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Guidance Note

A practical guide to good governance

The Hong Kong Institute of Chartered Secretaries
Chartered Secretaries. More than meets the eye.

Directors and Officers Insurance



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Directors and Officers Insurance

1. Introduction

Hong Kong Companies Ordinance (Cap 32) S. 165 allows a company to purchase and maintain for any officer of the company insurance against (i) any liability to the company, a related company or any other party in respect of any negligence, default, breach of duty or breach of trust (save for fraud) of which he may be guilty in relation to the company or a related company; and (ii) any liability incurred by the officer in defending any proceedings, whether civil or criminal, taken against him for any negligence, default, breach of duty or breach of trust (including fraud) of which he may be guilty in relation to the company or a related company. Directors and Officers Liability Insurance ("D & O Insurance") is not a mandatory requirement for companies in Hong Kong. It is however a recommended best practice under the Listing Rules that "an issuer should arrange appropriate insurance cover in respect of legal action against its directors"¹.

In other countries, there is generally no legal requirement for companies to take out D&O Insurance. However, it is a common practice for most listed companies to limit their liability exposures by the purchase of D & O Insurance. In the US, the *Sarbanes-Oxley Act 2002* imposes significant personal liability risk on the directors and managers for the mishaps of the company. There are increasing number of legal cases against the officers by different stakeholders, including shareholders, regulatory bodies, creditors, employees and competitors. The court awards have also increased substantially in recent years. In general, the additional measures introduced by the regulatory bodies worldwide to promote corporate governance in the post-Enron era have increased the risk of potential claims against directors and officers. The primary protection function of D & O Insurance is therefore increasingly important in protecting the company and the officers from personal liability and defence costs. The provision of D & O Insurance will be expected by capable directors (both executive and non-executive directors) and officers so as to reduce their liability exposure.

D & O Insurance plays a role in promoting corporate governance and enterprise-wide risk management of the company. As a matter of procedure, the insurer will conduct an impartial evaluation of the risk liability of the company at the time of effecting or renewal of the insurance policy. In the course of such evaluation, relevant documentation will have to be produced by the company. The issues which will usually be considered by the insurer in assessing the risk liability of the company include matters such as:

¹ See A.1.10 of Code on Corporate Governance Practices (Appendix 14) of the Rules Governing The Listing of Securities on The Stock Exchange of Hong Kong Limited

1. corporate governance practice including but without limitation to:
 - a. the size of the board
 - b. the composition of the board
 - c. whether there is separation of CEO and Chairman of the board
 - d. the shares in the company owned, if any, by the directors and officers
 - e. system of internal control
2. shareholders profile
3. business strategy and outlook
4. overview of operations, in particular, the extent of business activities in the US
5. territorial exposures/coverage, e.g. whether including North America and the relevant benchmarking of retention on claims
6. recent M & A activities
7. litigation management philosophy and track record of litigation

In addition to the above issues, the insurer will always perform due diligence on the governance, financial distress and volatility of the company. One research finding in the US confirms that the level of D & O Insurance premium reflects the quality of corporate governance².

D & O Insurance also provides an effective resource for monetary protection and legal expertise in case of legal actions by third parties.

2. Brief Outline of D & O Insurance

Different insurers have different policy wordings with varying degree of coverage and terms. The needs of companies also depend on their own circumstances. There is therefore no "specimen policy". The following is a highlight of D & O Insurance coverage, main extensions and exclusions. It is advisable to consult professional insurance brokers or legal advisers for specific advice.

2.1 What is covered?

D & O Insurance covers a claim alleging a wrongful act of officers for the:

- 2.1.1 company liability to indemnify the directors and/or officers against any liability and defence cost
- 2.1.2 personal liability of the directors and/or officers against any liability and defence cost.

²John E. Core, "The Directors' and Officers' Insurance Premium: An Outside Assessment of the Quality of Corporate Governance", JLEO V26 N2, P449

It can be extended to cover:

- 2.1.3 company securities liability to defend or pay any claims from shareholders for the loss in value of their shares.

Points to note:

- A "wrongful act" must be something done in the capacity of director or officer. A "wrongful act" may not include any acts by directors or officers done on behalf of any charitable organizations or trade associations as they may be considered as outside of the official scope of their duties. Additional coverage or clarification from the insurers is recommended.
- Although a "claim" is usually defined narrowly requiring the evidence of written demands or legal proceedings, it is a policy condition for the company to immediately notify the insurer of any facts or circumstances that may give rise to a claim or an inquiry. As D & O Insurance is a claims-made basis policy, a prompt notification of a potential claim to the insurer is critical. It should be a regular item on board meeting agenda to consider whether any events have taken place which could give rise to a "claim" under the insurance policy. In addition it is a good practice to send to the insurer all press releases or other notices or announcements to shareholders issued by the company.

2.2 Who are covered?

The policy normally covers:

- 2.2.1 directors (executive or non-executive) for personal liability
2.2.2 officers (including usually senior managers, auditors, company secretary or other named person) for personal liability
2.2.3 insured company for company liability

It can be extended to cover:

- 2.2.4 former directors & officers
2.2.5 outside directors – covering directors and officers sitting on boards outside the insured group at the request of the company

Points to note:

- Usually, the company itself, parent and/or subsidiary companies may be covered as "Insured Company". However, associated companies may not be included unless specially arranged with the insurer. Directors or officers seconded to work in an associated or unrelated company should be covered either under the main or the associated/unrelated companies' policies.
- Potential directors or officers should request a written confirmation that they will be added in the D & O Insurance. A good understanding of the D & O Insurance terms and renewal documentation helps the directors in understanding the quality of corporate governance of the company.

2.3 What is the amount of cover?

There is no fixed rule or formula for companies in determining the appropriate level of insurance amount. Some academic studies suggest the following variables:

- 2.3.1 Corporate size – as determined by Measure of Value of Equity (MVE) or asset value. Usually, the larger the corporate size, the higher is the limit of insurance.
- 2.3.2 Return on Asset (ROA) – As a general rule, the higher the ROA, the lower is the limit of insurance required.
- 2.3.3 Financial distress – as measured mainly by leverage ratio. The higher the financial volatility, a higher limit is preferred.
- 2.3.4 Level of business activity in the US.

Points to note:

- Policies may be subject to per claim basis with or without per year limit. For some companies subject to higher litigation risks, the likelihood of two or more claims in a year should be considered in determining the policy annual aggregate limit.
- Smaller and higher growth companies may need a higher limit of protection due to their relatively higher financial volatility.

2.4 Common restrictions and/or exclusions

Below is a list of common restrictions or exclusions. This list is not exhaustive as some general exclusions or conditions typically found in other insurances are not listed. Moreover, policy wordings also vary substantially from company to company.

- 2.4.1 Claims-made basis – Most policies are insured on claims-made basis. Only claims first made or brought against the insured during the policy period are covered.

- 2.4.2 Existing conditions – Cover normally excludes any claim occurring or made prior to the commencement of the cover.
- 2.4.3 Fraud & Dishonesty – Any fraudulent, criminal or wilfully reckless, malicious or dishonest act is excluded.
- 2.4.4 Acquisitions – Some insurance policies may cover newly acquired subsidiaries automatically with or without the same terms of coverage. However, a typical clause generally excludes US and Canadian listed companies.
- 2.4.5 Duty of disclosure – It is important to notify the insurer promptly of any claims or circumstances which may give rise to a "claim". However, insurance policies generally incorporate severability clauses pursuant to which the rights of each insured person is not prejudiced by the fault, non-disclosure or misrepresentation of another insured person. The conduct of an insured person shall not be imputed to another insured person who is innocent of and has no prior knowledge of such conduct.
- 2.4.6 Fines, penalties and punitive damages levied by the court or regulators.
- 2.4.7 Legal jurisdiction – Some policies may not provide worldwide jurisdictions coverage. Attention must be paid to any geographical or jurisdiction restrictions.
- 2.4.8 Insured v insured – Some policies will not cover actions between parties covered by the same insurance policy including an action taken by the company against a director or one director against another director. This can be highly complicated if one policy covers a group of companies including directors and officers of the parent and various subsidiary companies.
- 2.4.9 Professional services – Professional services rendered by directors or officers are generally excluded. The insurance will generally not cover personal guarantees or undertakings given by directors or officers.
- 2.4.10 Libel and slander – May be included, but not always.
- 2.4.11 Pollution – There is generally a sub-limit for pollution liability, which may not be sufficient for some companies.

Points to note:

- D & O Insurance can be extended to include a longer "discovery period" or "extended reporting period" after the end of the policy period for notifying the insurer of claims, if the policy is cancelled or not renewed. However, such extension is restricted to those claims occurring during the policy period.
- In a merger & acquisition, it is advisable to consult the insurance broker for professional advice on run-off insurance arrangement where changes in risk render the acquired company's D & O Insurance policy invalid from the time of merger.
- Pollution liability insurance may provide another alternative to increase the protection limits to the company and the insured directors or officers.

2.5 Main policy conditions

- 2.5.1 Notification of actual or potential claims – The insurance policy imposes a wide interpretation of a "claim" as to include any written demand of claims or civil proceedings by the third parties, and any circumstances which may or are likely to give rise to a claim.
- 2.5.2 Right of litigation – Generally, the insured has the duty and right to appoint lawyers to conduct defence. However, since insurer has inherent interests in the litigation outcome, it will always have the right to act on behalf of the insured. Some insurers allow the insured to continue a court proceeding in protecting the company's goodwill even if the insurer would like to settle a claim. In that case, the policy liability will be restricted to the amount of liability and defence cost up to the date of such election by the insured.
- 2.5.3 Change in control – The policy will continue to cover after the change in control but only in respect of wrongful acts committed prior to the effective date of such change.

Points to note:

- For the purpose of notification of a claim, the following information should be included:
 - A description of a claim or inquiry
 - The nature of the alleged act, error or omission
 - The nature of the alleged or potential loss
 - The names of actual or potential claimants
 - The manner in which the company first became aware of the claim
- It is advisable to appoint a lawyer who has a good degree of insurance knowledge and with the prior approval of the insurer.

3. Best Practices

Corporate governance and D & O Insurance complement each other. They are not substitutes. D & O Insurance is a way to promote corporate governance. The level of premium payable by the company tends to correspond with the quality of its governance structure. A company with good governance encourages an independent assessment from the insurer on its on-going process of governance. D & O Insurance is also a good risk management resource in terms of legal expertise and, more importantly, the fund to pay claims and defence cost when a claim arises.

Below is a list of best practices for D & O Insurance though it is not considered as conclusive or exhaustive.

- 3.1 Ensure that coverage offered by an insurance policy is clearly understood by all board members. Any limitations of the policy should be communicated to the covered directors and officers.

- 3.2 Produce a written confirmation of D & O Insurance to the newly appointed directors.
- 3.3 Take great care in completing applications at the time of new applications and at each annual renewal. Directors must ensure the accuracy of all information contained in the applications in order to avoid any disputes at the time of claim.
- 3.4 Report promptly to the insurers all "claims" or "circumstances" or events likely to give rise to a "claim" under the insurance policy.
- 3.5 Ensure that all indemnification is authorized in accordance with the Articles of Association of the company. Since the insurer has an active interest in the legality and procedural correctness of any indemnification of the covered directors and officers, all indemnification arrangements and payments must be properly documented for the insurer's inspection.
- 3.6 Keep insurers informed of company developments e.g. announcements and circulars to shareholders.

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This guidance note is only intended to provide a general guide on the subject matter and should not be regarded as a substitute for detailed advice in individual cases. HKICS does not accept any liability for loss or damage sustained by any person or organisation as a result of reliance on the information or views stated herein.

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