Directors' Liabilities and Indemnification under the Companies Ordinance
Introduction

As a sequel of our newsletter about directors under the new Companies Ordinance (Cap 622) ("New CO") in December 2013 and January 2014, this newsletter focuses on directors' liabilities, indemnifications and exemptions, together with the directors' insurance thereunder.

Director's liabilities

As mentioned before, the New CO codifies director's duties to exercise reasonable care, skill and diligence, which were found mainly in common law. It provides that a director must exercise reasonable care, skill and diligence that would be exercised by a reasonably diligent person with general knowledge, skill and experience (a) that may reasonably be expected of a person carrying out the functions of that particular director; and (b) that the director has. Existing civil consequences of breach of duties under common law continue to apply. However, other fiduciary duties of directors remain uncodified and will continue to be governed by common law rules and equitable principles.

Further, the New CO introduces the term "responsible person", which, pursuant to s.3, includes a director or a shadow director who authorizes/permits or participates in the contravention or failure. It replaces the term "officer who is in default" under s.351 of the predecessor Companies Ordinance (Cap 32) ("Predecessor CO") by removing the "wilfully and knowingly" element. In short, a director would now be held liable for his recklessness. Besides, the New CO specifically imposes some obligations on directors, failing which personal liabilities would arise.

Needless to say, directors might also incur liabilities pursuant to the express terms in their service contracts which stipulate their duties and responsibilities in the capacity of directors of the company.

Exemptions

It is not uncommon that a company's articles of association or service contracts with its directors contain provisions that exempt the directors from liabilities owed to the company or its associated companies. Having said that, s.468(2) of the New CO prohibits a company from granting such exemptions where the liabilities (whether to the company or a third party, i.e. any person other than the company itself or its associated companies) would otherwise attach to the director in connection with any negligence, default, breach of duty or trust in relation to the company.

Indemnifications

Under the New CO, a company is prohibited from indemnifying its directors or director of its associated companies against any liability that would otherwise attach to the director in connection with any negligence, default, breach of duty or trust in relation to the company or its associated company.

s.469(2) of the New CO further provides that such indemnities against liability incurred by the director to third parties is permitted as long as such indemnities are not in connection with any negligence, default and breach of duty or trust in relation to the company for (i) criminal penalties/penalties imposed by regulatory bodies; (ii) defending costs in criminal proceedings in which the director is convicted; (iii) defending costs in successful civil actions brought by the company/associated companies or derivative actions brought by the shareholders on behalf of the company/associated company; or (iv) costs of the director's unsuccessful applications for relief for misconduct/in proceedings for misconduct.

Accordingly, the New CO does not completely disallow indemnification of a director's defence costs in judicial proceedings. The provisions in s.469 implies that a company is allowed to indemnify its directors of the legal costs incurred if (i) the director is eventually acquitted in the criminal proceeding; (ii) the action bought by the company/associated company or the derivative action against the director is unsuccessful; and (iii) the director successfully applies for relief for misconduct/in proceedings for misconduct.

Besides, s.469 does not preclude a company from indemnifying its director's legal costs incurred in regulatory proceedings such as proceedings brought against the director in the Market Misconduct Tribunal by the Securities and Futures Commission, albeit that any penalties imposed by such regulatory bodies cannot be indemnified to the director.

Insurances for the Directors

Though a company is not permitted to exempt or indemnify its directors against certain liabilities as mentioned above, it could take out insurance for its directors or directors of its associated companies against such liabilities (except fraud) and the directors' legal costs in defending any civil and criminal proceedings taken against them (including fraud) in relation to the company or its associated companies.

In case such insurance policy is accordingly taken out in favour of a director, even if a civil action is successfully brought by the company and/or its associated company against the director or the director is convicted in criminal proceedings, the director's legal costs and/or his liability to pay damages in the civil actions (other than for fraud) can still be recovered, notwithstanding that he could not obtain indemnification directly from the company due to the express prohibitions as mentioned above.

In fact, for listed companies, the Listing Rules of The Stock Exchange of Hong Kong Limited expressly provides that a listed company should arrange appropriate insurance cover in respect of legal actions against its directors (Appendix I4 paragraph A.1.8 of the Main Board Listing Rules and Appendix I5 paragraph A.1.8 of the GEM Listing Rules).

Practical Tips

The indemnity and insurance provisions under the New CO are reflected in the Model Articles under the Companies (Model Articles) Notice (Cap 622H) ("Model Articles") which allows indemnification of a director and empowers the directors to purchase and maintain, at the expenses of the company, insurance for a director of the company or a director of the associated company. However, notwithstanding the express provisions in CO and the Model Articles, the company is not obliged to offer the same to the directors. Thus, a director should be minded to bargain for equivalent express terms in his service contract with the company in order to better protect his interest.

On the other hand, the company should:

1. expressly set out in such directors' service contracts the specific indemnification and insurance policy that the company would provide for the directors in order to avoid disputes in the future;
2. make sure that the directors' liability insurance policy taken out provides sufficient coverage for (i) reimbursement to the company for any indemnifications that the company have provided for its directors; and (ii) the liabilities which cannot be indemnified or exempted by the company as mentioned above;
3. consider amendment of the Articles of Association so as to align with the new regime under the Model Articles, particularly companies adopting the Table A under the Predecessor CO, which does not expressly empower directors of taking out insurance policy for a director; and
4. disclose any permitted indemnity provisions which are in force in its directors' report and keep a copy of it at the company's registered office for inspection by members of the company.

[1] Means a subsidiary, a holding company and a subsidiary of the holding company (section 2 of New CO)
IMPORTANT:
The law and procedure on this subject are very specialized and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

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