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Guest Post: Addressing D&O Insurance in German Board Members' and Managing Directors' Management Services Agreements

By Kevin LaCroix on January 17, 2014
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A company's obligations to its directors and officers with respect to the purchase and maintenance of D&O insurance is a topic of ongoing interest and concern for the individuals involved. In the following Guest Post, Burkhard Fassbach and Thilo Fleck take a look at this topic with a particular focus on the issues involving German board members and managing directors. Burkhard Fassbach (pictured to the left), who is a partner with the Dusseldorf-based D&O advisory firm Hendricks & Co., is licensed to practice law in Germany and is standing legal counsel to the German operation of the London-based Howden Broking Group. Thilo Fleck is a founding partner of Berner Fleck Wettich, a Dusseldorf-based corporate law firm.I would like to thank Burkhard and Thilo for their willingness to publish their article on this site. I welcome the opportunity to publish guest posts written by responsible commentators on topics of interest to this blog's readers. Here is Burkhard and Thilo's guest post:

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The following article outlines the basic thougths for an innovatively designed contractual model clause for German Management Service Agreements. The model clause is presented at the end of this article.

Preliminary Remarks

Whilst negotiating their Management Service Agreements, Executive Board Members, Managing Directors and their legal advisors are foremost focusing their attention on issues concerning pay packages, remuneration, bonuses, retirement pension plans and company cars. More often than not, D&O Insurance Cover is simply not on the radar screen. However, most Managing Directors' Agreements of Services contain a contractual provision, in

which the company undertakes to bind D&O Insurance Cover for the benefit of its Directors and Executive Board Members. Unfortunately, such stipulations can be drafted rather simplistically, and thus deliver a deceptive sense of protection. Rather, the Company's Contractual Undertaking to bind D&O Insurance Cover for the benefit of its Executive Board Members and Managing Directors stipulated in the Management Service Agreements needs to meet the protective requirements accurately. This is crucial in the framework of a "worst case" scenario.

Worst Case Scenario

By drafting such a model clause, the starting point of all considerations needs to be the worst case scenario of a D&O claim. The maximum credible "incident" happens, when the company acts in a hostile manner and brings an action to court against its director by suing for a financial loss, which may potentially result in total destruction of the director's economic livelihood, potentially finishing his or her professional career forever. Executive Liability will then be subject to public court proceedings over the course of the various stages of appeal up to the German Federal High Court of Justice. The publicity and the media coverage involved in such court proceedings turns out to be a severe burden for the sued directors and it actuality leads to an occupational ban for the directors, who are already ousted from corporate power and can hardly take over new management positions. Rather, they get stuck in the sidings. The director's nerves are on edge at the latest, once civil court proceedings are accompanied by criminal investigations initiated by the public prosecution office.

Insured Event and Limit of Cover

In accordance to the claims-made principle, the insured event is triggered in the event that a claim for a financial loss is initially made in writing against an insured person with regard to breach of duty the insured person has committed in the course of activities for the Policyholder. Oftentimes, a very substantial sum of money in dispute is at stake and the director sued by the company can only hope that the insured limit of the D&O insurance cover is sufficient to settle the asserted claim. In particular, because high legal expenses to defend the claim are credited against the insured limit. The situation gets even worse, should claims be made at the same time against several directors who access the insured limit of the D&O Insurance cover. If in such an event, the insurer determines – on the basis of a forecast about the foreseeable course of the D&O claim proceedings – that the insured limit will not be sufficient, the insurer has to initiate the so-called reduction- and distribution proceeding. This may result in in sured persons' having to assume substantial amounts of the legal expenses related to defend the claim out of their own pockets as well as expenses by appraisers involved with the claims matter. Should the plaintiff win the trial, enforcement measures related to the private assets of the directors may become inevitable.

Furthermore, a high limit of indemnity may not grant the ultimate protection. It has to be borne in mind that – in particular in the framework of a corporate group structure – the insured limit needs to be shared between many insured persons. The equivalent wording in D&O Insurance Policies reads as follows: "Within one period of insurance, the insurer's duty to provide indemnification is limited to the overall insured sum for each insured event and for all insured events in the aggregate." For instance, the Executive Board Members of a holding company can consume the entire limit of insurance cover with one single insured event. Should a Managing Director of a subsidiary company then commit a breach of duty within the same period of cover, this Managing Director can stand without any protection and, thus, may be totally exposed. Therefore, Managing Directors of subsidiary companies should not trust in the D&O Insurance cover of the holding company's Master Cover. Rather, they should bind stand-alone D&O cover for the subsidiary company.

Legal Framework for Executive Liability in Germany

In general, pursuant to the German Stock Companies Act and the Laws on Limited Liability Companies, Executive Board Members and Managing Directors are subject to unlimited liability with their private assets. Almost every D&O claim in Germany is a matter of internal liability and not third-party claims. This means the company is asserting claims against its directors. With regard to German Stock Companies, the following statutory provisions are applicable: Executive Board Members shall exercise the director's due care and prudent business behavior in the course of the management of the business. Executive Board Members who breach their duties may be required to compensate the company with regard to financial losses arising from their breach of duty. In the German two-tier board system, the Executive Board Members cannot expect mercy from the Supervisory Board. The German Federal High Court of Justice has ruled in a landmark decision known as ARAG v. Garmenbeck that, in general, the Supervisory Board is obliged to pursue the company's claims against the Executive Board Members.

Due to the organizational function of the Supervisory Board to monitor and control the activities of the Executive Board, the Supervisory Board at its own responsibility has a duty to investigate and review the potential existence of the Company's claims against the Executive Board. In the event the findings of the Supervisory Board made on the basis of a diligent and proper risk analysis conclude that the Executive Board is subject to liability, the Supervisory Board shall evaluate whether or not, if yes, to what extent the pursuit of claims before a court results into compensation for financial losses. Thereby, certainty that a claim for damages will be successfully awarded by court is not required. In the event the Company is entitled to compensation for financial losses on the basis of the findings, the Supervisory Board in general has a duty to pursue such claims. Only by way of exception, the Supervisory Board can waive pursuance of such claims, if important reasons and good cause regarding the good of the company are compelling reasons not to pursue the claims and such circumstances outweigh the reasons which justify the assertion of claims or are at least of the same value. The Supervisory Board shall thereby only in exception

al cases consider any other aspects not related to the good of the company, which only concern the Executive Board Members personally.

Contrary to German Stock Companies, there is no general duty to pursue claims against Managing Directors of Limited Liability Companies. However, the shareholders of Limited Liability Companies nowadays pursue claims against Managing Directors more frequently due to the potential balance sheet protection of an existing D&O Insurance Policy. Likewise, Managing Directors of Limited Liability Companies shall exercise the due care of a prudent business director in matters of the Company. Managing Directors who breach their duties are subject to liability towards the company with regard to the financial loss arising from breach of duty.

Besides internal liability, whereby the company is asserting claims against its directors, the majority of D&O claims based on external liability are related to outside claims made by insolvency administrators against the Managing Directors and Executive Board Members.

The D&O Insurer's Behavior in Claims Adjustment

In the insured event of a D&O claim, the insurer has a statutory right to choose between out-of-court settlements by means of adjusting justified claims or the defense of unjustified claims made against insured persons. The D&O insurer is obliged to indemnify the insured persons against claims, which are made against the insured persons by a Policyholder or a third party on the basis of the insured person's responsibility and to defend unjustified claims. Hence, the level of premiums for D&O Policies reached its historical low point in the year 2013, whilst at the same time the number of D&O claims is on the rise and snowballing at high speed, the D&O premiums are de-facto calculated on the basis of a pure cover for legal expenses. The D&O insurer exercises the statutory right to elect between adjusting claims or defending claims almost invariably in a knee-jerk reaction by defending the claims made against insured persons and grant cover for the legal expenses related to defending the claims and thereby the issues of Executive Liability are subject to review by the courts. Out-of-court claims adjustment is the rare exception. If at all, the insurer only offers lousy settlements solely to save legal expenses for defending the claim, which would have been absolutely inevitable otherwise. In fact, the Policyholders are literally driven and forced to pursue the claims before the courts. A well-positioned and established D&O expert in the market who constantly keeps an eye and monitors the claims adjustment behavior of the D&O insurers can consider the insurer's reliability in claims' handling – besides the quality of the Policy wording. The best advice on the Policy Wording alone is worth nothing, if the D&O insurance cover does not work properly and smoothly due to unruly conduct by the D&O insurer in the event of a claim.

The D&O Insurance Policy in the Company's Safe

It is of utmost importance that the Company's Contractual Undertaking stipulated in the Management Service Agreements to bind D&O Insurance Cover for the benefit of its Executive Board Members and Managing Director needs to ensure that the company meet the duty to provide the Executive Board Members and Managing Director with a copy of the current D&O Policy and Policy Wording. Unfortunately, many companies still treat the D&O Policy as a secret, hidden in a safe to be kept apart from the Executive Board Members and Managing Directors. Thereby, it is not taken into consideration that only the insured persons are entitled to receive insurance benefits from the insurer under the D&O Policy. The company should not put off the insured persons by pointing to the insurer's duty to provide the insured persons with a copy of the certificate of insurance at the time a claim is made against them. Furthermore, it is necessary to ensure that the Policyholder is not entitled to cancel or to amend the rights of the insured persons under the D&O policy.

Network of D&O- Expert Attorneys

The D&O insurer's core benefit promise under the Policy is to defend unjustified claims made against insured persons and to indemnify insured persons against justified claims. Executive Board Members and Managing Director have a key and fundamental interest in keeping their clean reputation and fully clear their name, spoiled by allegations of breach of duty by successfully defending the claims. Therefore, the best possible defense is required. In order to succeed, the Executive Board Members and Managing Directors should be able to appoint the best attorney in the field of Executive Liability and D&O Insurance. Firstly, the insured person needs to know who the best attorneys in this practice area are. With regard to the quality of the D&O cover, it is crucial that the insurer actually pays the attorney bills of the top-class lawyers. Such specialist lawyers are billing on hourly rates rather than on the German statutory rules for the remuneration of lawyers. As a basic principle, the insured persons under D&O Insurance Policies do not have the free choice to select the lawyer they want. In order to ensure that the insured persons have access to the best lawyers, the D&O Policy Wording should stipulate that prior consent and agreement with the insurer is not required with regard to the attorney selection and the attorney fee arrangement if the attorney is introduced to the insured person by way of an expert attorney network. There are some D&O broker wordings in Germany which contain such provisions about an attorney network and have agreed upon such a procedure with the insurer in advance.

Quality of the D&O Policy Wording

The D&O Policy Wordings vary considerably with regard to quality. Only a renowned D&O expert can examine th

quality of the D&O Policy Wording and can identify the pitfalls. Since the D&O market is constantly on the move, such an expert review should be made in the cycle of the annual Policy renewals. Attention needs to be paid to the following issues:

Arbitration Proceedings

The Policyholder and the insured persons can avoid the publicity of a court proceeding (District Court up to the German Federal High Court) and media attention with adverse effect by referring the matter of Executive Liability to an arbitration court. It needs to be borne in mind that the proceedings before the public civil courts can last for many years and turn out to be a massive burden for the involved parties. Therefore, best quality D&O Policy Wordings stipulate that the insured person can request that the issues of Executive Liability are subject to an arbitration proceeding, should claims for financial losses be made. The court of arbitration should be assembled by expert lawyers from a highly professional network of corporate litigation attorneys. Even in complex matters of litigation the timeframe for an arbitration proceeding should be significantly shorter than proceedings before the public civil courts. However, it is a disadvantage that there is no possibility of serving third party notices in the course of an arbitration proceeding.

Operational Activities

D&O Policy Wordings can contain hidden and invisible exclusions of cover. This applies in particular for instance in the area of operational activities of Managing Directors and Executive Board Members. In the event a Managing Director picks up a calculator and causes errors in calculation with severe impact, the D&O Insurer denies coverage by arguing that the D&O Policy is only applicable for management decisions and the D&O Insurance cover is not designed for failure in day-to-day business.

This exclusion is plainly visible in D&O Policies for service companies and in particular in the financial services sector. For example, decisions by a bank's management board in terms of granting loans are basically excluded in the D&O insurance.

Cover in the event of set-off

Evermore frequently, it is noted that the policyholder declares that claims relating to employment contracts, claims which are directly connected with them in particular relating to salaries and pension benefit (salary demand), and claims which arise from severance and termination contracts are to be offset against liability claims

which would be insured within the scope of the terms of the D&O Policy. This can result in severe financial liquidi ty problems on the part of the insured persons. Therefore, good D&O Policy Wordings include provisions which enable continuing salary payments and assume severance payments.

Guarantee of Continuity

At the time of the placement of the D&O Policy no insured person can know and trust whether the scope of insu ance cover both with regards terms and conditions and the limit of indemnity will still be in existence at som point in the future when a claim is actually made. In the event that the insurer – in the framework of the annu D&O renewal negotiations – makes demand for restrictions on the D&O Policy Wording terms and condition such as exclusions of cover for corruption and cartel, and the insurer may even at the same time reduce the limit indemnity, then the restricted cover is applicable retroactively for breaches of duty in the past. High quality D& Wordings stipulate that old liability remains covered and that if the policy is continued with restrictions on its co ditions and/or a reduced limit of indemnity, then, with regard to breaches of duty committed prior to the com mencement of the amendment, the original scope of cover applies as agreed immediately prior to the restriction cover and/or reduction in limit of indemnity.

Extended Reporting Period

The Executive Board Members and Managing Directors have to keep in mind that they will be leaving the compan – for whatever reason – at some time in the future. On the last day in office the Executive Board Members and Managing Directors can still commit a breach of duty. Management Liability claims for Managing Directors of a Limited Liability Company and Executive Board Members of a Stock Company become time-barred and lapse in five years. In the event the company is listed on the stock exchange, the claims lapse in ten years. Claims made by Financial Institutions against its directors arising from the management service agreement or the position in the corporate board due to breach of duty also lapse in ten years. Noteworthy, the period of limitation begins to run once the financial loss, which is caused by the breach of duty, occurs. The D&O Policy needs to be maintained and upheld or, in the event the Policy is terminated, the Extended Reporting Period needs to be sufficient.

D&O Claims Advisory

Should the insured event occur, the Policyholder as well as the insured person should have immediate access to a D&O claims specialist. The D&O Claims specialist will assume a coordination role and moderation tasks in the talks and negotiations between insured persons, their legal counsel and the plaintiff as well as correspondence an communications with the insurer. Such activities include meeting appointments with the involved parties as well as the legal review of coverage issues. As a result, the flawless and proper function of the D&O insurance cover

shall be safeguarded.

D&O Contract Law Protection Policy

D&O claims settlements take up considerable periods of time. The processing is therefore protracted and hardly i the interests of the insured persons. Naturally, D&O insurers attempt to refuse the insurance coverage with the presentation of exclusion circumstances or the assertion of pre-contractual breaches of duty. Numerous passages in the wording of the D&O insurance policies – even in well drafted policies – can result in construction in the event of dispute and prevent spontaneous coverage. Insurers are also inclined to adduce exclusion circumstances again and again, as a result of which the time- lag mentioned above becomes unreasonable for the participants.

D&O contract law protection helps in this situation. Even with the first delay in the claims handling by the D&O insurers with the assertion of an exclusion circumstance or the vagueness of the cover, a lawyer specializing in D&O insurance law is appointed with the drafting of legal action against the insurer. All facets of the case are deal with in this draft of the legal action, in order to ensure that the time-lag in the exchange of arguments is reduced t a minimum. The legal expenses for actions related to pursue claims for coverage are generally equivalent to the costs of legal expenses to defend the D&O claim in the liability proceeding under civil law, so that there is increas- ing risk that the legal expenses are doubled, with the effect that the insured persons are fighting a war on two fronts. Thus, the economic livelihood of the insured persons is clearly at risk and therefore, the supplementary D&O Contract Law Protection Policy is almost compulsory.

Financial Loss Legal Protection Insurance Policy

D&O liability insurance often results in so-called “total losses.” In these cases, the extent of the compensation claim asserted corresponds exactly to the D&O sum insured. Even if the claim that has actually been incurred or is claimed exceeds the D&O sum insured, legal action is always taken for the insured amount. This does not just ap- ply for the large D&O cases of the Federal State banks, Siemens or Lufthansa, but also for liability scenarios in small and medium-sized enterprises.

In D&O liability insurance, the rule applies that defense costs are offset against the documented sum insured. If a settlement is made at the level of the D&O sum insured or if the amount is awarded by court judgment, the D&O insurer will pay the indemnification less the costs already expended. This can involve enormous amounts, where settlement by the insurer persons can jeopardize their economic existence.

This gap in the D&O cover is bridged by the financial loss legal protection insurance policy. The legal protection insurer assumes the share of the costs after the exhaustion of the D&O sum insured, so that a full claim settlemen is made possible via the D&O liability insurance.

The claims settlement practice of D&O insurance is substantially determined by the assertion of exclusion circumstances. The accusation of intentional, deliberate or willful breach of duty is in the spotlight in this context. Nothing is easier to prove for the D&O insurer than, for example, an intentional infringement of guidelines, by-laws or instructions. Even if well-conceived D&O insurance policies give provisional legal protection in accordance with the wording of the policies, D&O insurers more and more frequently reject the legal costs cover because the willfu act is all too obvious.

The financial loss legal protection insurance policy also bridges this gap in cover. In legal protection terms and conditions, willful intent exclusion is phrased in such a way that legal costs are only not assumed, if an insured person intended to bring about the occurrence of a claim and thereby cause a financial loss. Therefore, the willful breach of duty alone does not result in the exclusion from cover. It has to be determined by a binding judgment that the insured person has willfully brought about a claim and financial loss.

This is clearly fraud, particularly in the area of breach of fiduciary duty, so that the legal protection insurance also no longer applies. However, as the overwhelming number of cases end with stays of proceedings with or without fines, the legal protection function of the financial loss legal protection insurance policy generally survives.

Guidelines for the design and the drafting of Management Service Agreements

As a result it is noteworthy, that the Company's Contractual Undertaking stipulated in the Management Service Agreements to bind D&O Insurance Cover for the benefit of its Executive Board Members and Managing Director sis even more important and crucial than the D&O Insurance Policy itself. The binding of D&O insurance cover as well as maintaining the D&O Policy is thereby eluded from the sole discretion of the Policyholder. Furthermore, such a contractual clause and provisions shall ensure best possible quality of the D&O insurance cover. Hence the D&O market is subject to constant movement, the insurance cover needs to be reviewed by an expert in the field o D&O Insurance in the framework of the annual D&O Policy renewal.

Innovatively designed Model Clause for the Company's Contractual Undertaking stipulated in the Management

Service Agreements to bind D&O Insurance Cover for the benefit of its Executive Board Members and Managing Directors in Germany

1. The Company shall bind D&O insurance cover for the benefit of Mr. John Doe (Managing Director / Executive Board Member). Should a D&O Policy already be in place, the company undertakes to maintain and uphold the existing D&O insurance cover. In this respect and in the framework of the placement of a D&O Policy as well as in the annual renewal procedure of an existing D&O Policy, the company appoints a well-established and market renowned D&O expert to review and analyze the quotes in the tendering procedure, the annual renewal quotes, the terms and conditions of cover, the rating and the claims-handling practice of the insurer as well as adequate limit of indemnity. The company shall provide Mr. John Doe with a copy of the D&O expert opinion. (Alternatively: The company shall notify Mr. John Doe with immediate effect, should the company not follow the recommendations made by the D&O expert).

2. At the time of the inception of this Management Service Agreement the D&O insurance cover is applicable to the extent and pursuant to the D&O Policy and the terms and conditions of cover as enclosed as an exhibit to this Management Service Agreement. The company undertakes towards Mr. John Doe that the minimum standard of insurance cover (limit of indemnity, general and particular conditions of cover) as defined in the enclosed exhibit will not be undercut in the period of validity of this Management Service Agreement and shall likewise be not undercut subsequent to the termination of this Management Service Agreement for the runtime of the statutory period of limitation regarding claims for director's and officer's liability. The company shall elaborate and optimize the D&O insurance cover pursuant to the advice and annual recommendations given by the D&O Expert in accordance with subsection 1 of this clause. (Alternatively: The company intends to elaborate and optimize the D&O insurance cover pursuant to the advice and the annual recommendations given by the D&O Expert in accordance with subsection 1 of this clause. In the event that the minimum standard of insurance cover as defined in the enclosed exhibit cannot be upheld or cannot be further elaborated and optimized due to an increasingly fierce D&O market in the future, the company undertakes – on the basis of the D&O expert opinion – to provide the best possible D&O insurance cover for the benefit of Mr. John Doe, which can be bound in the tougher market situation.

3. In order to back up and flank the D&O insurance cover, the company shall bind Insurance Policies for financial loss legal protection and for D&O contract law protection as supplementary legal protection insurance.

4. The company shall provide Mr. John Doe with a copy of the current D&O Policy and the D&O Policy Wording as well as a copy of the current Insurance Policies and Policy Wordings for financial loss legal protection and for D&O contract law protection as supplementary legal protection insurance.

5. In the event Mr. John Doe leaves the company for whatever reason and resigns from his duties as Manag ing Director / Executive Board Member, the company shall maintain and uphold the D&O Insurance Cove for at least the runtime of the statutory period of limitation with regard to Executive Liability claims or, in the event the Policy is terminated, the company shall ensure the existence of an Extended Reporting Peri- od equivalent to the statutory period of limitation with regard to Executive Liability claims. The company shall provide Mr. John Doe with the respective proof for this purpose.

6. In the event a claim is made and the insured event thereby occurs, the company shall – also for the bene- fit of Mr. John Doe – appoint a well-established and market renowned D&O claims specialist, who shall ensure the flawless and proper functioning of the D&O insurance cover, assume legal review of coverage issues and implement the insurance benefits promised by the D&O insurer, in particular by the assump- tion of a coordination role and moderation tasks in the talks and negotiations between insured persons, their legal counsel, and the plaintiff as well as correspondence and communications with the insurer.