Directors’ and Officers’ (D&O) Liability Insurance in Hong Kong

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I. Introduction

Directors’ and Officers’ Liability Insurance (D&O Insurance) is a liability insurance which covers the directors and officers of a company on an indemnification basis for losses or defence costs in the event an insured (a director or officer of the company) suffers such loss as a result of a legal action brought for alleged wrongful acts in his or her capacity as director or officer. According to Section 2 Hong Kong Companies Ordinance (Chapter 622), “officer” is defined as a director, manager or corporate secretary of a company, and “manager” is further defined as a person who performs managerial functions under the directors’ immediate authority.

The insurance is closely related to corporate governance, corporations’ laws, and the fiduciary duty owed to shareholders or other beneficiaries. The D&O Insurance was first developed in the 1930s in the US, arising out of claims from shareholders against the directors of companies, claiming for mismanagement or other mistakes. Nowadays, over 90% of all companies on the NYSE have D&O cover, due to possible personal liability of their directors.

D&O Insurance in Hong Kong has been available for many years, but until recently, relatively few local companies sought cover, and many local insurance brokers were not very familiar with this subject.

This started to change in and after 1997 with the Asian financial crisis and the property market downturn in Hong Kong. This led to many companies with financial problems and negative equity, and shareholders and other stakeholders tried to aim at the directors and other company officers to make them personally responsible for their losses. Nowadays, around 65% of all public listed companies in Hong Kong have D&O cover.

II. Threats for Directors

Hong Kong is still one of the leading worldwide financial centres, and certain legal and business aspects in Hong Kong make directors vulnerable for personal liability:

- Many claims arise from shareholders in regard of IPOs and breaches of listing rules and other regulations of the securities and futures commission;
- Hong Kong is a centre for M&A transactions in Asia, which might lead to claims after transactions have been concluded and turn sour;
- Certain employment regulations bring personal liability for directors;
- The stock market is relatively volatile, which might lead to losses and claims from shareholders.

1. Shareholder lawsuits

50% of all D&O claims result out of lawsuits brought by shareholders against the directors of their company for mismanagement of the company. It is quite common in Hong Kong to name the director personally as defendant in addition to the company. According to a recent survey, settlement costs in such cases average USD 7.6 million with defence costs for the company and the director adding another USD 1 million. These are amounts that can bring a small or medium sized entity to its financial limits and it might be the case
that after settling with the plaintiff the company does not have sufficient capital to continue its business operation.

2. **M&A Transactions**

Other possible threats can arise out of mergers, where the board of directors decides to purchase another company. If this results in losses after the transaction, the directors might be held personally liable for their decision to take over the target company.

In a recent case in Hong Kong, a company reported a loss after taking over another company. The shareholders sued the company and its senior managers alleging they booked as goodwill the value of the target company which did not yet make any profit. The case was six years in court before the defendants were found not liable, and until this point, **USD 2.6 million for defence costs** had been accumulated. Even though most of these costs (approx. 70%) should be (in principle) able to be recovered from the other party, a substantial amount has to be borne by the defendants personally.

3. **The new Companies Ordinance**

In addition to the new statutory duty of reasonable skill and care, the new Companies Ordinance also imposes personal liability on directors to take all reasonable steps to ensure the company keeps proper accounting records.

In insolvency cases, directors can be held liable under Section 275 Companies (Winding Up and Miscellaneous Provisions) Ordinance for allowing the company to incur further credit knowing there is no reasonable prospect of avoiding insolvency.

4. **Other Legislation**

Other Hong Kong laws under which personal liability of the senior management can arise are:

- Directors can be held personally liable for a fine if they employ someone where they know the person’s wages cannot be paid (Sections 31, 63A Employment Ordinance). A failure to pay wages to an employee can also result in a fine or imprisonment for the director;

- Under the MPF Scheme Ordinance, the directors can be held personally liable and be prosecuted for various offences, such as failing to enrol employees in an MPF scheme or failing to pay mandatory contributions;

- Under the Occupational Safety and Health Ordinance, every employer is required to ensure the safety and health at work of all employees and failure to do so can trigger fines and imprisonment and provides for directors to be personally liable;

- If a director (as agent of the company) accepts an “advantage” from a third party in connection with the company’s affairs, he will be subject to ICAC investigation under the Bribery Ordinance;

- Under the Hong Kong Discrimination Ordinance, a director can be held personally liable if he commits an unlawful and discriminating act.
III. The Development in Company Law

With the introduction of the new Companies Ordinance in March 2014, the new law did bring certain changes to the responsibility of directors, as well as the provision of D&O insurances.

1. Standard of care

The new Companies Ordinance introduces a new statutory duty requiring a director to exercise reasonable care, skill and diligence in his role as director. In exercising his duty, the director will be tested against both: the standard of a reasonable hypothetical diligent director (“objective test”), and a subjective standard which takes into account the director’s own actual general knowledge, skill and experience (“subjective test”).

The objective test sets a minimum standard which all directors must meet, and the subjective test raises that standard for the particular director based on his actual professional experience and qualifications.

For instance, a director who is qualified as accountant or lawyer may be held liable to a higher standard, compared to a director without these qualifications. Or, a director who possesses vast experience in his field of business (e.g. sourcing, HR, etc.) needs to meet a higher standard under subjective test.

This subjective test is not completely new, but it replaces the previous “duty of reasonable care test”. It is important to note that the directors owe this duty primarily to the company and not to the company’s shareholders.

To comply with the new standard, directors should give thought to the higher standard to which they will be held by virtue of their specific expertise, qualifications, and experience, and they should ensure that their focus and contribution in and outside board meetings reflects this standard.

2. The old Companies Ordinance

Until 2004, Section 165 (1) of the old Companies Ordinance restricted the scope of indemnities companies could provide for its directors. The law rendered void any contractual provision exempting a director from liability, not just under its Articles of Association.

This held back the use of D&O Insurances in Hong Kong for many years and was completely outdated, because it prevented directors from relying on insurance cover taken out by the company. In 2004, Section 165 (3) was introduced and stated that it was legal for the company to buy a D&O Insurance for its directors, as far as negligence, default, breach of duty or breach of trust were concerned.

3. The new Companies Ordinance

The new Companies Ordinance clarifies the limits placed on the ability of a company to indemnify a director for his liabilities out of company assets. Section 468 (3) provides a complete prohibition on a company to indemnify a director out of company assets for any liability owed by a director to the company. This means a company cannot indemnify a director out of the company assets for a breach of duty which is owed to the company itself. However, Section 469 allows a company to provide a limited indemnity out of its own assets to a director for any liabilities owed to third parties under the following conditions:

- The indemnity cannot cover a director’s liability for criminal fines or other regulatory penalties, defence costs incurred in criminal proceedings in which the director is convicted, and defence costs for the director in civil proceedings, brought by or on behalf of the company, in which judgment is rendered against the director;
The indemnity must be disclosed in the annual director's report and be made available for inspection by any shareholder.

Section 468 (4) expressly states that the prohibitions on the company’s ability to indemnify its directors out of the company assets does not prevent a company from purchasing and maintaining a D&O Insurance for the directors. Such insurance may also cover:

- A director’s liability for damages in negligence, default, breach of duty in relation to the company (except fraud), and
- The director’s liability for defence costs incurred by the director in defending any proceedings (civil and criminal) for any negligence, default, breach of duty or breach of trust (including fraud) in relation to the company.

With this, there is no restriction under the new Companies Ordinance on a company’s power to purchase D&O Insurance and the insurance can cover directors for liability which the company cannot cover by way of indemnity and the only restrictions might arise out of common law, based on public policy grounds.

Another advantage of the D&O Insurance is that it is not required to be mentioned in the director’s report.

IV. Details of the D&O Insurance

1. Cover of the D&O Insurance

A typical D&O Insurance policy covers a director for liability which cannot be indemnified by the company, called Side A Cover.

Furthermore, the policy covers the company for its liability in respect of any indemnity provided to the director of the company, called Side B Cover, or “company reimbursement cover”.

A policy can also provide for Side C Cover, or “entity cover”, which would cover the company itself against claims or employment practices liability from third parties.

2. Extensions of Cover

As directors’ exposures have grown, the possible extensions became more and more. An important extension is the coverage for a director’s legal costs in responding to regulatory investigations (especially in Hong Kong, where the investigatory power of certain regulators are quite extensive).

Another useful extension is the extension to cover risk-management add-ons which assist the company in mitigating such as covering the costs of a public relations consultant to protect them against potential public exposure and negative influence of the reputation of the company.

3. Important Clauses

- Make sure that all regions are covered in which the company is active and in which claims against directors can arise. This is especially true for the US. Many insurers try to exclude cover for claims in/from the US or arising out of the US due to the huge legal costs in the United States. However, only minimal ties to the United States are already sufficient
to establish jurisdiction of a US federal or state court. This can end up in a legal dispute of the company in the US, and trigger huge amounts of costs for overseas lawyers.

➢ To avoid any conflict in terms of position and coverage, make sure that the policy is worded so that it covers directors, officers and employees undertaking “those activities which can and are normally carried out by directors and officers”.

➢ If the policy does not provide for “Side C Cover” (entity cover), the insurer will never respond to claims against the company itself, and if claims are made against the company and an individual director as well, the insurer will carve out the portion relating to the D&O policy and only provide cover for these costs. If no “Side C Cover” is provided, then it is useful to include an arbitration clause in the policy which assists in resolving any arguments as to such apportionments.

➢ When answering the questions during the policy application and upon every renewal, it is crucial to answer all questions thoroughly and disclose all relevant information so that the insurer later cannot refuse a claim.

➢ Close attention must be given in case the company has subsidiaries in other jurisdictions and the policy should also cover those jurisdictions. These jurisdictions will often have different company laws which might affect the conditions under which companies can take out D&O Insurances and/or indemnify their directors. It is essential the policy provides cover in line with the various indemnification laws.

➢ When a director is newly appointed to the board of directors, the company should seek written confirmation from the insurer that such new director is covered by the existing policy. For a director leaving the board of directors, the director should make sure that the policy covers “present and past directors” to ensure that he is covered even after retirement in respect of situations occurring after his period in office (run-off cover).

➢ In case the company intends to acquire another company in the future, the policy should cover the newly acquired company as well.

➢ It is essential to update the insurer about any material changes, especially in circumstances such as the appointment of a new US based director, which may fundamentally change the risk.

➢ The insurer needs to be informed about any claim made immediately, whereas claim is defined as “a demand made in writing”. Anything else, e.g. a threat of legal action, has to be notified as “circumstance”.

V. Summary

Personal liability of a director in Hong Kong can arise quickly and out of several laws and regulations, and it can be expected that the personal liability will be extended in the future.

Even though it is now possible for a company to indemnify a director under certain preconditions, it is still strongly recommended to conclude a D&O insurance. This does not only provide additional cover for areas where the company cannot indemnify the director, it also helps avoiding problems between shareholders of the company and the company in respect of indemnification.
of the director, because the D&O insurance covers the expenses and the company does not have to use its own assets.

This potential conflict of interest between shareholders, the company and the directors makes it advisable that the director and the company should be represented by separate law firms when negotiating the D&O policy, and the director’s law firm should be one who does not usually act for the company.

We hope that the information provided in this newsletter was helpful for you. If you have any further questions please do not hesitate to contact us.

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