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The Dilemma and Way out of the Application of Directors and Officers Liability Insurance Contracts in China

MA Mingming
University of International Business and Economics, Beijing, China

With the development of corporate social responsibility (CSR) theory, the function of Directors and Officers Liability Insurance (D&O Insurance) contracts has achieved the third level of transformation from spreading the risk of directors and officers, to improving the governance structure of the company, and to realizing the social responsibility of the company. Deficiencies in the design of the insurance contract itself have become the main obstacle to the development of D&O Insurance and its function in China. Combined with a comparative law examination of the terms of D&O Insurance contracts, a reasonable way to regulate the issue of Directors and Officers Liability Insurance contracts in China is: On the identification of the subject of the insurance contract, it should be affirmed that the insured include the directors and their successors and legal representatives, and the company's status as an insured should be denied, but its status as the insurance applicant and the third party should be affirmed. With regard to the definition of misconduct and the exclusion of liability, the misconduct should be clarified by distinguishing the subjective psychology state of the insured and introducing Business Judgment Rules (BJR), and the exclusion clauses should be reasonably designed under the guidance of CSR theory and the business strategy of the insurance industry.

Keywords: Directors and Officers Liability Insurance, insurance applicant company, Business Judgment Rules, exclusion of liability

Introduction

Currently, countries around the world are constantly strengthening the directors' duties and responsibilities under the trend of board centrism. In 2021, the Company Law of the People's Republic of China (Draft Revision) strengthened the provisions relating to corporate social responsibility, reinforced the responsibilities of controlling shareholders and management personnel, provided for the first time the connotation of directors' duty of diligence in the form of articles, and clarified that directors and supervisors should exercise the reasonable care normally expected of managers when performing their duties in order to achieve the best interests of the company. The above-mentioned provisions to strengthen the responsibility of directors show the legislator's efforts to correct the "passive inaction" or "recklessness" of directors in practice, but the career risks faced by directors will also increase significantly, and even experienced directors may make errors in economic activities due to lack of relevant knowledge or subjective negligence. To solve the above problems, countries often transfer the risk through the

MA Mingming, Ph.D. candidate, School of Law, University of International Business and Economics, Beijing, China.

Directors and Officers Liability Insurance (D&O Insurance) system to remedy the directors' liability arising from the execution of their duties. However, D&O Insurance market in China is still in its infancy, and there are many problems both at the legal regulation and judicial practice. For example, due to the lack of guidance from the general provisions of the law, a uniform system of directors' liability insurance has not yet been developed in the insurance market, thus leading to a large number of contradictory provisions. In addition, the Company Law of the People's Republic of China (Draft Revision) still does not clearly stipulate the criteria for judging the directors' duty of diligence, and the lack of specific, operable, and predictable provisions has made it difficult to eliminate the accumulation of directors not "knowing" and not "doing" in practice. If directors are subjected to onerous obligations without adequate remedial mechanisms, directors will hesitate to make business decisions, which may affect the efficiency of transactions and even miss business opportunities. Therefore, this paper centers on the problems in D&O Insurance contracts, analyzes the obstacles that restrict the local design of insurance contracts, and proposes feasible suggestions for the difficulties in directors' liability insurance contracts in China.

The Dilemma of the Application of Directors and Officers Liability Insurance

As a matter of fact, the introduction of Directors and Officers Liability Insurance system in China is not late; as early as 2001, the legislative level issued successively the "Guidance on the Establishment of Independent Directors' System in Listed Companies" and the "Code of Governance for Listed Companies" to escort the development of Directors and Officers Liability Insurance. However, over the past 20 years, the D&O Insurance market in China has not been robust and its implementation has been far less than the expected vision, with a significant two-way imbalance between supply and demand that has not turned around until 2019. The key reason is that the current legal environment and realistic conditions in China are not yet fully suitable for the development of directors' liability insurance, thus hindering the implementation of this insurance. What's more, in addition to the legal constraints, the drawbacks of the directors' liability insurance contract itself have greatly hindered the development of this insurance. For example, many of the director's liability insurance provisions developed by Chinese insurance companies lack reasonableness and even contradict the current legal provisions in China. Taking the insurance contract formulated by Ping An Insurance Company as an example, the company indemnity clause, the liability clause for the spouse of the insured, and the bankruptcy validity clause contained in its insurance policy are essentially invalid clauses, which are actually copied from the insurance design of foreign developed countries without considering the Chinese legal environment (R. G. Zhang & H. Zhang, 2019). Therefore, in order to meet the realistic needs of the development of D&O Insurance in China, these obstacles should be analyzed at the level of application of insurance contracts according to the actual operation of insurance practices, so as to lay the foundation for the localized design of insurance clauses. By summarizing the disputes in insurance practice, it can be seen that the contractual dilemmas restricting the development of China's insurance industry are mainly focused on the following three aspects.

Ambiguity in the Scope of the Insured and the Third Party: The Identity of the Company Causes Disputes

Due to the scope of the insured which is not defined by law, it results in the insurance company's insurance policy being unable to specify the scope of the insured. According to the terms set by Ping An Insurance Company, because it adopts the doctrine of broad directors' liability insurance, the insured individual and the insured insurance company are included in the ranks of the insured. However, since China has not established Corporate Indemnification System, the corporate indemnity insurance is essentially an empty shell. The insurance policy implemented in the market is actually directors' personal liability insurance, but the design of the insurance clause is copied from western insurance, resulting in the confusion of the scope of the insured in the insurance contract, and it is questionable whether the company can be the insured of directors' personal liability insurance.

Confusion in Defining Misconduct: Difficult to Adapt Subjective and Objective Standards

With the trend of increased director liability, the third parties are likely to sue for the fault or negligence of directors in the performance of their duties. However, not all civil liabilities resulting from directors' actions are covered by insurance, so D&O Insurance defines directors' business actions that result in financial compensation to third parties and are covered by insurance as "misconduct". The Company Law of China takes the directors' fiduciary duties as an important basis for regulating directors' conduct, which includes the duty of fidelity and the duty of diligence, and clearly enumerates the circumstances under which directors violate the duty of fidelity. However, the law does not provide for the content of the duty of diligence and the standard of reasonable care, nor does it provide for the legal liability arising from the violation of the duty and its reduction or exemption, which leads to the ambiguity of the situation of directors' misconduct arising from the violation of the duty of care in practice, and it is difficult to determine whether the directors' violation of the duty of diligence is the subject of directors' liability insurance.

Burdensome Exclusion Provisions: The Function of Risk Differentiation Is Put on the Shelf

Article 39 of the Code of Governance for Listed Companies, which provides "except for directors' liability arising from violations of laws and regulations and the articles of association", is generally regarded as an exclusion to D&O Insurance. However, according to this provision, D&O Insurance actually lost the basis of existence and the value of application, which is obviously a misrepresentation of the original intention of this provision. In the insurance practice, such as the "Insured v. Insured Exclusion" clause stipulated by the insurance company greatly limited the scope of D&O Insurance coverage, and the lack of localized design in the content of the clause, resulting in the limited application of circumstances. Taking the directors' liability insurance contract of Ping An Insurance Company as an example, there are as many as 25 exclusion clauses, which not only greatly squeezes the space for directors' risk diversification in directors' liability insurance, but also makes it difficult to meet the compensation conditions in practice. This also greatly weakens the function of risk diversification, which seriously weakens the incentive for companies to purchase insurance.

Screening of the Identity of Parties to Directors and Officers Liability Insurance Contracts

D&O Insurance has the characteristics of group insurance, and in U.S. insurance practice, when an insured under a D&O Insurance contract fills a lawsuit for damages against another insured listed in the same insurance contract, the insurer usually denies coverage according to the "Insured v. Insured Exclusion" clause. The exclusion clause arose from two well-known U.S. precedents, Bank of Am. v. Powers (Waldman, 1988) and National Union Fire Insurance Co.[1] In these two cases, the companies, as other insureds under the insurance

[1] See National Union Fire Ins. Co. v. Seafirst Corp., 891F.2d 762, 765-769 (9th Cir. 1989).

contracts, sued the directors who worked for them and the insurers who underwrote the directors liability insurance, asserting that the insurer should be liable in lieu of the directors who were sued. The U.S. courts have upheld plaintiff companies' claims; under this provision, the insurer is not liable for losses arising from a suit against directors and officers where the plaintiff is a corporation, a subsidiary of a corporation, an institution representing the interests of a corporation, or other directors and officers. Most insurance contracts in China also provide for this clause, but the exclusion clause has caused considerable controversy in practice. Therefore, the following will define the identities of the multiple subjects involved in the insurance contract, with a focus on the complex legal identity of the insured company, so as to clarify the basic legal relationship structure of the directors' liability insurance system, and thus achieve the effect of reshaping the basic subject structure of the insurance contract.

Determination of the Scope of the Insured

In order to solve the problem of the scope of the insured, we must first define the subject matter of the insurance, then clarify which subjects can become the insured, and finally clarify the extension of the insured.

Affirmation of the insured status of directors and their senior management. As mentioned above, D&O Insurance contracts cover the liability risks of directors and officers in the performance of their duties, and therefore the status of directors and officers as insured should be confirmed first. In corporate practice, according to different classification criteria, directors can be divided into three types: formal and informal directors, internal and external directors, independent and non-independent directors. In addition, the insured of the directors' liability insurance include the company's senior staff, which are traditionally very broad in scope and cover the following positions: chief executive officer, chief financial officer, chairman of the board, president, vice president, secretary, and chief accountant (Su, 2000). The legal profession usually uses the term officer in a narrow sense, i.e., officers are those who hold important positions in the company, the scope of which mainly includes managers, supervisors, board secretaries, financial officers, etc. (Sun, 2011).

Negation of the Identity of the Insured Person of the Insurance Applicant Company

At present, the provisions of directors' liability insurance drawn up by the insurance companies represented by Ping An and Minan in the Chinese insurance market not only stipulate directors, supervisors, and senior management as the insured, but also stipulate the insurance applicant company as the insured (Zhao, 2022). However, the design of such clauses has caused controversy in the academic community. The point of confusion is that Directors and Officers Liability Insurance by its name should be for directors and their senior management, so why do all foreign policies include the insurance applicant company as an insured? The root cause of this practice, as far as foreign countries are concerned, is the Corporate Indemnification System in their Corporate Law. The Corporate Indemnification System is a common and important system in Common Law countries to protect corporate officers from the threat of personal liability arising from normal business decisions in order to encourage them to make full use of their talents for the development of the company. In insurance practice, the coverage of D&O Insurance is divided into Side A, Side B, and Side C according to the subject matter of the insurance. The first category provides insurance coverage for individual managers against risks arising from shareholder litigation; the second category provides insurance coverage for the company's assumption of vicarious liability to its managers; and the third category provides insurance coverage against risks arising from shareholder litigation when the company itself is a party to the shareholder litigation. Therefore, for directors and officers in the U.S., if their conduct that triggers a claim by another person satisfies the elements that trigger both corporate indemnity and D&O Insurance coverage, the directors' liability insurance coverage for them should be limited to the indemnified portion of the company, which corresponds to the aforementioned Side A coverage, in order to avoid duplication of coverage. At the same time, since the essential purpose of corporate indemnity is the same as that of directors' liability insurance, which is to mitigate the liability risk of directors and supervisors, so the corporate indemnity liability is included in the coverage of D&O Insurance (Side B coverage).

Legal transplantation needs to be based on the practice of legal development in the country; domestic scholars have proposed that China follows the U.S. Corporate Law to establish a Corporate Indemnification System (Hao, 2013). However, the Chinese legal system is very different from the common law system, and it is debatable whether we need to transplant the Corporate Indemnification System and include the company into the category of the insured. First of all, the Company Law of the People's Republic of China, the Securities Law of the People's Republic of China, and other laws and regulations and relevant judicial interpretations have never directly or indirectly provided for the Corporate Indemnification System, and Corporate Indemnification System in the United States is mainly aimed at the civil liability of directors and supervisors to other subjects outside the company, and some of these external liabilities belong to the false statement liability under the Securities Law, that is, the liability for violating the obligation of information disclosure. According to the relevant provisions of the Securities Law of the People's Republic of China, in such cases, the company as the issuer often needs to bear joint and several liability with the directors and supervisors and others for the losses suffered by investors. Since the company itself is also jointly and severally liable subject, there is no need for directors and supervisors to bear the responsibility of compensation. It can be seen that the establishment of Corporate Indemnification System would have contrary consequences to established Chinese institutional norms (Zhao, 2022). Secondly, the coverage of D&O Insurance is wider than that of Corporate Indemnification System, which can better play the role of risk diversification (Johnston, 1978). Finally, the company's own securities liability risk should likewise not be diversified through directors' liability insurance. Therefore, under China's corporate legal framework, it is not reasonable and justifiable for the insurance applicant company to be a director's liability insurance insured.

Substantial Expansion of the Insured's Status

According to the actual situation in China, it is suggested that the insured of D&O Insurance in China should mainly include directors and officers who were or are directors and officers of the company as well as the legal representatives, estate administrators, and heirs of these two. If the insured individual dies, loses full civil capacity, becomes bankrupt, or has financial difficulties, and a third party makes a claim against his or her heirs or legal representatives, and the claim is caused by the insured individual's negligence in the course of performing his or her duties, the insurer will treat the claim as a third party's claim against the insured individual and apply the provisions of this clause. As far as directors, a distinction needs to be made between inside directors and outside directors. Because outside directors differ from inside directors in terms of liability and exposure to litigation, the parties should make a special agreement as to whether outside directors can be insured. Usually this requires the policyholder to provide the insurer with full information about the outside director on matters affecting the insurance coverage, and the insurer then decides whether to include him or her as an insured, and sets the appropriate targeted insurance terms. In addition, since China's D&O Insurance is still in its initial stage, many insurance provisions and other supporting regulations are not yet perfect, and the scope of employees appears to be too broad and not easily defined, so it is not appropriate to include employees in the scope of the insured at this stage. Directors and officers are the groups that are more likely to suffer from D&O Insurance accidents at this stage, so the focus should be on these two, and it will be appropriate to re-evaluate whether employees are included in the scope of the insured only after the various provisions of directors' liability insurance have been improved in practice over time.

The Identification of the Scope of the Third Party Subject

In D&O Insurance, the third party is a person who has suffered damage due to the misconduct of the director. At this stage, the third party who has the right to file a lawsuit in China's D&O Insurance is still mainly the shareholder who suffers damage due to the misconduct of the director. They have the potential right to sue for damages against the director and can demand the director to bear the liability by filing a lawsuit. However, it is questionable whether the company can claim damages from the insurance company as a third party. In the practice of Chinese directors' liability insurance, insurance companies usually exclude the claims of directors and supervisors from the coverage. This may be due to the consideration of preventing malicious collusion between the insurance applicant company and the insured directors and supervisors to obtain insurance benefits, but whether it is reasonable to excessively exclude directors' liability insurance coverage for the internal liability of directors and supervisors is really worth exploring in depth. This article argues that it should be granted third-party status to the insurance applicant company for the reasons reviewed below. First of all, according to the above analysis, the insurance applicant company does not have the legitimacy and reasonableness to be the insured of D&O Insurance, both from the legal level and the practical level. This point shows that in the design of the future contingency clause of China's directors' liability insurance, the insurance applicant company will naturally not have the identity of the insured, and thus the viewpoint of denying the identity of the insurance applicant company as a third party cannot be supported. Second, even if the insurance applicant company's status as an insured is recognized under the current D&O Insurance provisions, this does not prevent the insurance applicant company from acquiring the status of an injured third party in a particular case. As a type of group insurance, when the policyholder of liability insurance is a single entity and the insured are a number of entities including but not limited to the policyholder, the policyholder, although qualified to be the insured, does not ipso facto constitute the actual insured in all cases (Zhou, 2017). Where the actual insured are a subject other than the policyholder, the policyholder may still have the status of an injured third party. Therefore, by criticizing the view that denies the third party status of the insurance applicant company, it is clear that the insurance applicant company can claim from the insurer as the third party under certain circumstances.

Identification of Directors and Officers Liability Insurance Contracts Coverage

In The Company Law of the People's Republic of China (Draft Revision), although the connotation and extension of directors' duty of fidelity and diligence are clearly explained in the form of legal articles, the content of the duty of diligence and the standard of reasonable care, as well as the pursuit of legal responsibility and the reduction of legal responsibility are not provided for. This has led to ambiguity in practice regarding the circumstances of misconduct arising from a director's breach of duty of care. Therefore, the types of misconduct are defined below with a view to developing a uniform standard in insurance practice.

Typology of Misconduct for Definition

In D&O Insurance, determining the scope of "misconduct" is the basic premise for defining the scope of liability. In the United States, directors' misconduct is usually listed in the insurance contract. An examination of the patterns of conduct enumerated in U.S. insurance contracts shows that the extension of misconduct is very broad and difficult to list all of them, but the analysis reveals the following commonalities in misconduct. (1) Misconduct occurs in the course of a director's duties, including acts within and beyond the scope of the director's duties. (2) The subjective psychology of directors is mainly negligence. (3) Misconduct is mostly related to many aspects of corporate management and information disclosure matters, mainly manifested as negligent acts, errors, omissions, false statements, misleading statements, negligence or other breaches of duty of care. The core element of the Business Judgment Rules is that directors are immune from liability for their business decisions as long as they are made in good faith and with reasonable care. In common law countries, a director's duty of diligence is referred to as a "duty of care", "duty of diligence, care and skill", or "duty of care and skill". The implication is that, by virtue of the fiduciary relationship between the director and the corporation, the director is obligated to perform his or her duties to the corporation as a director, and the performance of those duties must be in good faith and in a manner that the director reasonably believes to be in the best interests of the corporation and with the reasonable care expected of a person of ordinary prudence in a similar position and circumstances. In civil law countries or regions, it is generally based on the appointment contract or agency theory that directors have a "good managerial duty of care" to the company, which mainly refers to the general honesty and diligence of society and a person with considerable experience should have the attention.

Under the Company Law of China, the abstract nature of the directors' duty of care makes it difficult to define its scope precisely. A more feasible way to determine whether a director's conduct meets the requirements of the duty of care is to draw on the Business Judgment Rule derived from case law in the common law system as a measure of whether a director's conduct complies with the duty of care.

This article argues that in the intricate commercial field, due to the fault committed by directors as operators, there are various cases of subjective factors, including malice, negligence, gross negligence, general negligence, etc. It cannot be generally concluded that all faults are illegal, and at least in the field of commercial law illegality and fault should not be equivalent. Therefore, we should break through the traditional understanding that the concepts of fault and illegality are interchangeable in the field of civil law, and introduce a more flexible principle of imputation to sever the link between illegality and fault. This will not only enable the directors' liability insurance system to be truly effective, but also prevent, to a certain extent, directors from colluding with insurance companies to harm shareholders' interests. The Business Judgment Rule is such a flexible rule that gives the court greater discretion, and some Chinese courts have previously relied on the Business Judgment Rule in cases of directors' breach of duty of diligence and have explicitly relied on the rule as a basis for directors' exemption from liability. In order to make the court's decision based on the law and the application of the Business Judgment Rule more standardized and reasonable, China should properly introduce the Business Judgment Rule and specify it (Yang & Lin, 2022). The duty of diligence, as an abstract filler rule, leaves room for flexible discretion (Xu &

Jian, 2022). In the preceding article, it is considered that the duty of reasonable care included in the duty of directors' diligence should be evaluated objectively based on the premise that the directors have objective access to valid and necessary information and the degree of care equivalent to their professional competence and professional experience, while whether the directors have made every effort to obtain the relevant information and the level of professionalism they should have should be evaluated afterwards in the judicial process, taking into account the specific circumstances of the commercial activities and the director's professional expertise and other variables.

However, when the Business Judgment Rule is used to exclude directors from liability, not all directors' breaches of duty of care fall within the scope of "misconduct" in D&O Insurance. Since the connotation of directors' duty of diligence is difficult to clarify, in order to clarify the subject matter of directors' liability insurance, this paper typifies the conduct of directors and classifies it into two types: conflict of interest conduct and non-conflict of interest conduct. Among them, the duty of fidelity is based on conflict of interest and regulates directors' conduct involving conflict of interest, while the duty of diligence is based on the principle of honesty and credit and regulates directors' conduct not involving conflict of interest. In addition, the non-conflict of interest behavior of directors is further refined into two categories: directors' business decision-making behavior and non-business decision-making behavior. Directors' business decision-making behavior refers to directors' active participation in the company's management and transactions, making decisions to enable the company to obtain greater benefits, while non-business decision-making behavior is more ambiguous in its direction and usually includes directors' supervisory behavior, capital contribution reminding behavior, informing behavior, information disclosure behavior, etc. In order to encourage directors to seize the fleeting business opportunities and at the same time motivate directors to perform their duties diligently, a differentiated judgment standard can be adopted in respect of the subjective psychological state of directors, i.e., the judgment standard of gross negligence for directors' non-conflict-of-interest business decisions and the judgment standard of general negligence for directors' non-conflict-of-interest non-business decisions. The criterion of gross negligence means that the directors' business decisions are made with complete disregard for the interests of the company, the content of the decisions is completely incompatible with their own professionalism, the process of the decisions is completely without reasonable investigation or in violation of laws, administrative regulations, and the articles of incorporation, and the criterion of general negligence means that the directors should be held liable if they failed to act in a non-business decision and cannot prove that they have taken other remedial measures.

Definition of the Scope of Liability of the Exclusion Clause

The scope of the insurance company exclusion is the exclusion of D&O Insurance. The exclusion of liability is an important measure to prevent moral hazard arising from D&O Insurance and is also the main way to control the risk of large insurance coverage. Article 39 of China's Code of Governance for Listed Companies, which reads "except for directors' liability arising from violation of laws, regulations and articles of association", is generally regarded as an exclusion to the scope of directors' liability insurance, but the terminology is too general and the lack of differentiation of directors' subjective psychology leads to the squeezing of the application space of this provision. While directors are naturally not covered for intentional violations of the law, negligent violations should be included in the scope of directors' liability insurance, and the failure to distinguish between the two has resulted in the “no coverage for violations” rule that has seriously hindered the development of directors’ liability insurance in China.

Therefore, China can learn from Japan’s provisions that give priority to the public interest of society and design exclusion clauses that meet the actual situation of the country while taking into account the business strategies of the insurance industry. This article believes that the scope of insurance liability can be determined by combining the criteria of work conduct and subjective negligence. When a director’s work conduct causes damage to a third party, if this conduct meets the elements of the Business Judgment Rule, his or her conduct is not liable, and therefore belongs to the exclusion of liability, and at this time, the director’s subjective state should be no negligence or minor negligence. If the act does not meet the elements of the Business Judgment Rule, there are two cases: When the director is subjectively intentional, then such act is also excluded from insurance coverage, and when the director is subjectively negligent, then the work conduct is covered by insurance. The insurer may agree with the insurance applicant on a more specific scope of liability with a combination of general coverage and specific exclusions. At the same time, in order to balance the interests of both insured parties, to ensure the effective application of directors’ liability insurance while considering the operating interests of insurance companies, and to prevent the inhibiting function of civil liability from being weakened, so that directors can maintain appropriate caution in business management, a loss-sharing system can be set up in the insurance contract, which can be regulated by stipulating deductibles, co-insurance clauses, liability limits, and other systems.

Conclusions

Defect in the design of the insurance contract itself is a major constraint to the development of Directors and Officers Liability Insurance in China. Firstly, clarify the status of the subjects involved in the basic legal relationship of the insurance contract. In terms of the scope of the insured, the insured status of directors and officers should be affirmed, and the insured status of the company should be denied. In the definition of the type of third party, the third party status of shareholders and companies should be affirmed, and it is not appropriate to blindly expand the scope of third parties according to the current situation of the development of directors’ liability insurance in China. Secondly, the scope of “misconduct” should be defined, the subjective psychological state of the insured should be distinguished, the Business Judgment Rules should be introduced, misconduct should be clarified, and exclusion clauses should be reasonably designed under the guidance of corporate social responsibility and insurance industry business strategy. Finally, in terms of premiums and losses, the reasonableness of joint guarantee by the company and the directors should be affirmed, and the company should be allowed to make its own agreement on the subject of premiums and the sharing ratio by means of the agreement of the articles of association and the resolution of the shareholders’ meeting.

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