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Recent German Case Law on Side A-D&O Insurance

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Faculty of Law

Overview

I. Scope of Cover under D&O insurance
II. Characteristics of D&O-Coverage in Germany
III. Assignment of the Right to Indemnification to the Company/Policyholder
IV. Notice of Circumstances/Allocation of the Sum Insured/Costs Inclusive (Wirecard)
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I. Scope of Cover under D&O Insurance

Claim against Directors & Officers → Indemnification?

Securities Claim against the Company

	No	Yes	
Who is at risk?	**Insured**: Directors and officers	**Insured**: The company	**Insured**: The company as a defendant in securities claims only
What is at risk?	Personal assets	Company assets	Company assets
Cover?	**D&O Insurance:** Non indemnifiable liability of directors and officers	**D&O Insurance:** Company reimbursement of directors' costs	**D&O Insurance:** Company liability for securities claims
		Retention applies	Retention applies
	Side A	**Side B**	**Side C**

Source: Allianz Global Corporate & Specialty,Introduction to D&O insurance, page 2

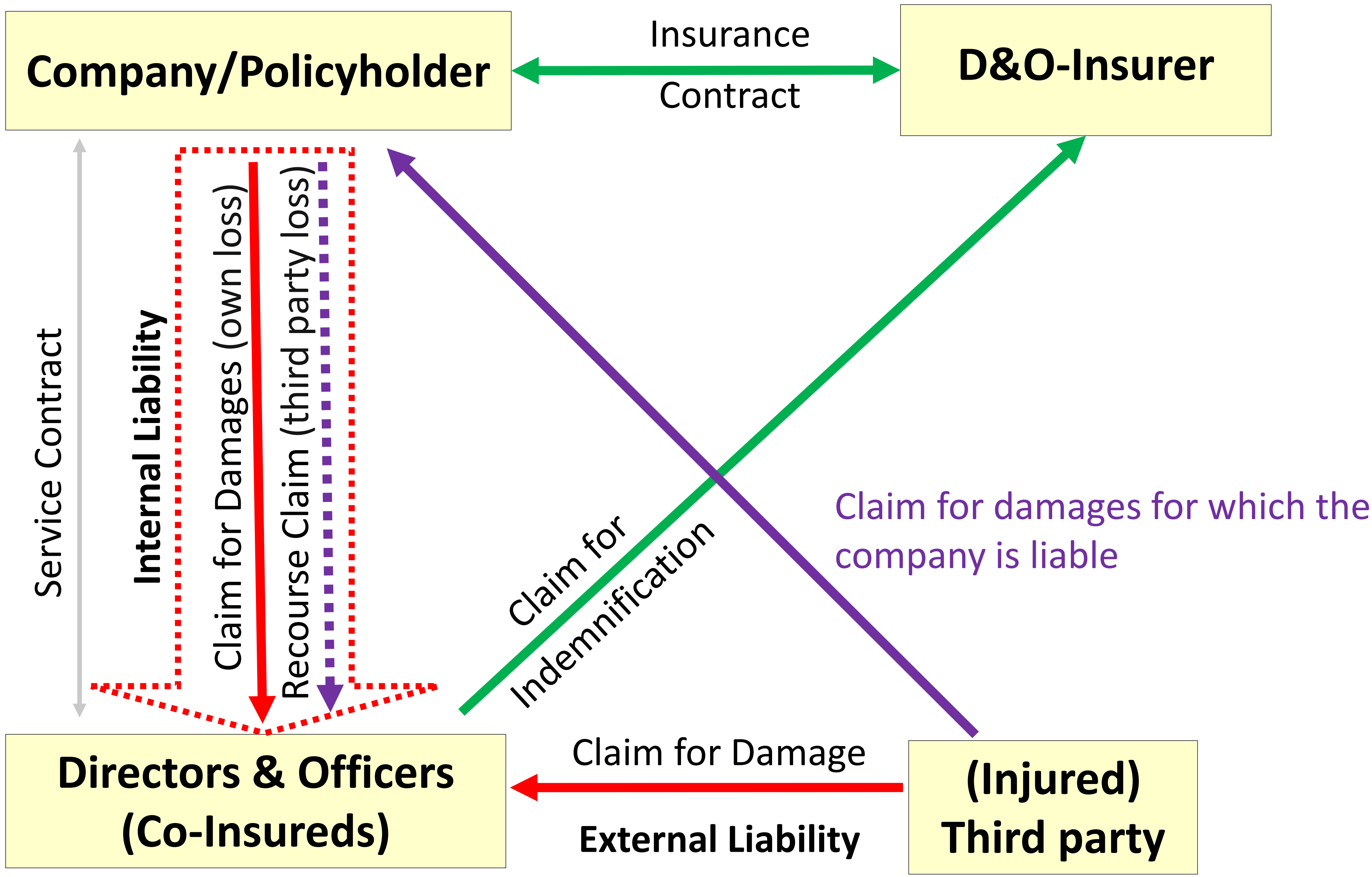
II. Characteristics of D&O-Coverage in Germany (1)

- Side A and B cover, Side C cover only for stock corporations.
- Executive Board Members owe <u>duty of care and diligence towards the company</u> (internal liability, simple negligence suffices), but not towards third parties (external liability).
- <u>External liability only in exceptional cases</u> (e.g. tort claims, failure to pay taxes or social security contributions, or late filing for insolvency).
- Duty of care and diligence includes obligation to ensure that company acts lawfully and fulfils its legal obligations towards third parties (including public authorities).

  ⇒ Breach of duty by the Executive in dealings with third parties, for which the company is liable, also constitutes a breach of duty toward the company.

  ⇒ No obligation of the company to indemnify the executive; rather, the company has a <u>right to take recourse against the Executive</u>.

II. Characteristics of D&O-Coverage in Germany (2)



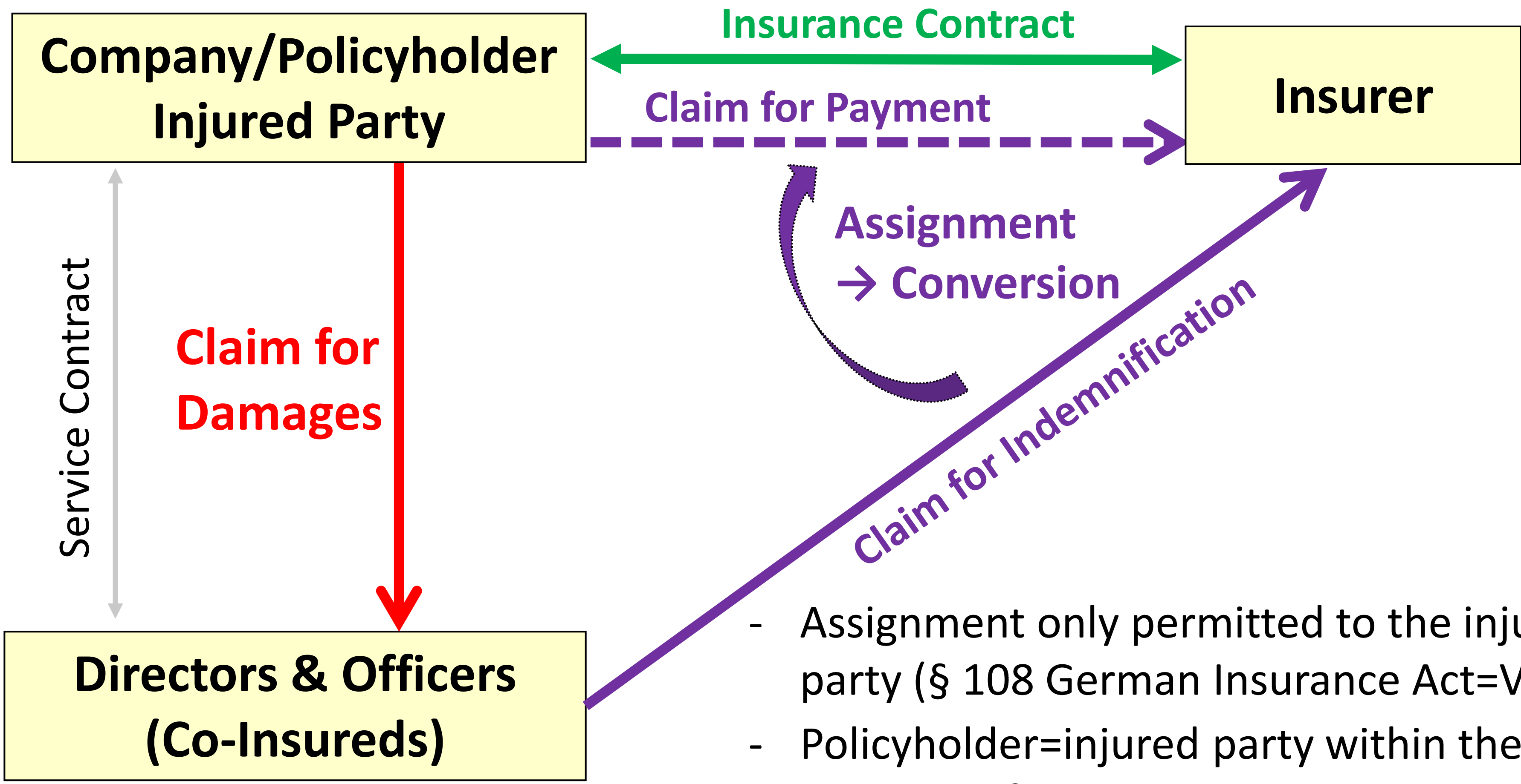
II. Characteristics of D&O-Coverage in Germany (3)

- In stock corporations, the Supervisory Board ("Aufsichtsrat") has the duty to assert claims for recourse against Executives on behalf of the company if they become aware of breaches. If the Supervisory Board fails to do so, it may also be held personally liable.
- Waiving such claims is permitted only three years after the claim has arisen, and only if the general meeting gives its consent and no minority shareholders whose shares together amount to one-tenth of the share capital objects (§ 93 para 4 sent 3 Stock Corporation Act=AktG).

⇒ More than 90% of D&O claims in Germany not brought by third parties, but by the company itself (or its insolvency administrator) against its own Executive and/or Supervisory Board members.

⇒ Need for Side A coverage to protect the Executive/Supervisory Board Member's personal assets, no need for Side B Coverage.

III. Assignment of the D&O`s Right to Indemnification to the Company/Policyholder (1)



- Assignment only permitted to the injured party (§ 108 German Insurance Act=VVG).
- Policyholder=injured party within the meaning of § 108 VVG?
- BGH, 13.4.2016 – IV ZR 304/13: yes.

III. Assignment of the D&O`s Claim for Indemnification to the Company/Policyholder (2)

Shifting the burden of proof from the insurer to the company as a result of the assignment?

- Burden of proof lies with the Board Members if it is disputed whether they exercised the due care of a prudent manager (§ 93 para 2 sent 2 AktG) because they are in a better position than the company to explain the circumstances that speak in favor of the proper fulfilment of their duties.
- Some authors take the view that the burden of proof shifts to the company.
- Cologne (21.11.2023 - 9 U 206/22) and Frankfurt (8.5.2025 – 3 U 113/22) Court of Appeal and prevailing opinion in literature: no shift in the burden of proof to the company.

III. Assignment of the D&O`s Claim for Indemnification to the Company/Policyholder (3)

- **Assignment of the D&O`s claim for indemnification against the insurer to the company**
  - In lieu of fulfilment of the claim for damage (§ 364 para 1 German Civil Code=BGB) → liabililty claim ceases to exist.
    - Not effective if company is a stock corporation (§ 93 para 4 sent 3 AktG.
  - On account of fulfilment of the claim for damage (§ 364 para 2 BGB).
    - Pactum de non petendo: company may not bring its claim for damages against Board Member until court has dismissed action for payment against insurer.
    - Limitation period of claim for damages is suspended (§ 205 BGB).

IV. Notice of Circumstances/Cost Inclusive/Allocation of the Sum Insured (Wirecard) (1)

Frankfurt Court of Appeal, 29.11.2024 - 7 U 82/22 (pending before the BGH)

Wirecard, a German payment processor and financial services provider whose former CEO, COO and other executives have been arrested or otherwise implicated in criminal proceedings became insolvent. The D&O insurance provided cover for PR costs, subject to a sub-limit of €100,000 per person. The total sum insured for the 2020 insurance period amounted to €15 million, including costs for legal defense in civil and criminal courts and for PR. The insurer refused to cover the PR costs of one director on the grounds that the sum insured had been exhausted.

IV. Notice of Circumstances/Cost Inclusive/Allocation of the Sum Insured (Wirecard) (2)

Issues:

- Requirements for a valid notice of circumstances (there was a notice in 2019 for which the sum insured amounted to €25 million).
- Validity of the ‘cost inclusion’ clause of legal defense costs in the sum insured.
- Allocation of the sum insured where it is insufficient to cover all directors against valid claims made by the company, as well as legal defense and PR costs.

IV. Notice of Circumstances/Allocation of the Sum Insured/Costs Inclusive (Wirecard)(3)

Requirements for a valid notice of circumstances

- Contract stipulated that notice must specify potential breach of duty, name of the D&O, potential loss, and potential claimant or potential legal action.
- Frankfurt Court of Appeal held that
  - potential liability must be specified in such detail that the insurer can calculate its ongoing risk of liability and set aside provisions;
  - notice must include information on whom the breach was committed against and to what extent s/he may have suffered damages.
  - Here: no valid notice in 2019 was made, as the insured merely
    - referred to an article in the Financial Times in which concerns were raised regarding suspicious transactions and alleged actions by a member of the finance team in Singapore;
    - reported that a class action was brought in the US District Court for California seeking damages for alleged breaches of US securities laws;
    - reported that the authorities in Singapore launched an investigation into the aforementioned circumstances and allegations.

IV. Notice of Circumstances/Allocation of the Sum Insured/Costs Inclusive (Wirecard)(4)

Validity of the ‘cost inclusive’ clause

- VVG provides that liability insurance covers the costs of legal defense, even if these costs, together with the amount required to compensate the injured party, exceed the sum insured (§ 101 para. 2 VVG).
- D&O contract practice: defense costs deducted from the total policy limit (‘cost inclusive’ clause).
- Validity of ‘cost inclusive” is disputed
  - Court of Appeal Frankfurt/M. (9.6.2011 - 7 U 127/09) and scholars: ‘cost inclusive’ clause is void because the insurer acts at his own risk when assessing the merits of the claim against executives.
  - <u>Court of Appeal Frankfurt/M. (29.11.2024 – 7 U 82/22)</u> ‘cost inclusive’ clause is valid, as the factual and legal situation regarding D&O insurance differs from that of other forms of liability insurance, given that such cases typically involve high and, moreover, unforeseeable defence costs.

IV. Notice of Circumstances/Allocation of the Sum Insured/Costs Inclusive (Wirecard)(5)

Sum insured not sufficient to cover all executives against valid claims made by the company, as well as legal and PR costs

- § 109 VVG provides that, where there are several injured parties whose claims exceed sum insured, insurer must settle those claims in proportion to their respective amounts (pro rata).
- not applicable in internal liability cases since there is only one injured party, i.e. the company → Allocation on a pro rata basis, on a 'first-come, first-served' basis, or on a per capita basis?
- <u>Here</u>:
  - The issue is not about indemnifying executives from claims for damages, but about allocating PR costs.
  - <u>Frankfurt Court of Appeal</u> held that,
    - insurer is entitled to make payments in the order in which it receives claims from the executive, regardless of whether these payments result in the sum insured being exhausted or reduced ('first come, first serve') – <u>not convincing</u>.

V. Validity of Severability Clauses (Greensill)(1)

Cologne Court of Appeal, 29.11.2024 - 7 U 82/22 (pending before the BGH)
Greensill Bank AG went bankrupt in 2021 following allegations of fraud and balance sheet manipulation. As early as the end of 2019, the Deposit Protection Fund of the Association of German Banks had urged Greensill to reduce its concentration of loans and exposure to companies linked to Sanjeev Gupta's GFG Alliance. Greensill's directors did not disclose this matter in their warranty statements.

⇒ Insurers declared the contract void on the grounds of fraudulent misrepresentation, even though they had waived the right to avoid the contract.

⇒ Insurers asserted the invalidity of the substitute provisions which replace the waiver.

V. Validity of Severability Clauses (Greensill)(2)

Wording of the Severability Clauses

10.10. Waiver of the right to void the contract

[1]In the event that the insurer would be entitled to void the contract on the grounds of fraudulent misrepresentation, the insurer waives this right.[2]However, this waiver shall not apply in respect of those insured [dishonest] persons who a) have given cause for the exercise of the right, or b) were aware, at the time of concluding this contract, of the acts which would entitle the insurer to exercise the rights.

10.11 [no heading]

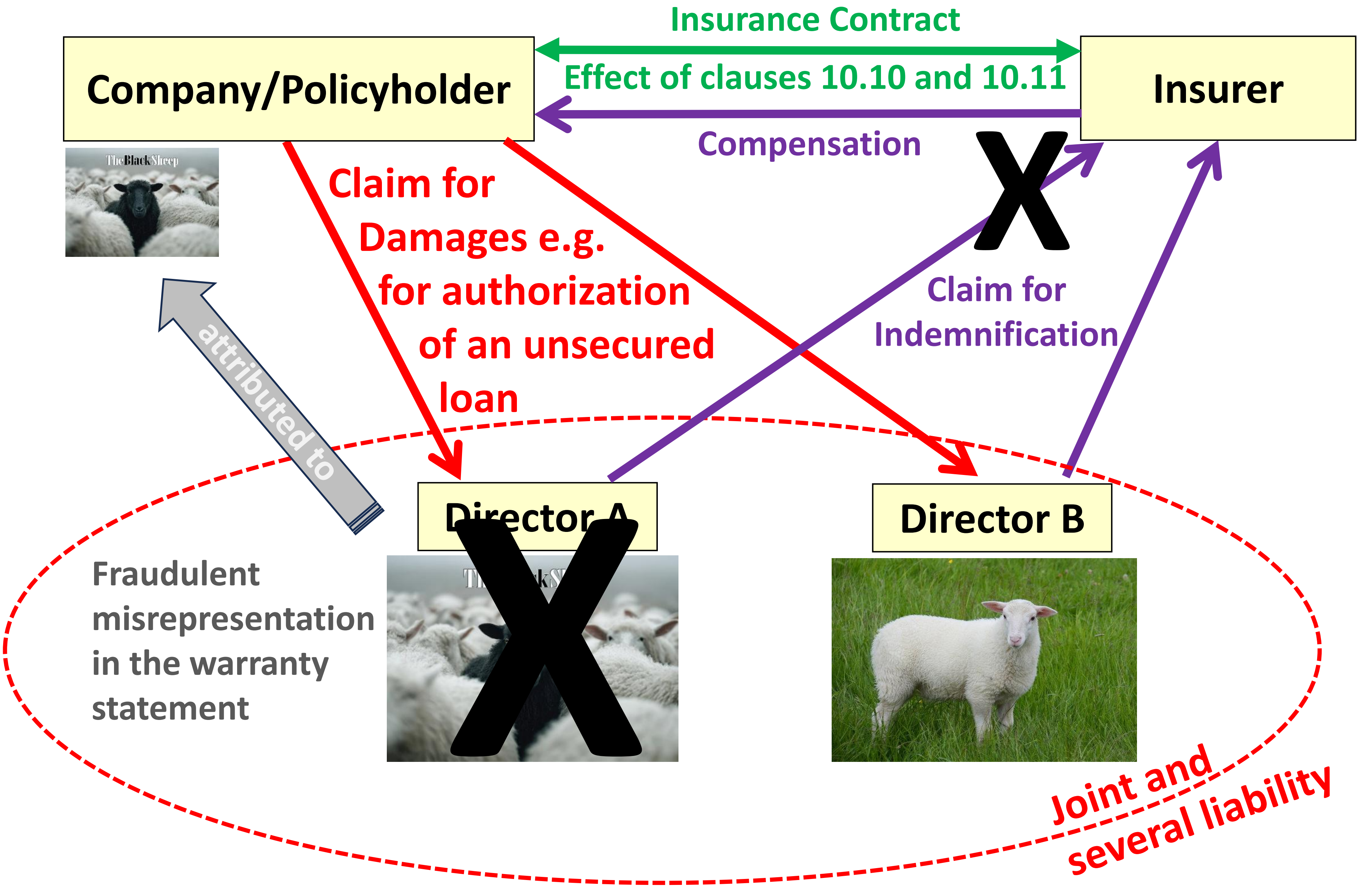
[1]If the waiver is not legally permissible and the insurer declares the contract or the renewal agreement avoided, the following legal consequences shall apply:
[2]… the renewal agreement shall be set aside with retroactive effect.
[3]… the contracting parties agree that the renewal agreement would nevertheless have been concluded in respect of those insured [dishonest] persons who did not commit the fraudulent misrepresentation or who were unaware of the fraudulent misrepresentation at the time of the extension of this contract."

V. Validity of Severability Clauses (Greensill)(3)

The Cologne Court of Appeal held,

- that the waiver (clause 10 sent. 1), the severability clause (clause 10 sent. 2) and the fallback-clause (claue 11.11) are contrary to public policy and therefore void,
- because, in the event of joint and several liability for both honest and dishonest board members, the company would be compensated for any losses, if the insurance cover for the honest members remained in place, even though the conduct of the dishonest member would, by law, be attributed to the company.

V. Validity of Severability Clauses (Greensill)(4)



V. Validity of Severability Clauses (Greensill)(5)

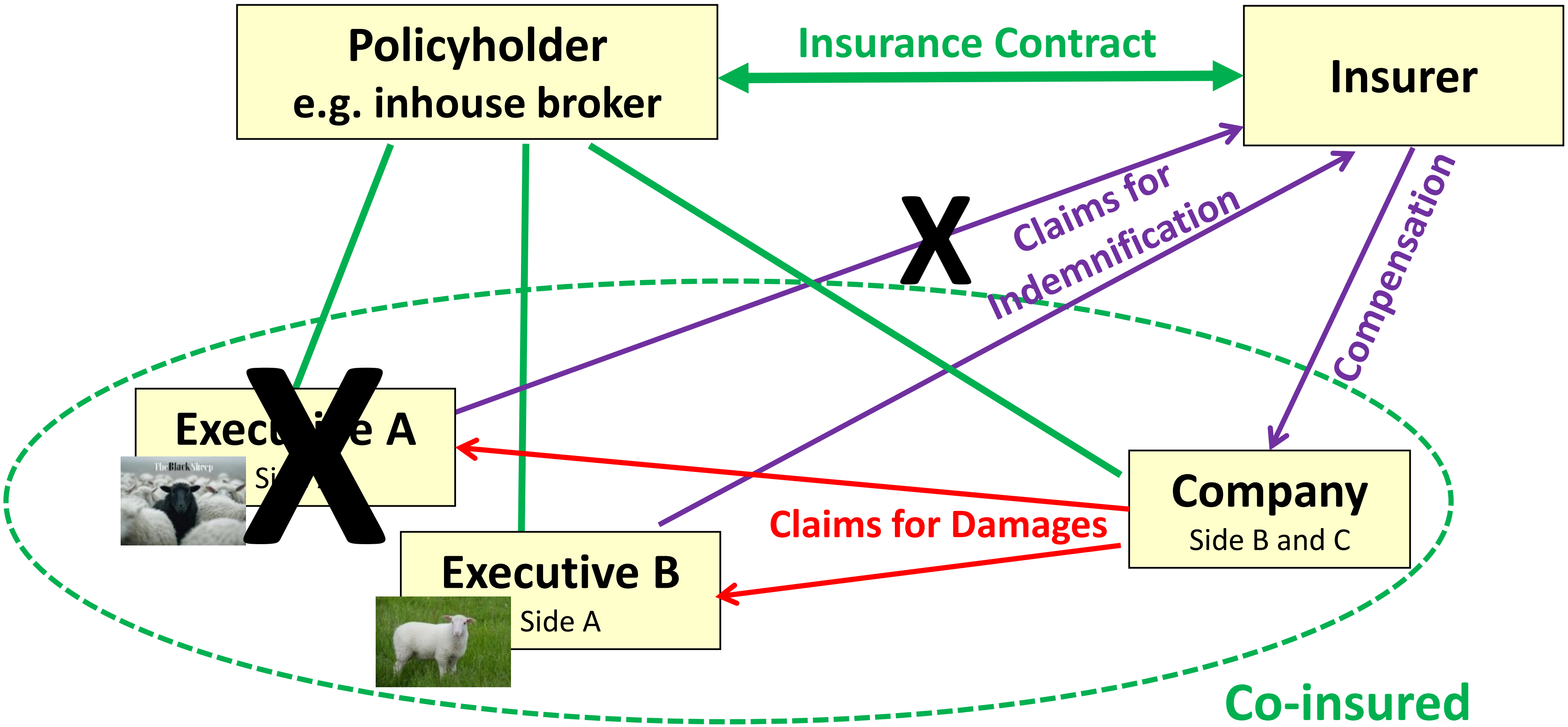
Options for protecting honest board members in the event that the BGH upholds the ruling of the Cologne Court of Appeal

- Taking out personal D&O insurance (not enough capacity).
- Separate policies for Executive Board and Supervisory Board members (does not solve the problem if the company takes out the insurance contracts).
- Third party (e.g. independent – perhaps inhouse – broker) instead of the company takes out insurance for the benefit of the board members (Side A) and their company (Side B and C).

V. Validity of Severability Clauses (Greensill)(6)

Options for protecting honest board members in the event that the BGH upholds the ruling of the Cologne Court of Appeal

- Third party (e.g. independent – perhaps inhouse – broker) instead of the company takes out insurance for the benefit of the board members (Side A) and their company (Side B and C).



Thank you for your attention!

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