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D & O (Directors and Officers) Liability Insurance in German Supervisory Board Practice

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This article highlights three aspects: (I) Officers often only take up office once the supervisory board has assured them of D&O insurance cover. (II) The practice in damage cases is pervaded by conflicts of interest: in liability proceedings, an executive board tends to react according to the motto 'attack is the best form of defence', and threatens the supervisory board with recourse claims for contribution predicated on connivance and co-responsibility. (III) Does the separation of managerial and monitoring capacities require separate D&O policies for executive boards and supervisory boards through distinct insurance companies?

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Statutory Provisions
§§ 93, 111, 116 AktG (Stock Corporation Act); § 52a KWG (Banking Act); §§ 66, 67, 72, 73 ZPO (Code of Civil Procedure)

I. Entitlement to D&O insurance cover by company organs

The special matter of D&O insurance[1] is more frequently than ever dawning on organ members as a result of increasingly media-effective managers' liability proceedings. Unthinkable some years ago, former icons of the German economy are now standing in the dock. While executive boards in the past did not concern themselves with the perusal of their D&O policy until the emergence of a claim scenario, they are nowadays increasingly anxious that they be afforded with contractual assurance of optimal D&O insurance cover from the supervisory board prior to their accepting an appointment. Exorbitantly high damages for even the slightest culpability bear the potential of destroying the economic livelihood of executive board members found liable (§ 93 Sect 2 AktG) [2]. In the absence of regulation in a contract of employment, the executive board members are not entitled to insurance cover. The vast majority of contracts are equipped with inadequately drafted provisions. Precise adoption of the parameters of D&O cover[3] is lacking.

A detailed model clause has recently provided assurance[4]: according to that provision, it will be upon an independent D&O expert to scrutinise the contractual benefits of the insurance cover, particularly the quality of the insurance conditions, the regulatory practice of the insurer, and the adequacy of the amount of the insurance sum. The company is then obliged to buy insurance cover on the basis of this expertise. The protective umbrella must be commensurate in length to the respective term of office and, beyond that, encompass the expiration of the statutory periods of limitation regarding organ liability claims. Finally, an executive board member must have a right to be afforded with literal possession of the current D&O policy.

A supervisory board equally partakes of the benefits deriving from first class D&O insurance cover for the executive board. Both organs belong to the circle of insureds and, through the adoption of U.S. American cover concepts in Germany, are customarily jointly covered 'under one roof'. In the U.S. American system (one-tier board system), management is not institutionally separated from monitoring. Both functions are performed by one and the same organ (the Board of Directors).

By virtue of incorporation by reference, members of a supervisory board are subject to the same harsh liability as executive board members (§§ 116, 93 Sect 2 AktG). In recent years, demands on the performance of tasks by the supervisory board have considerably soared. In correlation to the D&O procurement clause in the employment contracts of executive board members, an entitlement to

[1] Fundamentals of D&O Insurance, Gruber/Mitterlechner/Wax, D&O Insurance with International Dimensions, Munich 2012.
[2] Bachmann, NJW-Beil. 2014, 43 (44).
[3] Armbrüster, VersR 2014, 1 ff.
[4] Model clause by Fassbach/Fleck, in full text, printed in the Business Week Management Blog of 18 Dec 2013, blog.wiwo.de/management/

D&O cover for the supervisory board members should be provided for in the articles of incorporation. According to the authority regime in the Stock Corporation Act, it is upon the supervisory board to decide on the granting of insurance protection for executive board members, and in the discretion of the shareholders whether to afford it to members of the supervisory board[5]. The D&O policy is then to be concluded by the executive board. The idiosyncratic need for protection of the supervisory board members in the dualistic system (two-tier board system) must be taken into account in the fashioning of insurance cover. With the departure from the 'strong room' policy, a paradigm shift is looming. The right to claim benefits from the insurance contract is one vested solely in the persons insured. The company, as the policyholder, should not be authorised to revoke the rights of the insureds under the policy, or to compromise any benefits accruing to them.

Having said that, there are still provisions in many D&O policies according to which the granting of benefits to insureds is subject to approval by the policyholder. But it is vital to bear in mind that a D&O procurement right of organ members ultimately conduces to the company's wellbeing.

In its D&O policy, an insurer promises to defend its insureds against claims for damages. If these turn out to be valid, the insurer's ensuing duty is to indemnify its insureds by effecting payment to the policyholder. Wilfried Terno, ret. Presiding Judge at the German Federal Supreme Court, recently made it clear that, in conformity with case law, the insurer's promises to both defend and indemnify are conterminous and based on equal footing.[6]

The following parameters are of paramount importance for effective protection:

1. Insurance Sum

The amount of the insurance sum is a matter of life and death for those affected. In the event of damage, a distribution problem arises as soon as the fixed insurance sum proves to be insufficient. The insurer's duty to pay proceeds within an insurance period is limited to the documented insurance sum per insurance case and for all insurance cases in the aggregate. A risk-orientated, sufficiently high insurance sum should be specified in the insured's D&O procurement claim. If the insurance proceeds have been exhausted by an earlier insurance case, an insured person can only demand a 'replenishment' of that sum from the policyholder where it is premised on a contractual right to that effect[7].

2. Continuity guarantee

D&O policies are based on the 'claims made principle'. The point in time of the first written claim is dispositive of the determination of the insurance sum and the insurance conditions of an insured event. Accordingly, the time of the breach of duty is irrelevant. When an insurer demands coverage exclusions in the course of an annual insurance extension, e.g. for corruption or antitrust violations, then this diminution in insurance coverage applies retroactively to any breach of duty. Subsequent compensation claims running afoul of such retroactive exclusions do not partake of coverage. Good policies offer a continuity guarantee and thereby exclude the retroactive effect that blights cover, so that insurance exclusions only bear implications for the future; possible 'legacy issues' (breaches of duty prior to the time of curtailment of coverage) remain insured. This is particularly important with

[5] Armbrüster, loc. cit.
[6] Terno, SpV 1/2014, 2 ff.
[7] Ambrüster, loc cit.

regard to the more rigorous and liability fraught duties of the supervisory board in the compliance area[8].

3. Statutory periods of limitation

A member of the supervisory board can still commit a breach of duty on the last day in office. Pursuant to the pertinent statute of limitations (§ 93 Sect 6 AktG), organ liability claims against supervisory board members of a stock corporation expire after five years; if the corporation is quoted on the stock exchange at the time of the breach of duty, claims expire after ten years. Claims by banks against members of supervisory or administrative organs predicated on a breach of a duty of care also expire after 10 years (§ 52a Sect 1 KWG). It must be specified in the D&O procurement claim that D&O protection shall extend for the time frame of the statutory periods of limitation.

4. Lawyers' network

In the event of damage, the supervisory board should ideally have immediate access to high-quality lawyers in whom it trusts[9]. There is, however, no free choice of lawyers in liability insurance as of right. The selection must be made in unison with the D&O insurer. High-quality D&O conditions therefore provide that the choice of counsel and the fee agreement do not hinge on a consensus with the D&O insurer, as long as the lawyer is retained via a highly specialised lawyers' network. The insurer's fee guarantee should be tantamount to the usual hourly rates of prestigious lawyers in the field. Ordinarily, such lawyers will not render services within the scope of the Lawyers' Compensation Act.

5. Arbitration court

Court-adjudicated liability bears the potential of constituting a massive burden for the defendant litigants due to the precept of publicity in civil proceedings. Consequently, Dieter Leuering - a lawyer practicing in the city of Bonn - has recently carved out the possibility of an arbitration proceeding in organ liability cases[10]. In case the parties have made an arbitration agreement, the proceeding will be conducted behind closed doors. High quality policies pave the way for arbitration court proceedings, and bind the insurer to the arbitration award. It should be taken into consideration at this juncture already that third-party practice is virtually impossible in arbitration proceedings.

II. Conflicts of interest in D&O damage cases

Managers' liability actions are increasingly permeated by third-party practice. In the triangle between supervisory board, executive board, and insurer, this leads to a myriad of considerable conflicts of interest each of which shall be highlighted on the backdrop of the ordinary course of a D&O damage case:

[8] Siepelt, BOARD 3/2014, 107 ff.
[9] In a press release of the German Lawyers' Association from 19 Nov 2013, Monika Maria Risch postulates a free choice of lawyers in legal protection insurance.
[10] Leuering, NJW 2014, 657 ff.

1. The supervisory board's duty to prosecute

According to the Federal Supreme Court's 'ARAG doctrine'[11], a supervisory board, by reason of its remit to monitor and scrutinise the executive board's activity, has the duty to independently investigate the viability of a company's compensation claims against executive board members. If the investigation yields the legal conclusion that the company does have viable compensation claims, the supervisory board generally must pursue them.

The supervisory board runs the risk that, by virtue of its own initiation and pressing of the claim, the executive board members deplete the D&O money bucket (presumably as a result of a high defence burn rate alone) and that its members stand defenceless in later recourse proceedings. More often than not, such members of the executive board as have been extrajudicially confronted with the company's claim threaten to serve on the supervisory board members third-party notices once having been served with a complaint.

2. D&O loss regulation practice

The value of a D&O policy is frequently cast doubt upon where proceeds are not paid out. This incites irritation of concerned managers and shareholders across-the-board. No matter how diligently fashioned, insurance conditions are ultimately inefficacious where a D&O policy does not function properly in the event of damage. The volume of damages from payments and reserves currently exceeds by far the estimated market premium volumes to the tune of EUR 750 million for the year 2014 in Germany. Once an insurance event has been triggered, the outcome almost invariably depends on (1) the individual and oftentimes divergent damage regulation experience of the in-house claims officer, and (2) on the legal assessment of the external lawyers retained by the insurer.

In practice, insurers regularly thrust upon the supervisory board the liability proceedings against the respective executive board members that in most cases invoke as a defence the Business Judgement Rule, grounded in § 93 Sect 1 p2 AktG. Out-of-court settlements are scarce. Should the insurer only offer a small settlement amount, the conclusion of a 'shoddy' settlement can, in extreme cases, engender a breach of trust by the supervisory board where the sum offered bears absolutely no relation to the amount and prospects of success of the claim asserted. This is especially true against the backdrop of the supervisory board's potentially rendering itself liable to compensation if it does not live up to its basic duty to prosecute meritorious claims.

Following time-consuming litigation, most cases result in either the dismissal of a claim or in an eventual settlement. The mandatory retention set forth in § 93 Sect 2 Clause 3 AktG has no application to defence costs and settlement amounts. Since a binding judgment against members of an executive board is seldom rendered, the widely prevalent 'private' retention insurances are scarcely impacted by losses. More at issue in practice are the so-called 'contractual' co-payments that are increasingly demanded from executive board members in the course of liability settlements and that oftentimes total millions. These liability settlements are supplementary to the settlements relating to coverage that the company reaches with the D&O insurance consortium. The enforceability of settlement agreements negotiated by the supervisory board is subject to the condition precedent of consent by the shareholders' meeting (§ 93 Sect 4 Clause 3 AktG).

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[11] BGHZ 135, 244 - ARAG Garmenbeck.

3. Active defence against liability and base defence

Insurers are increasingly pursuing the path of active defence against liability. In this context, the insurer enters a liability proceeding by way of intervention (§ 66 ZPO) as an intervenor on the defendants' (executive board members') side. Thereby, the insurer is capable of exerting direct influence on the liability proceedings. He is entitled to assert all means of challenge or defence (§ 67 ZPO). In the course of the intervention, the insurer itself serves the plaintiff corporation with a motion to dismiss, and furnishes pleadings. Through its base defence, the insurer takes control of the defence strategy. The executive board's lawyers can subsequently submit additional individual pleadings and proffer evidence.

4. Third-party practice

The defendant executive board's lawyers almost invariably counsel their clients to engage in third-party practice so as to preserve possible recourse claims. Third-party notices are not directed against the supervisory board as a collective body but rather against the individual members of the supervisory board. They are permissible provided that the defendant executive board members (the notifiers) believe that, in the event of an unfavourable outcome of the dispute at bar, they could assert a claim for contribution (recourse) against one or more members of the plaintiff's (the company's) supervisory board (§ 72 ZPO). The third-party notice must set out the reason for that notice and is to be served on the supervisory board member concerned (the notified third-party(ies)) (§ 73 ZPO). The pleading reads as follows:

'Of this litigation we herewith notify the members of the supervisory board – the notified third-parties - in the name and on behalf of the defendants (executive board members), coupled with a summons to join the litigation on the side of the defendants....The plaintiff (the company, represented by the supervisory board) claims – unjustly – that the decisions in suit of the executive board constituted a breach of duty and caused damage to the plaintiff. The notified third-parties had knowledge as to the background and motivation of the decisions made, and countenanced and endorsed them. Should the plaintiff – contrary to expectations – prevail against the defendants, then, in their internal relationship, the defendants would be entitled to a recourse claim for contribution against the notified plaintiff's supervisory board members. Such recourse claims spring from §§ 116 p1, 93 Sect 2 AktG and § 426 BGB (German Civil Code). To preserve these possible claims a third-party notice is essential.'

The board members' recourse in the event of a contributory breach of duty by the supervisory board is effectuated in the internal relationship between the respective executive board members and the respective supervisory board members in accordance with the proportionality of the actors' individual degree of blame and the equitable liability quotas, pursuant to § 426 BGB. It is predominantly in situations where the insurance sum is or, predictably, will be depleted, where the executive board members have an interest in the safeguarding of claims for contribution by means of third-party notices.

5. Recourse legal opinion

The notified supervisory board members' lawyer produces a recourse legal opinion, and therein examines the central allegation of co-responsibility. In essence, the pivotal inquiry inescapably gaining centre stage is whether the executive board sufficiently/comprehensively informed the supervisory board (this will be the executive board's argument), or, on the contrary, whether the supervisory board was not (sufficiently) informed, let alone was deluded by the executive board (the supervisory board's argument). The conflict is reflected in the business media with headlines such as the following one: *'The Supervisory Board: Inquired Into Everything*, *Yet So Unwitting*".

6. The supervisory board's duty to monitor

According to the general standard of § 111 Sect 1 AktG, the supervisory board must monitor management. Professor Gregor Bachmann of Berlin University, a leading expert at the 70th German Jurists Day on the topic 'Reform of Organ Liability?' appositely couched the inherent crux of the duty to monitor in the following terms: *'As the monitoring of management rests with the supervisory board, any mistake made by management can theoretically be converted into a mistake by the supervisory board.'*[12]

The supervisory board's general duty to monitor has both a preventive and a repressive function: In a landmark decision[13] dealing with the preventive function of the duty to monitor, the Federal Supreme Court held that: The supervisory board's task to monitor management encompasses the duty to advise the executive board on higher level issues of company management. This scrutiny shall include the aspects of expediency and profitability. Such scrutiny cannot be efficiently exerted but through ongoing discussion with the board, as well as through continuous advice; consequently, consultation is the primary means of control of the executive board that is geared toward the future.

Consent provisos are a particular instrument of preventive scrutiny. According to Federal Supreme Court case law[14], the supervisory board breaches its duties to the company where it consents to disadvantageous business activity on a deficient foundation of information depriving it of the feasibility of a thorough cost-benefit analysis.

As a consequence, the following can be established for the relationship of both organs: in practice, it seldom happens that in the case of a breach of duty by the executive board, there is not also a concomitant breach of duty by the supervisory board due to a lapse in preventive control. Where there is a breach of duty by the executive board, there is frequently also an independent breach of duty by the supervisory board.

The supervisory board's basic duty to prosecute is an integral component of its repressive function. The consequence is this: The supervisory board is frequently obliged to assert claims against an executive board member in the context of practices that bear the potential of giving rise to a concomitant breach of duty by the supervisory board. The complaint can thus boomerang on the supervisory board members through the vehicle of third-party notices.

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[12] Bachmann, loc cit.
[13] BGHZ 117, 127 ff.
[14] BGH, ZIP 2007, 224 ff.

7. The D&O insurer between the battle lines

A third-party notice triggers an insured event under the company D&O policy, pursuant to which executive board and supervisory board are jointly insured. The notified supervisory board members must agree upon the choice of counsel with the D&O insurer and obtain a cover note for the lawyers' fees (particularly for recourse legal opinions), notwithstanding the facts that it is precisely this insurer that (1) previously acted on the defendants' (the executive board members') side as an intervenor, (2) filed a motion to dismiss the complaint, and (3) possibly endorsed the third-party notice initiated by one of the defendants' representatives.

If the insurer exerts his sole authority to conduct litigation (albeit under the caveat of refusal of coverage, depending on the outcome of the liability proceedings), then, in accordance with the legal precedents set forth by Civil Division IV of the Federal Supreme Court in charge of insurance law matters, it shall protect the interests of the insured person in the same way a lawyer retained by that person would[15].

In the case of third-party notices, the D&O insurer must refrain from simultaneously representing the opposing interests of defendant executive board members and notified supervisory board members. In this scenario, the insurer is ensnared in an inherent conflict of interest[16]. The misery manifests in the insurer's rights to information. If the insurer - citing to the notified supervisory board members' insurance contract obligations – requests the surrender of a recourse legal opinion, then the supervisory board members' lawyers apprehend that their submission to the request constitute a violation of the attorney-client relationship. A confidential recourse legal opinion highlights both the incriminating and the exonerating moments of the potential breach of duty by their clients. If the recourse legal opinion is passed to the insurer, then there is also the risk that it will be deployed to defend the executive board members.

III. Separate supervisory board D&O insurance

The separation of management and monitoring necessitates a separation of D&O insurance cover for executive and supervisory boards. In order to counter conflicts of interest, the company must conclude a D&O policy for the supervisory board with a risk taker who is not involved in the company's D&O insurance programme (primary and excess insurers).

1. Twin-tower model

In the twin-tower model, executive board members are exclusively insured by insurer A; supervisory board members are exclusively insured by insurer B. If both towers provide insurance sums of par amount, this can lead to a doubling of insurance premiums. A complete disincorporation of supervisory board members from company D&O policies that likely have existed for years also harbours the peril that supervisory board 'legacy issues' are no longer insured. The basic rule for unlimited retrospective insurance in a D&O policy applies: There is no insurance coverage with regard to breaches of duty committed prior to commencement of the policy for such insureds having

[15] BGH, r + s 2001, 499 (500); BGHZ 119, 276 (281).
[16] Schäfer, interview in Director's Channel, www.directorschannel.tv/do_-_versicherung_interessenkonflikt

been confronted with a claim as were cognizant of the facts giving rise to the breaches prior to the conclusion of the insurance policy. The new D&O insurer in the supervisory board tower will ask about currently known breaches of duty.

2. Two-tier trigger policy

According to the two-tier trigger policy specifically tailored to the supervisory board members' special needs, these organ members – as well as executive board members – remain insured with all their rights under the existing company D&O policy. The 'legacy issues' problem of the twin-tower model is thereby obviated. The two-tier trigger policy supplements the company D&O policy and exclusively insures supervisory board members. The policy is not triggered until conflicts of interest arise:

The first trigger is the exhaustion of the insurance sum of the company D&O policy (primary and excess). In this instance, the two-tier trigger policy functions like excess insurance. According to the 'following form' principle, it adapts the insurance conditions of the company D&O policy. It is thereby ensured that the supervisory board and the executive board are insured under identical insurance conditions. Its own additional insurance sum is available to the supervisory board through the separate policy. Ideally, it is identical to the insurance sum in the company D&O policy. This concept distinguishes itself by a significant premium advantage as opposed to the twin-tower model. With equally high insurance sums the two-tier trigger policy premium will be set in the range of 35 – 60 % of the company D&O policy premium. The upper bandwidth applies to banks and financial services companies.

The original scepticism as to whether suitable insurers were available has proved unfounded. Leading German and international insurance companies are now subscribing to the two-tier trigger policy. It has prevailed against the twin-tower policy in the market. Capacities of up to EUR 300 million are available.

The programme structure can also be conceptualised by way of open co-insurance[17]. Such a co-insurance solution has an advantage over a layer structure (D&O tower with one primary insurer and several excess insurers) in that those involved in an insurance damage case can resort to only one contact person (claims officer). In accordance with a strict leadership clause, only the leading insurer determines the fate of an insurance case. The co-insurers have to follow the lead carrier. For this matter, only an insurer experienced in claims handling should assume leadership.

The second trigger is the third-party notice. This trigger does not hinge on the insurance sum of the company D&O policy having been exhausted. Hence, the aforementioned conflicts of interest can be avoided.

The third trigger is the rescission of the company D&O policy. Whenever an executive board member has made misrepresentations (in conjunction with a declaration regarding known breaches of duty) prior to the conclusion of the company D&O policy, there is a risk that the insurer also discharges its contractual duties vis-à-vis the supervisory board members by rescinding the policy in its entirety. As a result, all the insured persons, including the supervisory board members co-insured in the company D&O policy, come away empty-handed.

[17] See Schaloske, The law of the so-called open co-insurance, Karlsruhe 2007.

The fourth trigger is a simultaneous lodging of claims against members of the supervisory board and executive board by special representatives, pursuant to § 147 AktG.

3. Personal D&O

Since very recently, an individual supervisory board member is able to conclude a personal D&O policy for herself and at her own expense. The insurance sum is no longer prone to diminishment from sharing with other organ members. Supervisory board members committed to multiple mandates in different corporations can thereby insure their activity in one 'private' policy.

IV. Conclusion

The mooring in contract or certificate of incorporation of an entitlement to the best possible D&O insurance cover is of vital significance to executive and supervisory board members. With regard to the insurance policy's compensatory function, such cover equally conduces to the company's interests. In a damage event, members of the supervisory board must reasonably anticipate that executive board members will not refrain from going on the 'counter attack' by means of filing third-party notices. The separation of management and monitoring calls for a separation of D&O policies. Ancillary to an existing policy for executive (and supervisory) board members, a company should put up a protective umbrella for the supervisory board members via separate supervisory board D&O insurance coverage with an independent insurer (two-tier trigger policy). A personal D&O policy affords individual cover.