

# D & O Insurance: What Officers of Listed Companies Need to Know in the Event of SFC Enforcement Action

*Enforcement action by the Securities and Futures Commission (“SFC”) against officers of companies listed on the Stock Exchange of Hong Kong is becoming increasingly prevalent. While the SFC has expressed concerns about the quality of new listings, even well-established companies such as CITIC have also been the subject of major enforcement action. This past year, Tom Atkinson, Executive Director and the Head of the Enforcement Division of the SFC, has stated repeatedly that corporate misfeasance is one of the top enforcement priorities and that the SFC is investigating a large number of cases involving dereliction of duty by senior management at listed companies. A failure to ensure proper supervision or controls, as a consequence of which there is either a collective failure or misconduct by a specific subordinate, may amount to negligence and may therefore result in personal liability.*

The financial burdens faced personally by officers of listed companies in the face of SFC enforcement can be substantial. The cost to a director in defending himself from the pre-investigation stage through to proceedings in a court or before the Market Misconduct Tribunal (“MMT”) can easily run into the millions of dollars. In this environment, it is timely for directors and other senior executives of listed companies to consider whether directors and officers liability insurance policies (“D&O policies”) which they may have in place will cover SFC enforcement action taken against them.

AIG, the largest underwriter of D&O policies in the world, indicated that in 2016, it paid over HK\$62 million in claims under such policies in Hong Kong, a 141 per cent. increase compared to 2012. It noted that about 90 per cent. of claims resulted from regulatory investigations and

April 23, 2018

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predicted a continuation of this upward trend due to increased focus by the SFC on enforcement action.

## Indemnity from the Company

Listed companies may pay directly for the costs of dealing with SFC investigations or defending their officers from SFC enforcement actions. However, depending on the laws of the place where the company is formed, indemnities from companies may be subject to statutory limitations which can significantly limit the level of protection. Hong Kong law restricts a company from indemnifying its directors but not other officers. A company may not indemnify a director against:

- liability to the company or any associated company in connection with any negligence, default, breach of duty or breach of trust (“**default**”);
- liability to pay any fine imposed in criminal proceedings or for non-compliance with any regulatory requirement;
- liability incurred by the director in defending criminal proceedings in which the director is convicted, or civil proceedings brought by the company itself (or an associated company or a shareholder) in which judgment is given against the director. The latter is a risk particularly because a court may order that a listed company bring proceedings in its own name against a director or former director.

One consequence of these restrictions is that arguably a Hong Kong company cannot indemnify its director against legal costs incurred to defend himself in criminal proceedings, or civil proceedings brought by the company, until the director has been exonerated. Otherwise, if there is ultimately judgment against the director, any indemnity already provided would have

been unlawful. This means that the director will himself typically need to pay legal bills as they are incurred.

## Indemnity through a D&O Policy

Some of these restrictions may be overcome through insurance. First, Hong Kong company law expressly permits a company to take out a D&O policy indemnifying its directors for liability to any person incurred in connection with any default in relation to the company, except for fraud.

Secondly, Hong Kong company law expressly permits a company to take out a D&O policy indemnifying its directors for liability incurred in defending criminal or civil proceedings alleging any default (including fraud) in relation to the company. In other words, even though a Hong Kong company cannot itself advance defence costs to a director in respect of criminal proceedings (or civil proceedings brought by the company), the company may take out a D&O policy which would do so.

The ability to take out a D&O policy for liability incurred in defending civil and criminal proceedings is particularly significant because SFC investigations are often open ended. This open ended nature gives optionality for the SFC to pursue criminal prosecution as well as or in lieu of civil remedies. An allegation of the failure of a listed company to properly disclose inside information may, for example, result in a criminal prosecution for market misconduct (disclosure of false or misleading information) or civil proceedings through the MMT. In the absence of the statutory provisions permitting indemnification for costs of criminal as well as civil proceedings the company arguably could not indemnify a director for costs incurred in connection with any SFC investigation related to that allegation, as these costs might amount to liability incurred by the

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director in defending criminal proceedings in which the director is subsequently convicted.

## Insured Perils

Though contractual language will vary, a D&O policy will typically provide indemnity for a “Loss”. The definition of “Loss” will then set out the types of claims the policy will cover. For example, the policy might provide coverage for:

- civil proceedings, whether through the courts or an administrative tribunal or agency, as well as criminal proceedings;
- investigations, which may be defined as being formal investigations which (i) are conducted by a regulatory body or law enforcement authority, and (ii) name a specific officer as a person under investigation; and
- pre-investigation enquiries which fall short of an investigation as defined in those policies.

The range of perils insured is important given the wide range of options available to the SFC to pursue its enforcement objectives. Under the Securities and Futures Ordinance (“SFO”), for example, the SFC may require a listed company to provide documents and, in that connection require a past or present officer of that company to provide an explanation or statement in respect of those documents. Whether the requirement for an officer to provide such an explanation or statement constitutes an investigation may be significant for the purposes of determining D&O coverage and will depend upon the particular language of the D&O policy.

On the other hand, the SFC may make enquiries without invoking its statutory powers. An officer of a company responding to such an enquiry does so voluntarily but

under the unstated threat that a failure to respond may result in an escalation of enforcement action. A D&O policy which covers investigations may not regard such an enquiry as being an investigation and as a result, may not cover the cost of legal representation in responding.

## Losses Covered

A D&O policy may (and should) provide coverage not only for legal costs of a director to defend himself against civil and criminal proceedings but also for liability for breach of any duty.

D&O policies often exclude coverage for regulatory fines. Some D&O policies contain express exclusions to this effect. Others contain express inclusions subject to applicable law. In many jurisdictions, applicable law prohibits companies formed in that jurisdiction from taking out such coverage, and the company is also prohibited from indemnifying its officers directly.

Where a company formed in a jurisdiction that does not prohibit coverage for regulatory fines takes out a policy that does not expressly exclude such coverage, the position is unclear. If the policy is governed by Hong Kong law, newer case law suggests that mere negligence resulting in the fine may be sufficient to annul coverage.

In the context of regulatory fines, the SFC typically does not settle enforcement actions without an admission of liability. Consequently, an officer who seeks to settle with the SFC may find himself liable to pay the settlement amount without the benefit of D&O coverage as such an amount may constitute a regulatory fine.

## Form of Coverage

In broad terms, coverage under a D&O policy is offered in 3 forms, commonly referred to as Side A, Side B and

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Side C coverage. Side B and Side C coverage provide coverage to the listed company itself rather than to its officers. In Side B, the insurer reimburses the company for sums paid by the company to indemnify its officers from liabilities personally incurred by them. In effect, Side B enables companies to transfer to an insurer the financial burden of any contractual liability they may have to indemnify their own officers. In Side C, the insurer indemnifies the company from its own liability.

Side A provides direct coverage to officers for any loss suffered by them where indemnification from the company is unavailable because (i) the company will not provide indemnity (e.g. because the company is insolvent), or (ii) the company is not permitted to provide indemnity. As noted above, Hong Kong company law restricts the indemnification of directors. As a result, directors of Hong Kong companies may need to rely on Side A coverage instead.

## Assured Parties

Generally, the policy holder of a D&O policy is the listed company itself, with directors and other officers being named as assured parties. Where the policy also provides coverage for officers of the company’s subsidiaries, there may be an issue as to whether such coverage extends to officers of subsidiaries which were not subsidiaries at the time coverage was effected. Officers of newly acquired or newly formed subsidiaries should enquire whether they are covered under a D&O policy and if not, what steps need to be taken to effect coverage.

Some D&O policies define who is an “officer”. Typically, coverage will extend only to persons acting in a supervisory capacity.

## Standing to Enforce

Though it is often assumed that the officers named as assured parties under a D&O policy may themselves enforce the policy, this is not necessarily the case. The officers may be regarded as third parties to the D&O policy, particularly where their terms of employment do not oblige the company to maintain the policy, and thus officers may have no standing to enforce the policy themselves. This may be particularly significant where the officer is no longer on good terms with the company.

In Hong Kong, the Contracts (Rights of Third Parties) Ordinance would not give the officer standing if the D&O policy is intended to be only enforceable by the company rather than the assured parties. Accordingly, officers may wish to satisfy themselves that if relations with their company become hostile, they will nevertheless be able to rely upon a D&O policy.

## Claims Made

D&O policies are generally written on a “claims made” basis, meaning claims may only be made during the currency of the policy. By contrast, a “losses occurring” policy provides coverage so long as the claim relates to an event during the currency of the policy.

Under a “claims made” policy, the assured parties should include present and past officers of the company. SFC enforcement action typically focuses on past conduct and by the time the SFC investigates a particular individual, he may have ceased to be an officer.

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## Claims Procedure

Where the SFC invokes its statutory powers to compel cooperation in the context of an SFC enforcement action, the secrecy provisions of the SFO will likely apply. That will prohibit a person from disclosing any matter coming to his knowledge by reason of assisting the SFC in its enforcement process, unless otherwise exempted. An officer may breach the SFO where, in filing a claim, he notifies the insurer of the enforcement action.

However, the SFC has given standing consent to notify an indemnity insurer of the general nature of the enforcement action. If the insurer requires specific details of the action, the officer will need to seek specific consent from the SFC.

## Limits

Like all liabilities policies, D&O policies are subject to monetary limits. The limits are normally shared between all the assured parties. Where the SFC takes enforcement action, it is not uncommon for the action to be taken against a company as well some of its officers. In this case, if the D&O policy provides for Side A and Side C coverage, the company and the officers will all be drawing down on the policy. As the company and each officer may be unaware of the extent to which the others are drawing down on the policy, there may be some uncertainty as to how long coverage will last.

## Conclusion

Considering the real and unpredictable risks of enforcement action, directors and other officers of listed companies would be well advised to ensure that they understand the extent of any indemnity afforded to them by the company, and to consider whether their D&O policies provide sufficient coverage.

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- Representing a director of AcrossAsia in the first case before the MMT alleging a breach by a director of the statutory requirement to disclose inside information.
- Representing Andrew Left before the MMT in respect of his report on Evergrande in the first case anywhere in the world by a regulator against an activist short seller
- Representing Pacific Sun, a hedge fund manager, before the Court of Final Appeal in the leading case defining the scope of the professional investors exemption in investment offers

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