracts due to high transaction costs, the Coasean prediction would be a single supplier of kidnap insurance. Conversely, customers expect choice and competition when buying insurance.

The Lloyd's solution is, therefore, an ingenious answer to the problems presented by kidnap insurance. All kidnap insurance is underwritten or reinsured at Lloyd's. By setting clear parameters for commercial resolution, Lloyd's enables "fair" competition between different providers and avoids kidnap insurance being sold monopolistically. There is a protocol for insuring and resolving kidnaps, which emerged from the members themselves. Its use is mandatory and it (largely) prevents individual insurers from conferring externalities to the rest of the sector. The insurance market works smoothly because Lloyd's enables relevant case information to flow easily between insurers without compromising client confidentiality. Underwriters constantly interact with each other and individuals who do not pass (truthful) information to the Lloyd's insurance community or spread it beyond its confines can be ostracized.

Kidnap insurance at Lloyd's is, therefore, a perfect example of the way in which externalities and transactions costs shape the institutions, which make up the economic system (Coase, 2012, p. 13; Williamson, 2002). The analysis contributes to the literature that points out the elegance and ingenuity of (informal) private solutions to seemingly intractable governance problems (Munger, 2010). Because all kidnap insurers need a Lloyd's connection, Lloyd's can internalize the externality and facilitate a reasonably competitive market for kidnap insurance. As Lloyd's is in essence a private members club, its threat of closing down "rogue" syndicates is credible—there is no legal redress if a syndicate is closed (Stringham, 2015). This allows Lloyd's to act like a government vis-à-vis its members, regulating the methods of production. Lloyd's minimizes transaction costs by setting and enforcing desirable rules without recourse to costly legal appeals.

Lloyd's role as a "private regime" therefore has a clear basis in Coasean economics (Cutler et al., 1999b), though as a "club" Lloyd's combines aspects of Coase's (1960) "firm" OR "government" prediction.

There is an important policy implication of this analysis. Governments that intervene on behalf of kidnapped citizens regularly pay premium ransoms (*New York Times*, 2014). Unlike the participants in the private governance regime, governments often act myopically and under media pressure. They have neither binding budget constraints nor a profit motive to contain ransoms. There is no mechanism to internalize the spillovers of one government's settlements on other negotiations. Paying multimillion dollar ransoms solves political problems in the short term but confers significant externalities on concurrent and future victims, their governments, and the insurance sector.

Mostly government involvement is limited to (legally uninsurable) terrorist kidnaps, but ransom demands in the criminal sector are rising in response to terrorist successes. This has been contained by increased patience on the side of private negotiators, spending additional weeks and months convincing kidnappers that private ransoms will not be comparable to government-funded ransoms. With the inexorable rise of government-negotiated ransoms, opportunists and criminals are therefore beginning to pass hostages to terrorists (Interviews IV, V; Safer Yemen, 2014). For citizens of non-negotiating nations (such as the United States and United Kingdom) this is often fatal, making them unemployable in many areas of the world. As long as some governments enter the hostage trade, the legal distinction between insuring "terrorist" and "criminal" kidnaps, therefore, has unintended and counterproductive consequences for hostages, firms, NGOs, and international efforts to reduce terrorist financing.

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NOTES

¹ For comparison, the UNODC (2016) estimates market sizes of US\$320 million for illicit firearms, US\$1 billion for Internet identity theft, and US\$1.6 billion for counterfeit medicines.

² Oceans Beyond Piracy (2012, p. 16) reported average detention periods of around 4 days for piratical kidnap cases in the Niger Delta.

³ In Frey and Buhofer (1988), ransoms were negotiated according to soldiers' rank. Somali pirates priced according to ship type, size, flag state, crew numbers, and nationalities (World Bank, 2013).

⁴ Usually both sides nominate "communicators" to relay information between decision makers.

⁵ FBI transcript of CEC Future ransom negotiation: hijacked October 7, 2008, released January 15, 2009.

⁶ FBI transcript of CEC Future.

⁷ Company-specific information in this section reflects the status quo in July 2016.

⁸ This does not mean that it is never attempted. In 2012 the Australian insurer Accident and Health International headhunted the former global manager of kidnap insurance from Chartis (AIG) to head its (tiny) kidnap for ransom division. However, updating information without a Lloyd's connection would be difficult and it is likely that the products are reinsured at Lloyd's.

⁹ The Olive Group website gives examples of direct clients.

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APPENDIX: INTERVIEWS

- Interview I: Professional ransom negotiator interviewed March 2012
- Interview II: Professional ransom negotiator interviewed March 2012
- Interview III: Professional ransom negotiator interviewed December 2014
- Interview IV: Professional ransom negotiator interviewed January, February, May, and June 2015
- Interview V: Professional ransom negotiator interviewed March and May 2015
- Interview VI: Professional ransom negotiator interviewed April 2015
- Interview VII: Attorney interviewed March 2012
- Interview VIII: Attorney interviewed April 2013
- Interview IX: FCO official interviewed January 2015
- Interview X: Per Gullestrup, former CEO, Clipper Shipping Group interviewed January 2015
- Interview XI: Ship owner and piracy victim interviewed February 2015
- Interview XII: Employee Crisis Response Company interviewed February and March 2015
- Interview XIII: Employee Crisis Response Company interviewed January 2015
- Interview XIV: Partner Crisis Response Company interviewed April 2013
- Interview XV: Family member of kidnap victim interviewed June 2013
- Interview XVI: Insurance specialist interviewed June 2015