Directors & Officers Liability Insurance – Update on Germany

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Directors & Officers Liability Insurance (D&O insurance) has been subject to many developments in Germany. In particular three topics have arisen in the recent past due to the revision of the German Insurance Contract Act (*Versicherungsvertragsgesetz*) and higher German court rulings and are still being discussed. Although these three issues are by far not the only legal topics that come along with D&O insurance, they have received the most attention and therefore shall be introduced here.

1. Risk of rescission of the insurance contract

The risk of rescission of the insurance contract in the context of D&O cover came to public attention as a result of a ruling of the German Federal Court of Justice, the highest German court in civil and criminal matters (*Bundesgerichtshof*). The Federal Court of Justice held that if a representative of a policyholder (e.g. a member of the management board of the policyholder) intentionally misrepresents the factual circumstances of the policyholder, the insurer is entitled to rescind the insurance contract with retrospective effect, i.e. the whole insurance contract is deemed to never have existed. While the decision referred to transport insurance the legal community started discussing the applicability of the judgement to D&O insurance. The problem was that due to the intentional misrepresentation of one board member, trying to conceal his own wrongdoings when entering into the policy, the insurer can cancel the complete D&O insurance cover – including the cover of the other board members irrespective of whether any of them participated in the misrepresentation.

Not only directors and officers, but also the insurance industry itself considered this to be a rather unsatisfying result. The risk that the persons who were rightfully looking for protection could lose their cover without own fault threatened the market reception of D&O policies. Hence, the insurance industry tackled this problem by waiving their right to rescind the contract due to intentional misrepresentation already from the outset and included such a waiver into their terms and conditions. However, in two further decisions the Federal Court of Justice declared such a waiver to be invalid. It held that a party to a contract cannot waive any of its rights resulting from intentional misconduct of the other party as a matter of mandatory law. Indeed, this legal concept was developed to help contractual parties not to be defrauded and works perfectly well in a simple one-to-one relationship, but did not fit in the situation at hand.

In the aftermath of these decisions the insurers have developed several other solutions which are more or less practicable: It was suggested that the insurer could reaffirm the insurance cover in the event it gained knowledge of the misrepresentation, thus waiving its right to rescind the contract subsequently (which is legally permissible). But whether or not the insurer would be prepared to do so when situation actually arises and huge damage payments are looming is more than questionable from an insured's perspective. Another idea was that the insurer exercises its right to rescind the contract only vis-à-vis the misrepresenting insured person. However, German civil law opposes such solution as partial rescission cannot be contractually agreed on. The respective statutory provision regulating partial invalidity, Sec. 139 of the German Civil Code, which here is applied, is however a rule of interpretation rather than something on which parties to a contract can agree.

The exclusion of the opportunity to misrepresent has also been discussed. This could be reached by the insurer not asking questions at the outset at all so that wrong answers (and thus misrepresentations) would not be possible. This, however, would not be compliant with an insurer's obligation to understand what it actually underwrites. It would also be impracticable where larger groups of companies should be covered by the D&O insurance.

Another idea was to conclude individual insurance contracts with each of the directors and officers. This might be practicable for companies with only a few insured persons. But in particular larger enterprises with several affiliated companies and many lavers of board members, directors and officers will have difficulty to properly monitor the process. Also insurers hesitate to take the burden of administrating hundreds of addi-

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tional underwriting processes (the questions regarding cover would have to be put to each of the directors and officers who would have to answer them accordingly).

Finally, a proposal provided for an additional agreement between the insured person and the insurer in which the insurer agrees to grant cover in case the actual insurance contract is rescinded (so called Rescission Policy or "*Anfechtungspolice*") which is as complex to handle as the previous idea. A variation thereof is to conclude an insurance contract with another carrier which covers only the event of rescission of the first contract. However, all suggested solutions contain uncertainties or are impracticable. It remains to be seen which proposal will be generally accepted – careful drafting is advisable in any case.

2. Assignment of the insured person's indemnity claim to the policyholder

The assignment of the insured person's indemnity claim to the policyholder, usually the company where the insured person is director, has emerged from changes made during the revision of the German Insurance Contract Act, in particular provisions regarding liability insurance.

Sec. 108 para. 2 of the German Insurance Contract Act in its revised form, which came into force as of 1 January 2008, provides that the assignment of the indemnity claim against an insurer to the aggrieved party cannot be excluded by general conditions of insurance. While former insurance contracts contained such exclusion, the insured person – i.e. the director and/or officer – is now free to assign its indemnity claim against the insurer to the aggrieved party which can also be the policyholder, i.e. the company of which the insured is director. In the event of an internal recourse the assignment would lead to a direct claim of the policyholder against the insurer. The result of such an assignment would be that the insured person could be named by the company as a witness in the lawsuit of the company against the insurer claiming cover of the damage caused by the insured director. Obviously this is an uncomfortable position for the insurer, because the insured person has a direct interest in the result of the lawsuit. In any event the insured person will be well advised to join the lawsuit as the policyholder claims its damages as well as the cover in one single lawsuit. Whether or not the assignment should be made depends on the circumstances of the individual case.

3. Provision regarding the cover of costs

A recent decision of the OLG Frankfurt regarding the cover of costs for defending a claim against a director or officer has caused uproar in the legal gazettes and is generally seen as being erroneous: Statutory law provides that costs to defend the insured are generally not counted against the limit. However, this is law is not mandatory, which means that a deviation from this rule in general terms of insurance is admissible. Thus, German D&O policies generally stipulated that costs incurred for defending the claim are part of the limit.
The general problems of the question whether or not costs are part of the limit are obvious: if several insured persons are affected by a claim the calculation of costs against the limit would lead to a race for cover. If the costs and the claim (if covered) exceed the limit the insured person bears the risk of having to be personable liable for the excess amount. The insurance industry has reacted by including so called Allocation Clauses ("*Allokationsklausel*") in their wordings. Pursuant to this provision cover is granted for such proportion of the costs as the insured person's share in liability.

The court, nevertheless, held that a clause containing such provision is invalid. It argued that the provision is intransparent as it is unclear whether also costs incurred by the insurer shall be counted against the limit. The insured person cannot estimate the amount of such costs of the insurer which lead to a costs risk to the detriment of the insured. Moreover, the provision would contradict the general legal principle that defence costs are not counted against the limit. This view would lead to the result that an allocation of the limit is not possible with respect to such costs.

The criticism hit this decision not only by pointing to the non-mandatory nature of the rule. Also the court did not consider that costs of the insurer do obviously not count against the limit (they are not to be borne by the insured at all), so the provision is not intransparent. Further, without the limit the agreed premium would be inadequate and complex risks would be incalculable. While the legal commentaries are in general agreement that the OLG Frankfurt decision is incorrect, redemption from this uncertainty seems to only the agreement on a separate limit for costs.