

## Insurance Law Update

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# First Chinese Special Representative Securities Action Spikes Demand for D&O Insurance, but Coverage Availability Remains Unclear

By: [Huiyi Chen](#), Yinuo (Norah) Zhang, and [David M. Kroeger](#) <sup>[1]</sup>

Purchasing directors and officers insurance (D&O insurance) is a standard practice for public companies in the United States. D&O insurance is often critical to recruiting and retaining quality directors and officers for companies, because it helps to protect them from personal exposure to significant damages and attorneys' fees resulting from the execution of their job duties. Without adequate D&O insurance coverage, potential qualified candidates might be deterred from serving as directors and officers, which would be a loss to the company, the shareholders, and to society at large.

The same is not standard practice in another major economy in the world, China. With only 15% of public companies (or 650 out of over 4,500) carrying D&O insurance, and with overall annual premiums of only 100 million CNY (around 15.8 million USD),<sup>[2]</sup> the Chinese D&O insurance market is obviously underdeveloped and likely underpriced.

The reason for this phenomenon is two-fold. First, the regulatory fines for false representations, which had been the major financial deterrence to companies and D&Os, given that investor collective actions in court had virtually been non-existent until very recently (more discussion below), and the regulatory fines were extremely low (with an upper limit of 300,000 CNY, or 47,500 USD, for individual directors and officers). The low regulatory fines, coupled with the lack of enforcement by the regulators, contributed to the low demand in the Chinese D&O market. Second, although the D&O insurance rates were relatively low in China compared with those in the United States, the premiums still seemed unjustifiably high to most public companies in China, especially in light of the lack of material securities-related penalty or indemnification precedents or a major example of a successful D&O insurance policy payment in the market.

But that may no longer be the case. The demand for D&O insurance has recently spiked in China in response to the new Chinese Securities Law that went into effect in March 2020 and raised the regulatory fines up to five million CNY (or around 792,000 USD) for individual D&Os, as well as recent Chinese court rulings that implemented a new type of securities class action, which could render directors and officers personally liable for billions of Chinese Yuan. Since the beginning of this year and as of February 20, 2022, 32 publicly listed companies in China have announced plans to purchase D&O insurance—more than three times compared to the same period last year.<sup>[3]</sup> We also understand that at least one insurer expects an over 50% sales increase this year for D&O insurance. This article discusses the new Chinese legal regime that gave rise to this change, as well as the likely future trend of D&O insurance development in China.

On November 12, 2021, in China's first-ever "special representative" securities action<sup>[4]</sup> brought by over 55,000 investors, Guangzhou Intermediate People's Court ruled that Kangmei Pharmaceutical Co., Ltd. (Kangmei), a public company listed on the Shanghai Stock Exchange, was liable for more than 2.4 billion CNY (around 379 million USD)<sup>[5]</sup> due to fraudulent accounting representations in its public reporting between 2016 and 2018.<sup>[6]</sup>

The landmark ruling is among the top 10 commercial cases in China in 2021, according to the Supreme People's Court—the highest court in China<sup>[7]</sup>—and was picked up in the English financial and legal media as well.<sup>[8]</sup> The significant price tag is only one of the noticeable factors that brought attention to the Kangmei ruling, and the shocking effect it exerted on the Chinese business and legal world is largely attributable to *who* were found to be personally on the hook for that huge amount of damages. Six directors and officers, including Kangmei's Chairman and Vice Chairman (who was also the Chairman's wife), were found to have directly and deliberately participated in the accounting fraud and were held jointly and severally liable for the entire damages amount.<sup>[9]</sup> Over a dozen other directors and officers were signatories to the fraudulent reporting at issue and were found to have breached their duty of care in not spotting the massive inflation of revenues, profits, and cash in the company's public statements.<sup>[10]</sup> For these co-defendants (which included five independent directors), their liabilities were capped at 5%-20% of the damages. That is, each independent director was jointly and severally responsible for at least 120 million CNY (around 19 million USD). To put it in context, according to a recent report, the average annual salary for independent directors in China is around 84,000 CNY (around 13,280 USD),<sup>[11]</sup> which is negligible compared to what they can now be personally responsible for as shown in the Kangmei ruling.

Also on the hook for the 2.4 billion CNY damages was Kangmei's outside auditor (GP Certified Public Accountants) and one of its partners, who issued an unqualified opinion for Kangmei's 2016 and 2017 financial statements.<sup>[12]</sup> According to a Chinese regulation jointly issued by the Ministry of Finance and China Banking and Insurance Regulatory Commission that went into effect on July 1, 2015, accounting firms auditing public companies are required to purchase professional liability insurance with an aggregate limit of at least (1) one million CNY (around 158,000 USD) multiplied by the number of partners; or (2) 50 million CNY (around 7.9 million USD), whichever is higher.<sup>[13]</sup> Before this regulation came into effect, only around 500 accounting firms in China bought professional liability insurance, or 6% of all accounting firms nationwide.<sup>[14]</sup>

Assuming GP Certified Public Accountants had bought the required professional liability insurance, it is unlikely that the policy limit would have been high enough to cover the gigantic joint and several liability—if the policy provided coverage at all. Like professional liability policies in the United States, such policies sold in China usually contain an “intentional act” exclusion. A form policy issued by one of China's largest insurers, Ping An Insurance, for example, excludes losses arising out of “intentional acts, criminal acts, gross negligence, fraudulent or dishonest acts” of the policyholder, the insured, or their representatives or employees.<sup>[15]</sup> Given that the court found the auditing work to have been “seriously flawed” and that the partner involved was “grossly negligent” in conducting the auditing,<sup>[16]</sup> and that the parties decided not to appeal the Kangmei ruling, there could arguably be a dispute over whether the “intentional act” exclusion applies to bar coverage.

In addition to the damages, the defendants were also jointly and severally liable for court costs of over 12 million CNY (around 1.9 million USD).<sup>[17]</sup> Unlike in the United States, where court costs are usually a relatively small amount, the court costs in China in commercial and property cases are charged at a degressive rate of the disputed amount, with a percentage of 0.5% for any amount over 20 million CNY (around 3.1 million USD).<sup>[18]</sup> The court costs need to be prepaid by the plaintiff and are ultimately shouldered by the losing party.<sup>[19]</sup> This is, of course, on top of the attorneys' fees—the defendants in the Kangmei case were separately represented by over 10 different law firms.<sup>[20]</sup>

The Kangmei case is not the first securities collective action in China, contrary to what many headlines suggest. It is the first “special representative” securities action in the country, a novel collective action mechanism authorized by the Supreme People's Court in a judicial interpretation that went into effect on July 31, 2020.<sup>[21]</sup> When there are more than 10 plaintiffs in an action that satisfies the conditions for joint civil action under China's Civil Procedure Law, the plaintiffs can nominate two to five representatives to pursue such an action on their behalf, and the trial court will determine the “class” definition and publish it for 30 days to allow investors to register as class members. This is the

“ordinary representative action” under Chinese law.<sup>[22]</sup> The first-ever ordinary representative action related to securities violations and misrepresentations in China was a lawsuit against another public company, Shanghai Feilo Acoustics, brought by 315 investors in August 2020, which resulted in damages and costs totaling 146 million CNY (around 23 million USD) against the company.<sup>[23]</sup> No directors or officers were sued in that lawsuit.

A “special representative” action, on the other hand, is where an investor protection institution receives authorization of more than 50 investors during the 30-day publication period in an ordinary representative action and represents all investors in the defined class, unless an investor opts out.<sup>[24]</sup> The Kangmei case started as an ordinary representative action with only 11 investors as plaintiffs, and turned into a special representative action after China Securities Investor Services Center (a nonprofit organization established in December 2014 and under the direct supervision of China Securities Regulatory Commission) accepted authorization of 56 investors during the publication period.<sup>[25]</sup> The class member was defined as any investor who bought Kangmei’s stock in the open market from April 20, 2017 to October 15, 2018 and still held the stock after the close of market on October 15, 2018, with certain exceptions.<sup>[26]</sup> Only nine investors opted out from the class.<sup>[27]</sup> The default rule of inclusion in special representative actions undoubtedly bolstered the number of plaintiffs and, hence, the ultimate damages amount.

Within two weeks after the Kangmei ruling, independent directors from 27 public companies in China submitted resignations.<sup>[28]</sup> And in the five working days following November 15, 2021, over 50 publicly listed companies expressed interest in purchasing D&O insurance from Ping An Insurance, according to a news report.<sup>[29]</sup> The trend of rising D&O demand in China continues to this date. The Kangmei ruling serves as a wake-up call to directors and officers in this market as they can become personally liable for billions of Chinese Yuan in the new Chinese securities law regime.

But uncertainties remain as to whether the insurers in China (whether local insurers or insurers with foreign investment from the major insurers in the West) are willing and able to meet the rising demand. To start with, we observe that insurers in China have expressed mixed feelings about the Kangmei ruling. On the one hand, they recognize the greater demand for the D&O product, the significantly increasing possibility of claims under the D&O policies, and that this case could be a game-changer for the industry. On the other hand, insurance actuaries are relatively undeveloped in China with respect to the D&O product, and the premium rate and the insurance coverage have been relatively low for the purpose of controlling risk, compared with the international market up to this point. So far, insurers may still not be confident enough in pricing the risk to develop and market the product that could satisfy the market demand on a grand scale under the new era after the Kangmei case, because the insurance coverage in the market may need to increase significantly to be able to cover the potential losses under the new securities regulatory and litigation circumstances. The Kangmei ruling has turned a possibility of a nightmare scenario that could bankrupt insurers into reality, and Chinese insurers can no longer view the D&O product as a source of steady profits with low risks. We anticipate Chinese insurers with international backgrounds, or those at a larger financial scale or with a better risk control system, will take the lead in setting the parameters of D&O product development in China, as they are relatively more experienced in this area and can shoulder more risk. In addition, the traditional D&O insurance normally does not cover regulatory fines, which could be a significant portion of the directors’ and officers’ personal liability after the new Securities Law went into effect. This is another factor that injects uncertainties in the development of the D&O market in China on the demand side.

We also anticipate a rise in coverage disputes in the Chinese D&O insurance market in the near future. In China, insurance contract disputes must be resolved in the court where the insurer is located, and, given that Chinese insurers are mostly headquartered in the major cities with mature judiciary systems, we might very soon see precedent-setting cases coming out of China with respect to D&O coverage disputes. Policyholders should pay close attention to the exclusions included in the D&O insurance policies and consider consultation with insurance counsel and brokers to minimize risks of coverage denial.

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## Contact Us



**Huiyi Chen**

[hchen@jenner.com](mailto:hchen@jenner.com) | [Download V-Card](#)



**David M. Kroeger**

[dkroeger@jenner.com](mailto:dkroeger@jenner.com) | [Download V-Card](#)

Meet Our Team

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## Practice Leaders

### David M. Kroeger

Co-Chair

[dkroeger@jenner.com](mailto:dkroeger@jenner.com)

[Download V-Card](#)

### John H. Mathias, Jr.

Co-Chair

[jmathias@jenner.com](mailto:jmathias@jenner.com)

[Download V-Card](#)

### Brian S. Scarbrough

Co-Chair

[bscarbrough@jenner.com](mailto:bscarbrough@jenner.com)

[Download V-Card](#)

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[1] Huiyi Chen is an associate at Jenner & Block LLP. Yinuo (Norah) Zhang is a partner at JunHe LLP, focusing on insurance practice in China. David M. Kroeger is a partner at Jenner & Block LLP and co-chair of the insurance recovery and counseling practice and the reinsurance practice at the firm.

[2] Yang Qianwen, *Kangmei Case Makes D&O Insurance Popular* (Nov. 24, 2021), available at <https://www.yicai.com/news/101238410.html>.

[3] Su Xianggao, *Public Companies' Need for D&O Insurance Increases Rapidly This Year*, *Securities Daily* (Feb. 21, 2022), available at [http://epaper.zqrb.cn/html/2022-02/21/content\\_809563.htm?div=-1](http://epaper.zqrb.cn/html/2022-02/21/content_809563.htm?div=-1).

[4] A particular kind of collective action analogous to a class action in the United States. See discussion below.

[5] The USD amount in this article is based on the exchange rate on February 20, 2022.

[6] *Gu Huajun v. Kangmei Pharmaceutical Co., Ltd*, Guangzhou Intermediate People's Court of PRC (Nov. 12, 2021), available at <https://finance.sina.com.cn/stock/s/2021-11-15/doc-iktzqtyu7331636.shtml> ("Kangmei Decision").

[7] The Supreme People's Court of the People's Republic of China, *Top 10 Commercial Cases Nationwide in 2021* (January 29, 2022), available at <https://www.court.gov.cn/zixun-xiangqing-344441.html>.

[8] See, e.g., Reuters, *Chinese Court Rules against Kangmei in 'Milestone' Case* (Nov. 12, 2021), available at <https://www.reuters.com/business/healthcare-pharmaceuticals/chinese-court-rules-against-kangmei-milestone-case-2021-11-12/>; Kevin LaCroix, *First-Ever Chinese Collective Investor Action Results in \$385 Million Damages Verdict* (Nov. 15, 2021), available at <https://www.dandodiarary.com/2021/11/articles/securities-litigation/first-ever-chinese-collective-investor-action-results-in-385-million-damages-verdict/>.

[9] Kangmei Decision at 36–37.

[10] *Id.* at 37–38.

[11] China Merchants Securities, Quantitative Analysis Team, *Market Hot Topic Analysis: Understanding Resignations of Independent Directors* (Nov. 26, 2021), available at <https://mp.weixin.qq.com/s/IL5cXSWvHDOkixLp3JL5Bw>.

[12] Kangmei Decision at 38–40.

[13] The Ministry of Finance and China Banking and Insurance Regulatory Commission, *The Interim Measures for Professional Liability Insurance for Accounting Firms* (eff. July 1, 2015), Article 9, available at [http://www.gov.cn/xinwen/2015-07/09/content\\_2894651.htm](http://www.gov.cn/xinwen/2015-07/09/content_2894651.htm).

[14] The State Council Information Office of the People's Republic of China, *Q&A regarding the Interim Measures for Professional Liability Insurance for Accounting Firms by the Ministry of Finance and China Banking and Insurance Regulatory Commission* (July 30, 2015), available at <http://www.scio.gov.cn/xwfbh/gbwxwfbh/xwfbh/bjh/Document/1442823/1442823.htm>.

[15] See [https://resources.pingan.com/app\\_upload/file/property/20110212175554997.pdf](https://resources.pingan.com/app_upload/file/property/20110212175554997.pdf).

[16] Kangmei Decision at 39–40.

[17] *Id.* at 43.

[18] *Decree of the State Council of the People's Republic of China No. 481, Rules Governing Litigation Fees* (eff. Apr. 1, 2007), Article 13, available at [http://www.gov.cn/gongbao/content/2007/content\\_512694.htm](http://www.gov.cn/gongbao/content/2007/content_512694.htm).

[19] *Id.* at Articles 20 & 29.

[20] Kangmei Decision at 1–7.

[21] Supreme People's Court of the People's Republic of China, *Provisions of the Supreme People's Court on Several Issues Concerning Representative Actions Arising from Securities Disputes* (eff. July 31, 2020), available at <https://www.court.gov.cn/zixun-xiangqing-245501.html>.

[22] *Id.* at Articles 5 & 6.

[23] Guo Yan, *Shanghai Supreme Court Rules in the First Ordinary Representative Securities Litigation*, *People's Court Daily* (Oct. 12, 2021), available at [http://rmfyb.chinacourt.org/paper/html/2021-10/12/content\\_210084.htm?div=-1](http://rmfyb.chinacourt.org/paper/html/2021-10/12/content_210084.htm?div=-1).

[24] *Provisions of the Supreme People's Court on Several Issues Concerning Representative Actions Arising from Securities Disputes*, Articles 32 & 34.

[25] Kangmei Decision at 24.

[26] *Id.*

[27] *Id.* at 25.

[28] Lin Jian, *Independent Directors from 27 Public Companies Resigned within 13 Days* (Nov. 25, 2021), available at <http://www.jwview.com/jingwei/html/11-25/445547.shtml>.

[29] Yang Qianwen, *Kangmei Case Makes D&O Insurance Popular* (Nov. 24, 2021), available at <https://www.yicai.com/news/101238410.html>