

The Viability of D&O Insurance in Foreign Jurisdictions – The Korean Experience

Are you an Officer or Director of an overseas entity, even if it's just a subsidiary of your parent company? Has your parent company indemnified the Directors, Officers and Managers of your foreign subsidiaries? Even if so, do you know how the laws of this foreign jurisdiction impact corporate indemnification and the viability of coverage provided by your Directors' and Officers' (D&O) liability policy?

We offer this brief as a baseline for the discussion of the issues surrounding corporate indemnification of Korean Directors, Officers and Managers and the financing of that indemnification vis-à-vis insurance. The "Korean Experience" should provide you with insights into how the laws and norms of foreign jurisdictions may affect your coverage and therefore your exposure, potentially both corporately and personally.

The central question we will address here is whether Korean Corporations can indemnify their Directors, Officers and Managers under Republic of Korea law and under which conditions they may be permitted or required to do so. Secondarily, how might an insurance product finance the indemnification of the Directors, Officers and Managers? And finally, to what extent there can be a "worldwide" insurance financing vehicle, for your company and its subsidiaries to address the various jurisdictional, articles of organization and/or contractual promises of indemnification.

Overview

The Republic of Korea uses the civil law system. In Korea, the Korean Commercial Code ("KCC") and the Security and Exchange Law govern a company and its Directors, Officers and Managers. These entities also govern such persons' liability and the extent to which corporations may indemnify them for liabilities arising from performance or non-performance of their fiduciary duties.

Under the KCC, Directors are elected pursuant to a resolution of the General Meeting of Shareholders ("GMS") and are registered with the court. Officers or Managers are not defined in the KCC. In practice, Officers are usually executives with managerial authority, such as a President, Vice President, Managing Director and Director. The term "Manager", typically refers to the head of certain departments, divisions or teams of a company.

The KCC provides that a Director shall be jointly and severally liable for damages to the company or to third parties, if such damages result from the Director's neglecting to perform his or her duties, violation of any laws, regulations or the company's articles of incorporation. It also appears that Korean courts have determined that an indemnification agreement is not valid with regard to covering losses caused by willful misconduct or gross negligence.

With the exception of tort liability, under the KCC, the liability of Directors of the company may be exempted only by the unanimous consent of the shareholders. The company may indemnify

Directors for tort liability with unanimous consent of the shareholders, as long as such liability does not involve willful misconduct or gross negligence. There is no explicit restriction on indemnification for liabilities to third parties, but similar to the principles set forth above, if the liabilities arise from willful misconduct or gross negligence (which is often the case with third party liabilities), indemnification would not be permitted.

Corporate Structure

There are four types of corporate entities in Korea. A joint stock company, or chusik heosa, is the most common. In addition to the corporate governance requirements of the KCC, public companies are also subject to the provisions of the Korean Securities and Exchange Act (“KSEA”). The remainder of this brief will be focused on issues related to Directors, Officers and Managers (“D&O’s”) of a chusik heosa under the KCC.

The major corporate authority of a chusik heosa are the GMS, Board of Directors (“Board”), Representative Director (“RD”) and Statutory Auditor (“SA”) or Audit Committee.

The GMS is the ultimate policy-making entity of the company, which controls basic corporate matters, including the appointment of Directors and SAs, amendments to the Articles of Incorporation (“AoI”), mergers, acquisitions, etc.

The Board has the authority to decide matters with respect to the operations of the company, which are not reserved for determination by the GMS. The RD is elected by the Directors pursuant to a Board resolution unless the AoI provides otherwise. The RD is authorized to represent the company in dealings with third parties, to execute commitments in the name of the company, to carry out the decisions of the GMS and the Board, and to manage the general affairs of the company.

The SA (or the Audit Committee), whose powers are determined by the KCC, has significant power and authority. It acts as an independent monitor of the activities of the management of the company. The SA also has the authority to inspect and supervise the activities of the Board, individual directors and the RD, as well as to audit the books and records of the company. Leading scholarly opinions posit that the legal effect of the resolution made by a sub-committee of the Board of Directors is equivalent to the same by the entire board unless it is revoked by the entire board afterwards.

Legal Framework

The relationship between a Director and the company is a mandate or a delegation under the Korean Civil Code. The interpretation of this relationship may differ slightly for the application of certain laws. For example, some court decisions have deemed RDs to be employees, with a

right to a severance payment under the Labor Standard Act. Officers or Managers typically are bound to the company by employment or independent contract.

Directors are deemed to be fiduciaries of the company, to which they owe a duty of due care and a duty of loyalty, with the applicable standard of care being that of a good manager under the KCC. Most legal experts describe the applicable standard of care as “the same degree of loyalty and care needed generally and objectively as an ordinarily prudent man”. Directors must act with care given their actual knowledge and such knowledge as they should have reasonably acquired. If deemed to be a de-facto director under the KCC, Officers and Managers also may owe a duty of care and duty of loyalty to a company under certain limited circumstances.. The KCC provision regarding the liabilities of the de facto director has not (to-date) been utilized by any plaintiff’s, however, the December 2003 amendments to the KSEA impose liabilities on the de facto director for any damages arising out of false or misleading statements in or material omissions from any public disclosure.

Although the concept of a Business Judgment Rule (a major defense in US D&O and other litigation) has not been expressly adopted by the Korean courts, the concept of “business judgment” has, to some extent, been used in determining Directors’ duty of due care and negligence.

In contrast to the approach in the United States, where the Directors have a fiduciary duty first to look out for the interests of the shareholders, the duties of the Korean D&O’s are directed towards the company, rather than the shareholders. There is a debate among the legal scholars in Korea regarding whether Directors should have an obligation to protect the shareholders, especially the minority shareholders, but the courts have not expressly recognized such an obligation. For example, the Supreme Court has taken the position that, unless the Directors fail to exercise due care (to the company, not the shareholders), certain actions they take that result in bankruptcy of the company do not necessarily invoke the Directors’ liability.

As contrasted with other jurisdictions, such as the Italy and Germany for example, in most circumstances under Korean law, D&O’s are not responsible for the tax, labor or environmental liabilities of the company. In certain situations of egregious violations of regulations, D&O’s could be held liable, but such instances are rare. The same holds true for criminal liabilities – D&O’s are liable only under certain specific circumstances.

Statute of Limitations

The statute of limitations varies with respect to specific rights and obligations. The following list provides a sense of the statute of limitations for various issues. .

- a) Liability to company arising from Directors’ liability: 10 years
- b) Contractual issues -- Civil disputes: 10 years, Commercial disputes: 5 years

- c) Tort liability arising from discrimination, sexual harassment or wrongful termination: 3 years from recognizing damages and responsible person and 10 years from occurrence of the tort.
- d) Fraud may result in tort or contractual liability – see b) and c) above.
- e) Tax issues: 5 to 10 years; however, as stated above, D&O's typically are not personally liable for company tax liabilities.

Who Brings Litigation Against Directors' & Officers' in Korea?

Corporation and Shareholders (derivative action)

A corporation (usually with the SA representing the corporation), either independently or in a private company at the request of a shareholder with 1% or more of shares, can bring an action against a Director(s). If the SA does not bring the requested action within 30 days from the shareholders' request, the shareholders may bring action against the Directors on behalf of the company. There were few derivative actions prior to 1997, but since the financial crisis of that year, the number has increased significantly.

Shareholders (direct actions and class actions), Creditors and Other Third Parties

Directors may be personally liable to shareholders and other third parties, for any damages incurred by such third parties as a result of the Directors' willful misconduct or gross negligence in failing to perform their duties to the company. The Director(s) may be held liable even if such failure does not constitute a tort against the third party under the Civil Code. Shareholders may bring direct actions against the Directors. Shareholders may also bring tort liability suits against the Directors. There has been a rise in activity of citizen watchdog groups, like the People's Solidarity for Participatory Democracy (PSPD), which have brought legal action against a number of chaebols.

A class action system has not yet been fully adopted in Korea. The current trend in the Korean legal system however, is to design legal measures to further protect the rights of the shareholders, especially minority shareholders. As such, the class action suit with respect to securities transactions is expected to be adopted in the near future. The Hyundai Elevator / Kumgang Korea Chemical case, by far the largest hostile takeover and proxy contest in Korean history with more than ten lawsuits filed and several disposition orders issued by Korean Securities and Futures Commission, illustrated how one prospective acquirer (Kumgang) attempted to invoke minority shareholder rights in an attempt to get an injunction against Hyundai's takeover defense, which was characterized as an attempt to perpetuate the current management team.

The Securities-Related Class Action Act (SCAA) took effect on Jan. 1, 2005. The SCAA was enacted to apply to damage claims in connection with securities issued by listed companies having assets of two trillion won or greater. Application of the Act was to be postponed until Jan. 1, 2007, for companies with fewer assets. Regardless of company asset size, claims arising

from insider trading and market manipulation can be brought to the court at any time. Further, to bring a class-action claim under the SCAA, 50 or more injured shareholders, with (collectively) at least 1/10,000 of the outstanding shares of a listed company on the either the Korea Exchange or the KOSDAQ, must join forces.

Insolvency Administrators / Trustees in Bankruptcy

Insolvency administrators or trustees in bankruptcy may take action against the management of the company for a violation of fiduciary duties. In the few cases to-date where liability actions have been brought against the management, the cases pertained to financially distressed financial institutions where public funds were injected by Korea Deposit Insurance Corporation.

Regulatory Authorities

Regulatory authorities do not have standing to initiate civil actions against D&O's, however they may impose administrative sanctions or file charges against the company. If relevant regulations are violated, the Korean capital market regulators (e.g., the Financial Supervisory Commission, the Securities and Futures Commission, or the Financial Supervisory Service) may take various actions, including an issuance of a corrective order, a request for disciplinary action, a recommendation of dismissal or a suspension of service. Regulators are now observing the activities of directors more carefully, particularly with respect to insider trading and manipulation of securities prices.

For labor regulations in particular, administrative proceedings by Korean employment and labor regulators are generally initiated against the company or the business owner.

Employees

Employees may sue Directors, Officers and Managers for discrimination, sexual harassment and wrongful employment practices, claiming personal tort liability. However, with respect to wrongful employment practices, the employees usually sue the company rather than the D&O's.

The enforceability of a foreign judgment on Republic of Korea Directors, Officers and Managers under Korean law enforcing foreign judgments in Korea is not a simple matter. Foreign judgments must obtain an enforcement judgment from a Korean court in whose jurisdiction the defendant is domiciled or has assets. An enforcement judgment is rendered where the following requirements are met:

It must be proven that the foreign judgment is final and conclusive; Judicial power of court rendering judgment must not be recognized by law or treaty; Defendant named in the judgment, if he/she was Korean national, was either served with summons necessary to commence procedure by means other than publication with enough time in advance to prepare for the defense or to voluntarily appear; Judgment is not in violation of good morals or social order; and there is a guarantee of reciprocity.

Importance of the Application Process and Policy Wording

Insurers, with their robust information, learn quicker than the majority of their customers. As such Insurers are ahead of the curve to exclude as many liabilities as possible from the contracts they issue.

The insurance world has become increasingly complex. If you don't remain abreast of the policy language nuances and do not take the time to learn the particular risks to which you are exposed, you may be explaining to the Board that they are uninsured for a significant loss – potentially personally.

Our experience has been that Directors and Officers insurance policies provide much less protection than directors and officers expect. It is paramount, then, that every company must do its utmost to position itself so that it can transfer any liability, whether old or new, to the Manufacturer.

Practical Guidance with Burdensome Application Process

Qualify or limit responses if necessary; make qualifications or limitations clear.

Restate questions and answer as restated.

Reject “warranties.”

Base representations on knowledge of signer after reasonable investigation, as opposed to blanket statements that representations are “true.”

Don't stipulate that insurer relied on information in application.

Don't volunteer information that isn't called for to “bulk up” responses.

D&O Liability Policy Construction

The traditional U.S. D&O policy has four coverage parts or sides: A, B, C and D. These parts can be described as follows:

Side A: Non-indemnifiable

Directly reimburses the Directors and Officers in situations where the organization is not able (bankruptcy) or not permitted (derivative claims) to indemnify.

Side B: Corporate Reimbursement

Reimburses the organization if it is obligated (and permitted by law) to indemnify (and actually does) its Officers and Directors for their liability.

Side C: Entity Coverage

Reimburses the organization for its own liability (for public companies typically only in securities claims). Usually not found in a locally admitted Korean D&O Liability policy.

Side D: Outside Entity Insured Person Coverage

Reimburses the designated Insured Person for their liability arising from holding an Outside Entity position, excess of any indemnification or available insurance from the Outside Entity (so-called “Double Excess” basis).

Reductions in or exclusions of coverage are found not only in the Exclusion and/or Endorsement sections of the policy; you must also navigate through the larger morass of coverage reducing pitfalls, from every “Application” completed, every public filing made, to the scope of the entire policy. The Rule of Thumb is that if your policy does not have at least as many coverage broadening endorsements as it has base policy form pages, you likely have material coverage deficiencies.

Final Thoughts

Many non-government organizations and minority shareholders in Korea have requested transparent management and best practices in corporate governance since the 1997 financial crisis. Recently, Korean courts have become very strict in reviewing directors’ compliance with their duty of care and duty of loyalty. It is our opinion, therefore, that directors of Korean public companies are now exposed to more risk than at any time in recent history.

Similar to companies listed on U.S. exchanges, those listed on the Korean Stock Exchange are required to have a certain number of outside independent directors under the Security and Exchange Law. Most independent directors request indemnity from the company including a Directors’ and Officers’ Liability insurance (D&O insurance) policy to gain protection from the risk of derivative actions, etc. Directors’ exposure to potential derivative actions in Korea is now a reality.

Korean corporate law remains “pro-Board” for the most part, but there still is increasing demand, both from indigenous firms to foreign based multinationals, for Directors’ and Officers’ Liability insurance policies in Korea. Not unlike their U.S. counter-parts however, these policies typically are riddled with exclusions and other conditions, which insurers can use to avoid paying.

Many of the observations and concepts presented in this brief: joint and several liability, de-facto directors, “business judgment” rule, statute of limitations, citizen watchdog groups, and the role of the Statutory Auditor/Audit Committee in derivative actions require standard D&O insurance policies to be modified significantly to address the funding of the promise of indemnification.

While this document addresses issues specific to the Korean market, similar or even more alarming nuances of course also exist in other foreign jurisdictions.

So if you are a director, officer, or even manager of a foreign entity, the question is not whether you are exposed, but rather how exposed are you and has your exposure been appropriately addressed. So if you find yourself with considerable personal exposure to such liability, or your company is simply trying to make sure that it has properly addressed the key indemnification issues that exist in foreign jurisdictions, you should consider enlisting the navigational expertise of a risk advisory firm such as ARI. Without such assistance, you may be unknowingly exposing yourself and/or your company to substantial unmitigated liability.

Sources of Information for this Brief

Undated, D&O liability position paper prepared by Kim & Chang: “Directors, Officers and Managers Liability: The Legal Position in Korea”;

April, 2004, ARI white paper regarding Debunking D&O myths (see <http://www.aririsk.com/cases/case.htm>);

19 April, 2005, <http://korea.assembly.go.kr/> article regarding Amendment to Act on Class Action Lawsuits on Securities;

4 February 2005, <http://koreanow.koreaherald.co.kr/> article on Securities-Related Class Action Act;

15 April, 2004, “Directors’ Liabilities and the Business Judgment Rule in Korea”, Kim and Yi;

28 February, 2002, Asian Perspective Seminar, “Advancing Corporate Governance Reform in Asia”.

It should be noted that this is a general overview of the issues regarding Korean D&O liability and should not be considered legal advice.