

The New Companies Ordinance: Implications for Directors & Officers Liability Insurance

With the new Companies Ordinance coming into force next month, what are the considerations for companies and directors when taking out Directors & Officers Liability Insurance? The new Companies Ordinance codifies the common law duty of care, skill and diligence and introduces a new concept of “Responsible Person”. It also clarifies the rules on what the company can and cannot indemnify its directors for. Some matters however still remain unclear.

A director may incur personal liability in various ways both to the company as well as third parties. It is common for the director to be indemnified by the company and under a Directors and Officers Liability Insurance Policy (“D&O Insurance”). D&O Insurance generally covers directors for liability that the company is not permitted or required to indemnify (“Side A”) and reimburses the company for any liability or costs that it is required to pay to the director (“Side B”).

The new Companies Ordinance (Cap. 622) (“new CO”) comes into effect on 3 March 2014. We discuss below these changes under the new CO and their implications for D&O Insurance.

Directors’ Duty of Care, Skill and Diligence

Following in the footsteps of the other jurisdictions, Section 465 of the new CO codifies directors’ duty to exercise care, skill and diligence. The common law position is not entirely clear and the position is now clarified by Section 465. In exercising his duty of care, skill and diligence, a director is required to exercise the care and skill expected of a person carrying out these functions (an objective test) as well as bearing in mind his particular knowledge and skill (a subjective test). In determining whether a director has discharged his duty under Section 465, his conduct will be compared with that of a person who is reasonably diligent and taken to be carrying out the same functions as the director in question. If

the director possesses additional knowledge or skills, then his conduct will be compared with a person of comparable knowledge or skills as well. Directors are required to achieve at least the objective standard set out in Section 465 and the standard will be higher if they possess particular knowledge or skills.

Section 466 provides that the remedies for breach of the duty are the same as in common law or equity, namely, compensation or damages. The duty is owed to the company and any claim is likely to be brought by shareholders or liquidators by way of derivative claim.

“Responsible Person”

The new CO introduces concept of “Responsible Person”, who is a director or officer of the company and “*authorises or permits, participates in, or fails to take all reasonable steps to prevent*” contravention of the New CO. A Responsible Person will also be liable for any contravention of the new CO. A Responsible Person also includes a shadow director, who gives instructions and directions to the company even though he may not formally hold the position of a director.

The concept of “Responsible Person” replaces that of “*officer who is in default*” in Section 351 of the existing Companies Ordinance (Cap. 32) (“old CO”). Under Section 351, an “*officer who is in default*” means any officer who knowingly **and** wilfully authorises or permits the default or contravention of the old CO.

D&O insurers need to be aware that the new formulation of “Responsible Person” potentially increases exposure for directors. A director is liable if he authorised or permitted the contravention or failed to take reasonable steps to prevent the contravention. There is no further requirement that he must have knowingly and wilfully authorised the contravention.

Scope of the Company's Permitted Indemnification

Under Section 165 of the old CO, the company is prohibited from indemnifying its directors and officers against any liability to the company or its related company. Section 165(2) provides that the company may nevertheless indemnify its directors and officers if judgment is found in their favour. It was not clear whether the company can indemnify its directors and officers for any liability to third parties.

Under the new CO, the company is still prohibited from indemnifying the director for liability to itself or an associated company (see Section 468). However, Section 469(1) of the new CO expressly allows the company to indemnify directors for “*any liability incurred*” to third parties provided certain conditions are met. While Section 469(1) does not expressly mention legal costs, the director’s liability to pay legal costs to his lawyer is also a “liability incurred” to a third party.

Section 469(2) prohibits the company from indemnifying directors for fines and penalties, as well as “*any liability incurred*” in criminal proceedings where the director is convicted and derivative claims brought by the company or associated company in which judgment given is against the director (Section 469(2)). Therefore, if the director is convicted or found liable in derivative claims brought by the company, the company is prohibited from indemnifying the director for any liability to pay fines or damages as well as any legal costs.

This also suggests that the company is permitted to indemnify the director for defence costs in criminal proceedings if he is acquitted or in derivative actions in which judgment is given in his favour. However, the new CO does not clearly specify whether the company is permitted to pay the director’s legal costs *in advance* of judgment. Given the prohibitions in Section 468 and 469(2), we take the view that the company cannot pay the director’s legal costs in advance and will need to wait until judgment.

It is relevant to note that Section 469 makes no mention of regulatory action. It would appear as such that directors can still be indemnified for their legal costs incurred in relation to any regulatory action against them, although he would not be entitled to be indemnified for any penalties for non-compliance (see Section 469(2)(a)).

The new Section 468 permits the company to take out D&O Insurance for directors against liability to the company or related company as well as any liability incurred in defending any civil or criminal proceedings for negligence or default to the company or related company.

The old CO did not prohibit the company from indemnifying directors of related companies. This technical loophole has now been fixed in the new CO which expressly prohibits the company from indemnifying directors of related companies for their liability to the company or the related company.

Implications for D&O Insurance

Given the new codification of the duty of due care and skill and the new formulation of “Responsible Person”, there is a risk of increased exposure for directors. It remains to be seen whether this is the case and only time will tell. Further, the company is prohibited from indemnifying directors for breach of due care and skill to the company by virtue of Section 468(3). The company also cannot indemnify a director if he is convicted of any contravention of the new CO as a “Responsible Person”. Directors must therefore rely on the protection afforded by Side A of the D&O Insurance and should ensure that the cover extends to any breach of statutory provisions such as the new CO.

The advancement of defence costs under Side A is highly important for directors given the new CO is unclear as to whether the company is permitted to pay the director’s legal costs prior to judgment.

As the new CO expressly permits the company to indemnify directors for liability to third parties, companies should ensure that the reimbursement cover under Side B of the D&O Insurance is sufficient to cover any reimbursement. Companies and directors should also ensure that liabilities which cannot be indemnified by the company, such as fines and penalties, liabilities to the company and defence costs in civil and criminal proceedings where the director is found liable to the company, are adequately covered under D&O Insurance.

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