

D&O INSURANCE: INSIGHTS INTO THE CHINESE MARKET



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Overall

Since Ping An and Chubb offered the first D&O insurance to Vanke Real Estate for free with a sum insured of CNY 5 mill per year in 2002, the D&O insurance market in mainland China has been slowly developing. Zurich Insurance Group estimated that only 5% of listed companies

purchased D&O insurance by November 2010. A current estimation of leading underwriters in the Chinese D&O market shows that the domestic market is still small, with fewer than 20% of listed companies having bought D&O insurance by June 2019.

In 2001 the first D&O-related statute law was being introduced in China, creating the legal framework for D&O insurance, which started being offered on the Chinese market in 2002. After a revision in 2005, the State Council published an official recommendation for the promotion of D&O insurance. A milestone in the development of D&O insurance in China was the 2012 regulation of HKEX, which requires all listed companies on the Stock Exchange of Hong Kong to purchase D&O insurance unless those companies disclose the reasons why they decided not to buy D&O insurance. Until February 28, 2013, there were 1,544 companies listed in Hongkong, with 90% of the companies having bought D&O insurance. The reform in the stock-issuance mode led to a registration-based mode, giving more

freedom also more responsibility to directors, therefore they are more prone to liability risks. Secondly, the registration-based mode means less regulation and control on the stock market, so more companies of various quality could go public, bringing more risk to investors. In effect, registration-based mode makes IPO a lot easier, thus there will be more listed companies and more directors and officers to be insured, which will lead to a larger market size for D&O insurance.

Recent purchases of D&O insurance

Shenzhen BGI Group in 2019 recently announced that it intends to insure all directors, supervisors and senior management personnel of the company in accordance with the provisions of the "Guidelines for the Governance of Listed Companies". The offered sums insured range from CNY 100 mill to CNY 200 mill (USD 14.5 mill to USD 29 mill), with an annual premium amounting between CNY 210,000 to CNY 450,000 (USD 30,568 to

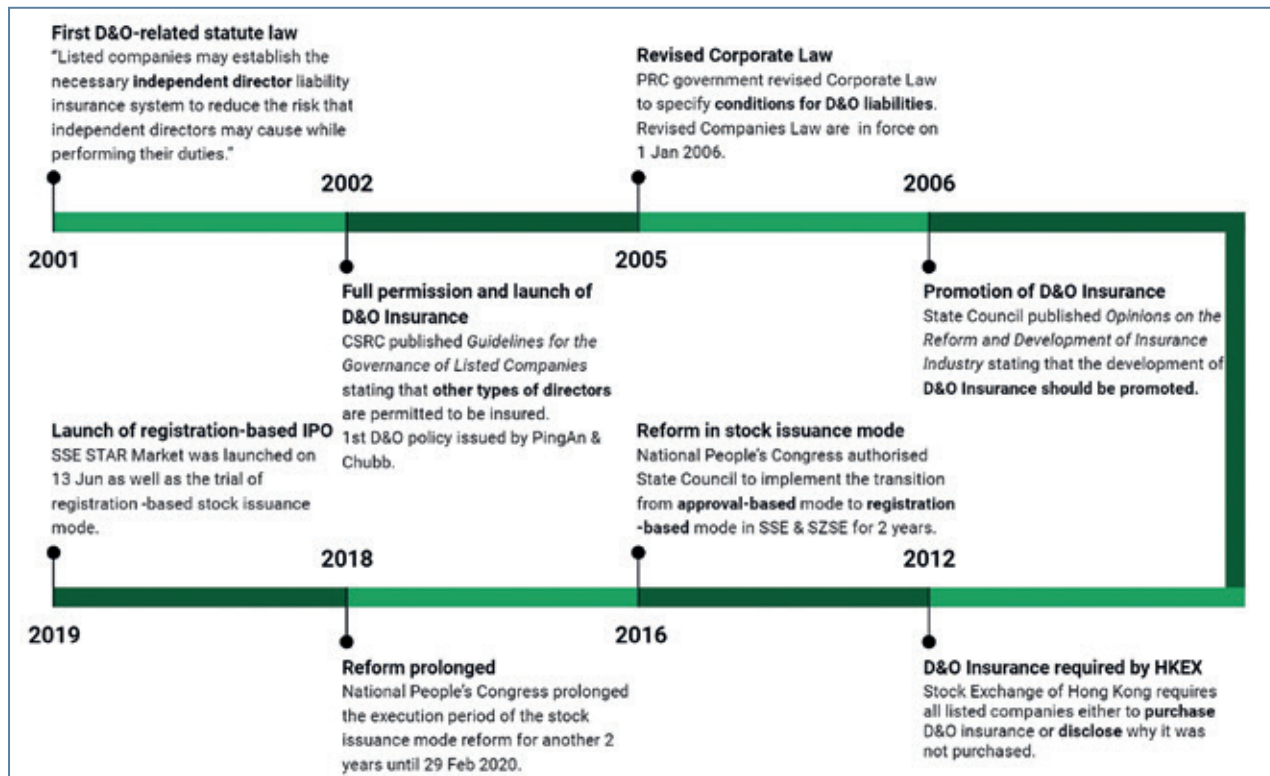


Chart 1: Timeline of major events impacting the Chinese D&O market

Quelle: Thomas Wang

USD 65,503). The proposal still needs to be submitted to the company's shareholders meeting for consideration. According to the Securities Times reporter's statistics, this year, there are 8 listed companies in China that purchased D&O liability insurance. In addition to BGI Group, there are SF Holdings, Sonoscape Medical, GCL System Integration, Guanhao High-Tech, Avcon, Tatwah Smartech and BNBM Group. Among them, SF Holdings is the largest deal with an annual insurance premium of CNY 720,000 (USD 65,500), and a sum insured of CNY 750 mill (USD 109.17 mill) per year.

General aspects on D&O liability according to the Chinese legal situation

The legal framework for the liability of directors is set by the Company Law of the PRC, which holds directors explicitly liable to shareholders for their conduct of the company's affairs. However, the duty of care is still less onerous than in western jurisdiction. According to the Company law directors can be indemnified by the company for any D&O liability.

Chinese law does not allow US-style class action suits in private securities litigation. However, several investors together can bring a 'joint action' in China if the object of the action is the same or in the same category. Joint actions further can be divided into two categories: actions in which the number of parties is fixed at the time of filing, and actions in which the number of parties is not known at the time the case is filed. This latter category is usually termed 'Chinese-style class action'. While Chinese-style class actions differ in several technical aspects from their US counterpart, they are similar to US-style class actions in that there are numerous plaintiffs involved and the judgment of the action applies to members of the plaintiff class who have not participated in the lawsuit. Since the Chinese-style class action was introduced in 2002, the number of cases has been rather modest, according to recent empirical studies. However, in about 90 % of these cases, the plaintiff successfully received recovery. While the number of cases is much lower, the ratio of recovery in China is significantly higher than in the US.

The following legal provisions shall be pointed out, as they are the basis on



which the exit from China may be denied to foreign individuals who are appointed as company organs. This is a relevant risk, as there are a number of current cases in China involving German managers, who are not able to leave the country due to those provisions:

- Art. 255 Civil Procedural Law: "Where an enforcee does not perform the obligations determined in the legal document, the People's Court may adopt or notify the relevant authorities to assist in adoption of measures such as restricting the enforcee from leaving China, announcement of information on non-performance of obligations through the creditworthiness system records or the media and other measures stipulated by the laws."
- Art. 37 Interpretations of Supreme People's Court on Several Issues relating to Enforcement Procedures for Application of the Civil Procedure Law: "Where the party subject to enforcement is an organisation, its legal representative, key person-in-charge or directly accountable personnel which affect performance of debt obligations may be subject to restriction for overseas travel.[...]"
- No. 2d Notice of Supreme People's Court, Supreme People's Procuratorate, Ministry of Public Security and Ministry of State Security on Issuing Several Provisions on Lawfully Restricting Foreigners and Chinese Citizens from Exiting China: "Where foreigners or Chinese citizens are involved in unsettled civil cases, the people's court shall decide to restrict their exit from China and

execute the decision accordingly. At the time of making the above decision, the people's court shall inform the public security organ thereof."

The Chinese D&O insurance market

The major insurers in the Hongkong and Mainland Chinese insurance market include AIG, Chubb, Zurich, Ping An and Huatai. The local market capacities are shown by the following chart:

Insurer	Capacity	Rating
AIG	USD 15 mill.	Moody's A2
Chubb	USD 25 mill.	A.M. Best's AAA
Zurich	USD 30 mill.	A.M. Best's A+
Ping An	USD 30 mill.	Standard & Poor's A-Moody's A2
Huatai	USD 30 mill.	Fitch A

Local Chinese market capacity of major players in Hongkong and Mainland China.

Quelle: Thomas Wang: Interviews with Chinese underwriters of the respective insurer

When it comes to coverage, local D&O policies are modified versions of standard international wordings, which are written on a claims-made basis with aggregate, costs-inclusive indemnity limits. Average sums insured range from CNY 10 mill to CNY 100 mill. (USD 1.45 mill

Rank	Company Name	Reason	Closing Date	Settlement Amount (CNY)
1	东方电子 Dongfang Elec	Misrepresentation	2009 05	330 million
2	佛山照明 China FSL	Illegal information disclosure	2015 12	180 million
3	佳沃股份(万福生科) JOYVIO	Misrepresentation	2013 07	179 million
4	海联 Hirisun	Misrepresentation	2014 10	88.82 million
5	银广厦 YinGuangSha	Misrepresentation	2006 04	39 million
6	科龙电器 Kelon	Misrepresentation	2009 06	25 million
7	中捷股份 ZOJE	Misrepresentation	2010 08	14.2 million
8	五粮液 WuLiangYe	Misrepresentation	2014 10	13.44 million
9	东盛科技 Topsun	Misrepresentation	2012 12	12.95 million
10	廊坊发展 Langfang Dev.	Misrepresentation	2013 12	12.95 million

Chart 3: Major D&O claims mainland China. 2006-2015.

Quelle: "Directors and Officer's Liability Solution for Companies Listed in China Security Market" By China PingAn Property Insurance Company Limited, 2016, Shenzhen, China

to USD 14.5 mill), with some exceptions exceeding this amount (see Some recent examples of D&O above). The local capacities provided amount up to USD 30 mill (see Chart 2). The premium level can be described as very low.

Insured and settled claims in the years 2006 till 2015 are ranked in the following chart. The top 10 settled claims range from CNY 12.95 mill to CNY 330 mill (USD 1.89 mill to USD 48 mill). Frequency and severity are rising, however, the number still lags behind the numbers of the US, Australia and Germany, which have been the regions with the most D&O claims in the world for many years.

Since 2013, all court judgement in China shall be made available online. However, unlike Germany or the US, judgements in China are usually very brief. They only state a brief summary of the case and the outcome, e.g. who is ordered to pay to whom. They often do not give more detail regarding the reasoning of the court and the relevant articles of law or regulations.

This makes it much more complicated to search for cases that belong to the same group or type, such as D&O cases. The following two smaller cases are accessible publicly, the first case was insured and settled by AIG.

The case of GAC Changfeng Motor's false statements

On January 7, 2009, GAC Changfeng announced that the Office of the Financial Ombudsman of the Ministry of Finance in Hunan Province carried out an inspection of the quality of the company's accounting information for 2007 from May 28 to August 22, 2008, and carried out a routine inspection of the relevant sub-branches and branches and extended the inspection of the previous relevant years and related units. Subsequently, the Administrative Penalty Decision was served on the company. The Decision on Administrative Punishment of the Office of the Financial Ombudsman of the Mi-

nistry of Finance in Hunan Province found that the company had violated the law in the basic work of accounting, and the implementation of the national fiscal and taxation policy, and in accordance with relevant laws and regulations, imposed administrative penalties on the company and required the company to pay all kinds of taxes. According to the Securities Law of the People's Republic of China and the Provisions of the Supreme People's Court on The Trial of Civil Compensation Cases Arising from False Statements in the Securities Market, investors whose rights and interests have been subject to administrative penalties for false statements may file civil compensation law suits with a court. In mid-November 2011, Li and 17 other people, on the grounds of securities misrepresentation compensation dispute, asked the company to compensate for the loss of its investment difference, commission and stamp duty loss and interest loss in part of the investment difference, and to bear the full litigation costs of the case. After the Changsha Intermediate People's Court presided over the mediation, 2 people withdrew the case, GAC Changfeng Company and 15 plaintiffs reached an agreement: the company gives a one-time compensation to 15 plaintiffs and to bear the costs of litigation in the case. In total, GAC Changfeng paid nearly 980,000 yuan. AIG Insurance took the first step in the settlement of the Chinese D&O liability insurance case, paid 800,000 yuan to GAC Changfeng.

The case of Hareon Solar

On June 12, 2014, due to technical errors, Hareon Solar's ex-right opening price is shown as 7.16 yuan instead of 7.95 yuan (the correct price). Subsequently, the Shanghai Stock Exchange found the problem and temporarily suspended the company's shares. On the same day, Hareon Solar published "The Self-Examination of the Ex-Rights Situation on 12 June". On June 15, the Shanghai Stock Exchange and Hareon Solar announced the "Plan for Compensation for Relevant Investors on the Error of Reference Price of Hareon Solar Stocks", indicating that they will compensate the investors who traded the stocks in the morning of 12 June and the compensation is calculated on the basis of the difference between the correct ex-rights price of 7.95 yuan and the actual



sale price of the investor. In the end of June, Hareon Solar issued the “Tip Announcement of Hareon Solar Technology Co., Ltd.”, stating that the compensation will be paid 50% by the Shanghai Stock Exchange and 50% by Hareon Solar. Considering the company purchased D&O Insurance, the company is actively consulting with the insurance company, and will settle the claim as soon as possible. On 27 June, compensations were paid to more than 500 investors. The maximum compensation for a single investor was 508,500 yuan, with the lowest amount being 0.75 yuan.

Reasons for the slow development of D&O in China

Currently D&O liability risk is being seen as a low-loss and low-probability risk in China. The directors and senior management personnel of domestic Chinese companies lack the motivation to transfer risks, resulting in insufficient demand for this insurance, and the market develops slowly. The reasons are, firstly, that the development of D&O insurance and the development of the legal system of a country are closely linked. China is still lagging behind in respect of the degree of establishment of both the tort law system and corporate governance stan-

dards, compared to Western countries. Secondly, the probability of a D&O liability for Chinese managers is still low, as they are less likely to be punished as the legal framework is very rarely being applied in practice. Another aspect hereby is that most executives of listed companies are board representatives of state entities or state-owned enterprises. The report “Lei Tang - Liability Immunity of Government Officials in China” refers to some local regulations, that have granted immunity to government officials. Apparently, the idea behind this is that the threat of civil liability could cause the government officials to avoid any risks and to be too careful when implementing reforms. In addition, the sanction of misbehavior of government officials is usually handled by the CPC itself. The report states that government officials ‘effectively’ are immune from suits. This de-facto protection of government officials further relates to the absence of a division of power between the courts and the government. Judges are unlikely to make a verdict against a government official in a civil liability law suits. Therefore directors with background as an official are effectively immune and in practice are rarely being sued in a civil litigation case.

Thirdly, even in case of a liability risk, the compensation is fairly low for two rea-

sons: the Chinese legal system only knows direct damages, no indirect damages, and the compensation legislation system is generally lacking.

Conclusion

In the current D&O market, there is still little demand, but the regulatory and legal environment are already changing. This trend leads to an increase in executive exposure. On the other hand, many Chinese state-owned or privately-held enterprises invested heavily overseas in the US or European markets. They are confronted with a comprehensive D&O package for their management abroad, which also applies to the Chinese managers being sent abroad. In the US, many class-action lawsuits were filed against Chinese companies listed in the US stock exchanges and their directors and officers. Therefore, a strong awareness on D&O liability exposure and respective management protection among Chinese expat managers in the US and Western Europe shall be noted, and accordingly leading to a stronger discussion about D&O insurance also in the Chinese headquarters. ■

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