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International Perspective on Directors and Officers Liability and Insurance

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I. Introduction / The Insured Event under a D&O-Policy

Entrepreneurial activities are inevitably fraught with risks. The so-called "Financial Lines Products" offer insurance solutions to protect corporations against financial losses. Directors and Officers Liability Insurance (D&O) is the supreme discipline of the Financial Lines product family. D&O insurance has its origin in the U.S.A. and has gained currency all over the world.

In the following, the mode of operation of a D&O policy in an insured event will be illustrated. Prior to outlining the crucial issues relating to the architecture of D&O cover, it seems expedient to illustrate, both from a U.S. perspective (Indemnification) and from a German perspective (Claim Assertion), the core elements of the functioning of the liability regime in these countries, because any concept of D&O insurance necessarily builds on the liability foundation. The corner pillars are: management's internal and external liability, indemnity, and the corporation's governance structure (one-tier board system, two-tier board system).

In the U.S., most D&O claims are triggered by securities class litigation initiated by shareholders alleging violations of the Securities Act of 1933 or the Securities Exchange Act of 1934. Internal liability cases are the rare exception.

Key element of the U.S. American liability system is the possibility of far-reaching indemnification. Pursuant to the "Checklist for Corporate Counsel Supervising the Creation or Renewal of an Executive Protection Program" published by the American Bar Association, the scope of indemnity is at the top of the checklist even before any D&O policy considerations come into play. The State of Delaware is a good example. Unlike most of the other states, Delaware has a rather liberal corporation law (Delaware General Corporation Law). More than 50% of all U.S. publicly traded companies and 63% of the Fortune 500 are incorporated in Delaware. In the event of a "third-party action", a Delaware company can indemnify its directors and officers provided that they "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation". Generally, indemnification comprises attorneys' fees, judgements, fines, penalties and amounts paid in settlements.

Contrary to the corporation law of Delaware and a host of other states, indemnification is not possible under German corporation law that is primarily based on internal liability of managers vis-à-vis the policyholder. § 93 paragraph 4 clause 3 of the German Stock Corporation Act (AktG) provides:

"The company may waive or compromise a claim for damages not prior to the expiry of three years after the claim has arisen, provided that the shareholders' meeting consents thereto and no minority whose aggregate holding equals or exceeds one-tenth of the share capital records an objection in the minutes."

For management board members the situation is aggravated by the so-called ARAG doctrine that the German Federal Supreme Court laid down in a seminal decision. In general, pursuant to the German Stock Corporation Act and the German Limited Liability Company Act (GmbHG), executive board members and managing directors are subject to unlimited liability with their private assets. As mentioned above, almost every D&O claim in Germany is a matter of internal, not external liability. This means that it is the company that asserts claims against its directors and officers, not a third party. As for German stock corporations, the following general rules govern the question of managerial liability: In conducting business, the members of the management board shall employ the care of a diligent and conscientious manager. Members of the management board who violate their duties shall be jointly and severally liable to the company for any resulting damage. In the German two-tier board system, the executive board members cannot expect mercy from the supervisory board. The German Federal Supreme Court ruled in a landmark decision known as ARAG/Garmenbeck that, in general, the supervisory board members bear a duty to pursue the company's viable claims against the executive board members.

As a flipside to the supervisory board's organizational function 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 executive board members. In the event the findings of the supervisory board made on the basis of a diligent and proper risk analysis yield the conclusion that some or all of the executive board members are subject to liability, the supervisory board shall evaluate whether or not and, if yes, to what extent the pursuit of claims before a court is likely to result in compensation for financial losses. There does not have to be a never-known-to-fail certainty that damages will be awarded by the court before the supervisory board can take action. Where the supervisory board's findings yield the conclusion that the court will grant financial remedy, the supervisory board generally has to file suit. Only where the supervisory board deems it to be in the best interest and in the furtherance of the economic wellbeing of the company not to assert claims against the corporation's directors and officers, can the supervisory board refrain from doing so.

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 to be afforded the contractual assurance of optimal D&O insurance cover from the supervisory board prior to accepting an appointment. Exorbitantly high damages for even the slightest culpability bear the potential of destroying the economic livelihood of executive board members. In the absence of stipulations in their contracts 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 is virtually non-existent.

A detailed model clause has produced relief and quickly gained currency: according to that provision, it will be upon an independent D&O expert to scrutinize 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 consistent with this expert opinion. 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 the literal possession of the current D&O policy.

Taking up the above-outlined liability framework, D&O insurance policies account for two distinct insured events:

Where indemnification is not possible or not applicable, the claims-made principle comes into play. Accordingly, the insurer grants coverage for the event that the insured person, in the exercise of his duties for the policyholder, breaches these duties, and is subsequently confronted with a first written claim.

In case indemnification can be achieved, the insured event of “company reimbursement” is triggered. Company reimbursement is a form of policyholder insurance. To the extent the policyholder, on the basis of a contractual or statutory duty to do so, absolves the insureds from their liability in a legally permissible way by successfully defending the insureds or paying the claim (“indemnity”), the indemnifying policyholder has a claim against the insurer for the same amount.

Insured persons are: company director, company supervisor, company manager, company secretary or officer.

The insurer’s contractual promise under the policy is twofold: for one thing, it promises to defend the insureds against unfounded claims. This being said, just as in most jurisdictions in the U.S. (insurance law is only partially federalized), there does not exist a statutory duty of an insurer to assist its insureds in the defense against liability claims (the so-called “no duty to defend” principle). Defense is a challenge the insureds have to shoulder themselves. Thereby, the insurer obviates the risk of being held liable by its insureds for blundering the defense against claims. The insurer merely promises to reimburse its insureds for reasonable defense costs. To that effect, the insurance contract terms tend to remain rather vague. It must be feared that litigation regarding the reimbursement of attorneys’ fees is bound to occur. It is wise to provide for the reimbursement of attorneys’ fees as early as in the policy drafting stage.

Furthermore, attention must be paid to the fact that, pursuant to policy wordings, defense costs are counted against the insurance sum. Consequently, where defense costs skyrocket, there are hardly any proceeds left for the settlement of the actual damage.

II. The ‘nuts and bolts’ of D&O insurance in Germany

Most multinational corporations have placed directors and officers liability insurance policies with worldwide cover in their home country. This can leave D&Os serving on supervisory and executive boards of subsidiary companies in Germany exposed. An additional and separate standalone local D&O insurance cover in Germany is highly recommended.

D&O claims handling in Germany

In an insured event, claims are processed and dealt with in German language and German law. Insurers based in Germany and their in-house claims department are highly experienced and familiar with the bespoke German legal system. To handle a German D&O claim’s case out of a foreign jurisdiction is very difficult because of the language barrier and the different legal systems. For the insured persons, a claims handling via a foreign D&O policy would have major drawbacks. A local German D&O policy provides comfort. Being personally sued can be crippling for individual directors or officers. Just the risk of lawsuits in Germany might cause qualified individuals to refuse to take director or officer positions, or it could motivate existing officers or directors to act with excessive caution in pursuing a corporation’s interests.

The limit of cover is reserved for local German management

It has to be borne in mind that – particularly 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 in a foreign country can consume the entire limit of insurance cover with one single insured event. Should a managing director of a subsidiary company in Germany 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.

Broad definition insured persons in German D&O policy wordings

Compared to international standards, German D&O policy wordings protect a wide range of insured persons: insured persons are present, former (including those who have quit service before the inception of the policy) and future appointed and de facto members of the management bodies (including interim managers) and of the supervisory bodies, as well as managing limited partners and their representatives, permanent representatives (section 13e of the German Commercial Code), special representatives in accordance with sections 30 and 86 of the German Civil Code, members of the representative assembly (section 43a of the Act Concerning Industrial and Trading Cooperative Societies), authorised representatives and managers – for the definition of managers, the interpretation applies which is the most favourable to them in each individual case under employment law, shareholders and their representatives, employees and other employed persons – if a claim is made against them together with the insured persons referred to above, or in their capacity as authorised representatives for the compliance, data protection, money laundering, security or environmental division and comparable legally defined representative functions, liquidators of the policyholder and its subsidiary companies – as long as they are not working on the basis of an external contract for services or in insolvency proceedings.

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 directors have a key and fundamental interest in keeping their clean reputation and fully clearing their name, spoiled by allegations of breach of duty, by successfully defending the claims. Therefore, the best possible defence is required. In order to succeed, the executive board members and managing directors should be able to appoint the best attorneys in the field of executive liability and D&O insurance. 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 bill on hourly rates rather than on 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 any lawyer they want. In order to ensure that the insured persons have access to the best lawyers, a good German D&O policy wording stipulates 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 a preselected expert attorney network.

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 become a huge 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.

Operational activities shall be insured

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 a 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. Good D&O wordings expressly stipulate that operational activities are insured.

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 to 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 liquidity 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 placing the D&O policy, no insured person can know and trust whether the scope of insurance cover both with regard to terms and conditions and the limit of indemnity will still be in existence at some point in the future when a claim is actually made. In the event that the insurer – in the framework of annual D&O renewal negotiations – demands restrictions on the D&O policy wording terms and conditions, such as exclusions of cover for corruption and cartel behaviour, and the insurer may even at the same time reduce the limit of indemnity, then the restricted cover is applicable retroactively for breaches of duty in the past. High quality D&O wordings stipulate that old liability remains covered and that if the policy is continued with restrictions on its conditions or a reduced limit of indemnity, then, with regard to breaches of duty committed prior to the commencement of the amendment, the original scope of cover applies as agreed immediately prior to the restriction of cover and/or the reduction in the limit of indemnity.

Extended reporting period

The executive board members and managing directors have to keep in mind that they will be leaving the company – 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 10 years. Claims made by financial institutions against their directors arising from the management service agreement or the position in the corporate board due to breach of duty also lapse in 10 years. Notably, the period of limitation begins once the financial loss 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 in the D&O policy wording needs to be sufficient.

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. As a result, the flawless and proper function of the D&O insurance cover will be safeguarded.

For the reasons outlined above, additional and separate local D&O insurance cover in Germany is better suited and recommended for corporate officers and directors of German subsidiary companies of large multinational corporations to mitigate risk and to seek protection, compared to a single worldwide D&O master cover policy placed by corporate headquarters outside Germany.

III. The two-tier trigger policy for supervisory board members in Germany

D&O damage cases are rife with 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. The separation of managerial and monitoring capacities in the German two-tier board system requires separate D&O policies for executive boards and supervisory boards through distinct insurance companies.

Conflicts of interest in D&O damage cases

Managers’ liability actions are increasingly permeated by third-party practice. Between supervisory board, executive board and insurer, this leads to extensive conflicts of interest which are highlighted during the course of a D&O damage case.

The supervisory board’s duty to prosecute

According to the German Federal Supreme Court’s ‘ARAG doctrine’, 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 must pursue them, and generally does so. 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, executive board members extrajudicially confronted with the company’s claim, threaten supervisory board members with third-party notices once they have been served with a complaint.

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 as an intervenor on the defendants’ (executive board members’) side. The insurer is thereby capable of exerting direct influence on the liability proceedings and is entitled to assert all means of challenge or defence. In the course of the intervention, the insurer 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.

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.

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. This is accomplished in accordance with the proportionality of the actors' individual degree of blame and the equitable liability quotas. 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.

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 and 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 deluded by the executive board (the supervisory board's argument). The conflict is reflected in the business media with headlines such as: "The Supervisory Board Inquired Into Everything, Yet Unwittingly".

The supervisory board's duty to monitor

According to the general standard of § 111 Sect 1 AktG (German Stock Corporation Act), 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."

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 the executive board and the 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 that it is precisely this insurer that: (i) previously acted on the defendants' (the executive board members') side as an intervenor; (ii) filed a motion to dismiss the complaint; and (iii) 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 German 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.

In the case of third-party notices, the D&O insurer shall 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. The misery manifests itself 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 constitutes 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.

The German two-tier board system requires a protective umbrella for the supervisory board members

As previously outlined, 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).

IV. Yates Memorandum: impact of new rules for manager liability in the US on D&O insurance

In the motherland of D&O insurance, the US Department of Justice (DOJ) has proclaimed to make short shrift with managers. This makes an adjustment of current D&O insurance protection necessary. As for German managers' and supervisory board members' US mandates, there is an equally urgent need for action.

In September 2015, utterly unnoticed by the broad public, the DOJ enacted new guidelines for managers' individual accountability arising from corporate misconduct and infringements of the law. A seven-page memorandum named after US deputy attorney general Sally Yates prescribes that companies shall relentlessly investigate cases of misconduct and closely cooperate with investigating authorities.

As of now, companies cannot expect clemency in the determination of civil penalties, unless they disclose all facts and details pertaining to the individuals that are involved in the misconduct. According to the Yates guidelines, it is from the outset that the conduction of both criminal and civil investigations shall focus on individuals.

The Yates agenda is literally as follows: (i) to be eligible for any cooperation credit, corporations must provide to the DOJ all relevant facts about the individuals involved in corporate misconduct; (ii) both criminal and civil corporate investigations should focus on individuals from the inception of the investigation; (iii) criminal and civil attorneys handling corporate investigations should be in routine communication with one another; (iv) absent extraordinary circumstances, no corporate resolution will provide protection from criminal or civil liability for any individuals; (v) corporate cases should not be resolved without a clear plan to resolve individual cases before the statute of limitations expires and declinations as to individuals in such cases must be memorialised; and (vi) civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual's ability to pay.

Will Volkswagen be a first test? The new guidelines have taken centre stage of press coverage as a result of the DOJ's billion-dollar action against Volkswagen on account of alleged infringements of the Clean Air Act. In the US, authorities, in cases where the law is broken, lack the competence to impose a fine against the wrongdoer by their own authority Therefore, in order to enforce civil penalties against wrongdoers, they have to bring actions in the District Courts.

As far as present undertakings to elucidate the allegations are concerned, the DOJ in its complaint deems these efforts entirely inadequate. Volkswagen allegedly obstructed ongoing investigations through misleading statements and by withholding essential evidence. Volkswagen is said to have denied disclosure of emails and other communication between executives to US prosecutors. The Californian Environmental Protection Agency's accusation is this: Volkswagen made the decision to cheat during emissions testing and then attempted to conceal it. They continued their endeavours to conceal everything, thereby exacerbating their lie. Upon getting snapped, they tried to deny everything. By contrast, Volkswagen continuously emphasises that it was fully cooperating with US authorities and that it was merely relying on data protection.

According to the new guidelines, the following policy comes into effect: a settlement between the authorities and the corporate defendant must never allow for the protection of individuals from civil and criminal accountability. Individual misconduct shall be relentlessly uncovered. Ms Yates put it this way: "Corporations can only commit crimes through flesh-and-blood people."

When managers are brought to justice by their own companies, the D&O policy will serve as their lifeline in setting up a personal defence. Leading American D&O experts sound the alarm: the new Yates-Guidelines necessitate ‘personal catastrophe coverage’ for the involved managers with sufficient and separate coverage limits. Managers can resort to Excess Side A/DIC policies when companies no longer provide the funds for a defence against the claim or the indemnification is not warranted.

The Yates Memorandum increases the perils of parallel proceedings. Companies and individuals should make early decisions about the need for separate counsel for employees at all levels when misconduct is identified. There is a strong possibility that the interests of the business may become adverse to those of a particular individual. It may be proper for individuals to consider obtaining separate counsel at the outset of any investigation.

For their US mandates, German managers ought to take out insurance in the form of an individual D&O policy in Germany. These policies provide the best solution to respond to the aforementioned risks. The concept of personal coverage has been going viral in the German D&O market for quite some time now. Coverage is worldwide and encompasses both German and US mandates. The policy provisions do not include exclusions concerning risks stemming from the new Yates guidelines. Inaccessible ‘strong room policies’ that managers cannot get their hands on are rather undesirable. The same is true for non-executive director mandates in the US. The only drop of bitterness for managers is that they will have to take the money for individual coverage out of their own purse.

V. Litigation Funding in the D&O-Claims Arena

One of the most significant recent developments in the litigation environment has been the rise of third-party litigation funding.

Only a handful of litigation funders have gained a foothold in the German market. The business strategy could not be any more straightforward: By virtue of litigation funding, a plaintiff may shift to the funder the entire risk of having to bear the costs of the action. In Germany, these costs encompass the defendant’s attorney’s fees, too, since it has a “loser-pays” rule. As consideration for shouldering the litigation costs, the funder will be entitled to a share of the amount in controversy if the plaintiff prevails. Customarily, such share comes in the range of 20 to 30 percent of the amount in controversy. The increase of Court and attorneys’ fees is degressive so that costs decrease with the increase of the amount in controversy. For the funders it is rather undesirable to finance a case for which the chances of success are smaller than or equal to the chances of having to bear its costs. Additionally, the defendant has to be sufficiently creditworthy so as to render the claim recoverable.

It has only been since recently that D&O insurers have become a target of litigation funders in Germany. According to the aforesaid, in cases where damages amount to millions, manager liability actions promise to be a lucrative business. Most D&O insurers’ current practice of settling claims provides an ideal breeding ground for the demand for litigation funding.

The need for litigation funding in the D&O-claims arena

According to the German Federal Supreme Court a D&O policy's component of satisfying claims rests on equal footing with its component of defending against such claims. In practice however, one gets the impression that insurers seek to fight off even meritorious claims. As a consequence, litigation with their managers is virtually thrust upon the companies. Companies typically lack the perseverance of litigating through the court system. Fatigued by litigation the damaged companies surrender on the lower court level. As a result, the D&O insurance policy has in effect transformed into litigation expense insurance that often does not provide but for a small pot of money to settle the case. The major part of payouts goes to lawyers, experts, and courts. The rule of thumb is this: An insurance sum of € 1m is offered in the market for an amount as low as € 1,000. Is such a premium level solid enough for an effective handling of claims? The obvious answer – no, it is not – presents the unpleasant corollary that the plaintiff companies have precious little choice than to accept derisory settlements.

Settlement regrets as a trigger for litigation funding

Unlike in the U.S., in Germany it is the company, not its shareholders, that typically brings claims against its managers. In a stock corporation, the supervisory board pursues the claim against the executive board members on behalf of the company and represents it in litigation. Indeed, a general duty is incumbent upon the supervisory board to pursue viable claims against the executive board members. The German Federal Supreme Court in its landmark ARAG/Garmenbeck ruling imposed this duty on the supervisory board as part of its duty to monitor the executive board.

In the majority of cases, these manager liability proceedings wind up being settled. While companies increasingly claim higher damages, the amounts settled remain low. Pursuant to the German Stock Corporation Act, the liability settlements that the company concludes with the defendant executive board members and the coverage settlements that the company concludes with the consortium of D&O insurance carriers are subject to the following conditions precedent: (1) The shareholders' meeting has to consent to those settlements and (2) no minority whose aggregate holding equals or exceeds one-tenth of the share capital may record an objection in the minutes. Attention must also be paid to the fact that a settlement may not be concluded prior to the expiration of three years after the claim has arisen.

Consequently, the supervisory board will regret the "lousy" settlement that it has previously negotiated and proposed to the shareholders, if the shareholders' meeting does not consent and, thus, the settlement does not give rise to contractual duties, or if the supervisory board is virtually "punished at the polls" through miserable voting results. In both cases, there is a great potential for concomitant negative press coverage that can bring about considerable reputational detriment to the supervisory board members. By the same token, the pressure on the supervisory board to settle the action can increase in light of the fact that "the wheels of justice turn slowly" and that litigation in court stretching over multiple years invariably leads to attorneys' fees ballooning. Additionally, it might be questionable whether the imponderables of the disposition of the action still warrant the action being proceeded with. Nine times out of ten, a liability claim involves highly complex legal and economic issues, many of which the German Federal Supreme Court ultimately decides. Thus, in the course of settlement negotiations, the supervisory board, while being counseled by the plaintiff company's lawyers, always has to assess whether or not the claim is fully enforceable throughout the court system. To that end, it has to evaluate legal and evidentiary issues that oftentimes require judgment calls.

As if this were not enough in terms of pressure and responsibility on the part of the supervisory board members, another point compounds the plight they find themselves in. In the event the shareholders find that the supervisory board, by prematurely settling a meritorious case, has breached its duty to bring viable claims against the executive members who have allegedly inflicted damage on the company, these shareholders, invoking a separate expert opinion, could lodge claims against the supervisory board members. With such claims they could demand the difference between the amount of the actual settlement and what could have potentially been adjudicated against the executive board members, had claims been brought against them. Moreover, in such a situation the supervisory board members are in danger of being charged with embezzlement and abuse of trust. Thus, a misguided settlement can be a road to financial perdition for them, particularly since the insurance proceeds most likely have been used up by now. But then again, the rejection of a settlement offer harbors the risk of liability, should the subsequent adjudication of the matter turn out to be more unfavorable in terms of the amount of damages awarded than the settlement offer.

Consequently, when assessing the adequacy of a settlement the supervisory board invariably has to deal with the issues of its duty to pursue viable claims and the risk of embezzlement and abuse of trust charges in case of the insurer's merely offering an untenably small settlement amount. For that matter, the supervisory board can best secure itself against settlement regrets by retaining full-fledged experts who not only possess the expertise to thoroughly assess the basis and enforceability of the liability claim but who also have at their disposal the requisite financial means to pursue meritorious claims to the bitter end of the court system. It is at this juncture where the litigation funders come into play.

Litigation funding as a means to escape the settlement pitfall

In the absence of a litigation funder, a damaged company has to finance the legal enforcement of its claims at its own expense. In the true sense of the word, the company has to throw good money after the bad. Given that D&O insurance is a form of liability insurance against financial loss, the assessment of the merits of a manager liability claim forms the basis of the litigation funder's decision whether to finance the claim or not. A positive answer will not ensue until a thorough and independent "due diligence" has been performed. The chances of success have to amount to at least 70 percent. Otherwise, the litigation funder could just as well try its luck at a casino.

The assessment of the validity of the claim focuses on questions like the applicability of the business judgment rule and issues of burden of proof. In the event that litigation funders, having scrutinized the case, should come to the conclusion not to take the risk of providing the financial means, this should equally serve as a red flag for the damaged companies. Consequently, a screening function can be assigned to litigation funding. The chaff is sifted from the wheat, and the insurers' money coffers provide for an expeditious and noiseless settlement of such cases as promise sufficient chances of success.

Conclusion

In the context of manager liability, the supervisory board and the shareholders of the damaged company should explore the possibilities of litigation funding. Litigation funders potentially operate as a counterbalance vis-à-vis the D&O insurers. Damaged companies should not give in to the insurers' dragging them by their nose ring across the circus arena. On the contrary, consistently bringing valid claims against management will make insurers keep their promise to effect payments in damage cases. In the absence of an effective damage settlement practice, D&O insurance carves out a miserable existence and stands to be at risk of extinction. But then, the protection of species is in the very interest of industrial insurers, too. Above all, the latter should treat damaged companies as clients and account them the payers of premiums.

VI. Insurability of Certain Business Risks through so-called Airbag Products from the Financial Lines Area

A D&O damage event stemming from particular risks (M&A transactions, cyber risks, etc.) can be nipped in the bud by means of an insurance umbrella that is put up around the company ("entity cover"). These so-called air bag products absorb the damage before the company makes it the subject matter of a liability action against its organs. Accordingly, each manager, for his own sake, should be anxious that a great deal of "airbags" be actually put in place. The following lines are meant to provide a concise overview of the range of products from the financial lines product family:

Cyber Insurance

As a newcomer to the financial lines product family, cyber insurance has quickly acquired renown. Cyber security is a concern for every corporation and it is an issue on which every company's board should focus. What is cyber insurance? Cyber insurance is an insurance product providing protection to businesses and individual users against various risks relating to information technology infrastructure and activities, be they internal or external, malicious or accidental.

Cyber attacks can be extraordinarily complicated and demand costly responses. These include digital forensic preservation and investigation, notification of a broad range of third parties and other constituencies, fulfillment of compliance obligations, potential litigation, engagement with law enforcement, the provision of credit monitoring and crisis management, and many more. Cyber risks, including cyber crime, IT failures, espionage and data breaches, have evolved as a major threat for businesses. As a consequence of the rapid evolution of cyber attacks, underwriters, brokers, and consumers have been experiencing difficulties with concocting the ideal policy eliminating the unique risks a company is exposed to. This has caused policy coverages and configurations to proliferate and rendered it difficult to chop one’s way through the undergrowth of policy provisions. It is imperative, however, that comprehensive cyber insurance provide international coverage and be tailored to individual risk profiles. A cyber insurer’s approach is typically based on a thorough assessment of the company’s risks and exposures. Therefore, insurers are usually teaming up with risk engineers, who specialize in IT security and evaluating a company’s IT risk maturity. Pinpointing a company’s vulnerabilities is the key factor in the underwriting process. Taking out off-the-shelf protection is highly inadvisable. But then, 100% protection against cyber-related damage cannot be guaranteed.

The American lawyer Paul Ferrillo authored a remarkable book entitled “Navigating the Cybersecurity Storm: A Guide for Directors and Officers”. To help corporate boards ferret out cyber risk exposures and determine the possible insurance coverage needed, the book provides the following checklist of first and third-party risk exposures that can (depending upon the carrier and cyber insurance policy purchased) be covered by cyber insurance:

“First-party Cyber Risk Exposures:

Loss or damage to digital assets – loss or damage to data or software programs, resulting in cost being incurred in restoring, updating, recreating or replacing these assets to the same condition they were in prior to the loss or damage.

Business interruption from network downtime – interruption in service or failure of the network, resulting in loss of income, increased cost of operation and/or cost being incurred in mitigating and investigating the loss.

Cyber extortion – attempt to extort money by threatening to damage or restrict the network, release data obtained from the network and/or communicate with the customer base under false pretenses to obtain personal information.

Theft of money and digital assets – direct monetary losses from electronic theft of funds / money from the organization by hacking or other type of cyber intrusion.

Customer notification/Public Relations expenses – legal, postage and advertising expenses where there is a legal or regulatory requirement to notify individuals of a security or privacy breach, including credit monitoring program costs and PR media assistance.

Third-party Cyber Liability Exposures:

Security and privacy breaches – investigation, defense cost and civil damages associated with security breach, transmission of malicious code, or breach of third-party or employee privacy rights or confidentiality, including failure by outsourced service provider.

Investigation of privacy breach – forensics investigation, defense cost, regulatory penalties and fines resulting from an investigation or enforcement action by a regulator as a result of security and privacy liability.

Loss of third party data – liability for damage to or corruption / loss of third-party data or information, including payment of compensation to customers for denial of access, failure of software, data errors and system security failure."

The vast majority of insurance policies contain separate per-loss limits and retentions for distinct events (e.g. for information security and privacy liability) as well as an aggregate amount. It is of utmost importance that corporate directors and officers understand the complex structure of the policy that reflects the many facets of cyber risks, prior to allocating their limited resources. Since multiple cases have occurred where a data breach went undetected for several years until it was discovered, corporate boards should see to it that favorable retroactive dates be included in the cyber policy, lest the insureds stand transfixed by the insurer denying coverage. Finally, recent cases in the U.S. highlight the pitfalls of many cyber policies in scenarios where the company falls prey to phishing or social engineering attacks. The insurers have denied coverage on the theory that the attackers' actions did not directly cause the company's loss, but rather that the loss had to be attributed to the employees independently transferring money to the cyber attackers.

In conclusion, it can be stated that corporate boards should be alerted about the potential liabilities that corporate directors and officers may face as a result of cyber security issues. After reviewing the current D&O litigation landscape relating to cyber, it is striking how numerous the cases are in which cyber security breaches translate into directors and officers being sued for a breach of their fiduciary duty of care. Therefore, boards should establish a factual record and documentation of board action and involvement related to IT governance, cyber security and cyber insurance.

IPO Insurance

Further, a company can take out IPO (initial public offering) insurance. This form of insurance is specifically tailored to the risks stemming from the placement of capital on the market and prospectus liability issues. In the event investors lodge claims, IPO insurance protects the insureds from mistakes that have been made in the context of investment advising and that cause loss of capital.

M&A Insurance

Transaction risks can be averted by taking out M&A (mergers and acquisitions) insurance. M&A insurance is a form of warranty insurance (which is why the product is commonly labeled W&I (warranty & indemnity) insurance) that covers damages both on the buyer and on the seller side. In China, too, this type of insurance is gaining momentum as mergers and acquisitions of companies show incremental growth. Accordingly, several lines should be dedicated to this relatively new product.

Put simply, W&I insurance transfers the risk of a breach of a warranty or indemnity provided in acquisition or recapitalization agreements to the insurance market. At first glance, W&I insurance acts as any other insurance policy, i.e. a risk transferal mechanism – in this case the risk being a breach of a warranty or indemnity. It was indeed this type of risk that resulted in the initial development of the product. It allowed sellers to exit a deal “cleanly”, safe in the knowledge that, should any dispute arise, insurance would cover the associated costs.

However, as the use of W&I insurance increased it became evident to both buyers and sellers that it had greater potential. Buyers and sellers started to use the policy to bridge gaps that arose from disagreement during negotiations – for example, a seller unwilling to provide the warranty cap demanded from the buyer could agree to the buyer’s demands if they purchased an insurance policy. Insurance mitigated the dispute and transferred the added seller risk to the insurance market. Buyers also began using insurance to reduce the heightened risks associated with cross-border transactions, such as an impecunious seller. Within the context of any transaction or recapitalization, both the buyer and seller face the risk of a warranty breach – a seller is exposed to the risk of lengthy litigation and losing a portion of the consideration from the sale of its business whilst a buyer is at risk of a court decision agreeing upon a lower settlement figure than anticipated (or at risk of no settlement at all where the seller is illiquid).

More recently, buyers have been using W&I insurance to differentiate their bids, particularly in auction scenarios. Buyers have been able to reduce the warranty cap and escrow amount demanded from a seller, and instead use insurance as an alternative means to obtain recourse in case of a breach. In some cases, especially those in which the seller is set to receive more money up front as a result of a smaller escrow, the buyer has even achieved a better overall purchase price.

Sell-side policies are known as “Third Party Indemnity” policies. For such a policy to be triggered, a breach of a warranty (or indemnity) must occur, and the buyer must instigate legal proceedings against the seller. The policy will in turn indemnify the seller for both the legal costs associated with defending the claim and the judicially awarded damages or settlement amount.

Buy-side policies are referred to as “First Party Indemnity” policies. This type of policy is triggered by the mere occurrence of a breach of a warranty (or indemnity). It is not a prerequisite that the buyer effectively commence proceedings against the seller before he can turn to the insurer and claim the insurance proceeds. In the majority of buy-side policies insurers have also forgone their right to subrogate against the seller, except where fraud is involved. Given the “first party” nature of buy-side policies, in general they tend to be a more powerful tool. Accordingly, buy-side policies make up over 75% of all W&I policies bought.

EPLI

Insurers now also offer EPL (employment practices liability) insurance for damages arising from claims brought by employees on the grounds of alleged violations of statutory rules and duties proscribing discrimination, harassment, or harm to dignitary interests in connection with employment. Current and former employees as well as applicants who feel discriminated against qualify as claimants. Up to now, this insurance concept has primarily gained currency in the U.S., where employment practices claims are daily fare and easily amount to millions.

Fidelity Insurance

By virtue of fidelity insurance, a company is protected against damages that arise from tortious conduct (larceny, false pretenses, conversion, etc.) committed by employees and other representatives. In recent years in China, too, a great deal of companies have fallen prey to economic crimes and have suffered substantial damage. Fidelity insurance ought to be taken out as a supplement to cyber insurance.

VII. The Non-Admitted Complex (Example China)

Many German multinational corporations have operations in China. With regard to compliance requirements the insurer's general promise of worldwide cover as stipulated in a commonplace German "Master Cover" policy wording can be critical. The crucial question is whether or not a wholly owned subsidiary company or a joint venture company in China can be insured under the German "Master Cover" D&O policy.

It is secured state of knowledge that China belongs to the circle of the so-called "non-admitted countries". The non-admitted prohibition is set out in Articles 6 and 7 of the Insurance Law of the People's Republic of China (hereinafter 'Insurance Law') and is intended to proscribe the procurement of insurance without the issuance of a local policy. The terms of such local insurance policy have to be ratified by the China Insurance Regulatory Commission (CIRC), which usually takes one month. The Chinese Insurance Law is supplemented by rules and regulations published by the CIRC. These rules and regulations govern how insurance companies and intermediaries have to conduct their businesses. The CIRC was established in 1998 to accede to the operation of the People's Bank of China (PBOC). The CIRC's guidelines in its "Notice on Issues Relevant to Banning Illegal Commercial Insurance Institutions and Illegal Commercial Insurance Business Activity" dating from 2008 flesh out the non-admitted precept, and list activities that are deemed illegal if undertaken without the CIRC's approval. German D&O insurance carriers are constantly watching the regulatory law in all jurisdictions worldwide and they are aware that full compliance is in their own interest. The leading D&O insurer Allianz Global Corporate & Specialty has classified China and the following other jurisdictions as so-called "critical countries": Brazil, Russia, India, Switzerland, Japan, Turkey, Argentina, Malaysia, Indonesia, Mexico, and South Africa. As a purely precautionary matter, the U.S. is also referred to as a "critical country" because of the diverging laws which vary from state to state as well as the high risk of claims. The list of the "critical countries" is by no means complete and conclusive. Across the globe, local regulatory requirements are subject to an everlasting change by lawmakers.

German policyholders often ask about fines and penalties which can be imposed against their subsidiary companies in China in the event of a breach against the non-admitted prohibition. Pursuant to § 142 of the Insurance Law, illegal gains can be confiscated and the CIRC can impose a penalty payment of up to five times the amount of the illegal gains.

D&O policy wordings of a German Master Cover include so-called non-admitted clauses, which carve back the general principle of worldwide cover. The following is an excerpt from a sample wording:

“If on the basis of foreign legal regulations insured persons or subsidiary companies are not permitted to have any claim against the insurer for insurance cover under this policy and they are otherwise threatened with penalties, then they are deemed not to be insured. Local D&O policies for foreign subsidiary companies under their respective legal system can be agreed separately.”

Local Policies in China and International Insurance Programs

In order to be fully compliant, the implementation of a local D&O policy in China is indispensable. Otherwise there will be no coverage in China for the insured event under a German Master Cover policy.

Local D&O policies for subsidiary companies and joint venture companies in China reflecting the legal landscape of the respective jurisdictions can be enquired through the “International Insurance Programs”, which are offered by internationally operating German D&O insurance carriers. The three local insurers with the largest market share in offering D&O insurance are People’s Insurance Company of China, China Pacific Insurance Company, and Ping An Insurance Company. The locally installed policies and their contents and stipulations are not deemed decisive for the outcome of any insurance battle. Rather, these policies serve as a means of window-dressing since they are used as a façade for international non-admitted insurers to be formally compliant with Chinese regulatory law.

An international insurance program often comprises several local policies in many jurisdictions of non-admitted countries. The implementation of an international insurance program is very time-consuming due to the load of information requested by the underwriters. German policyholders who have once managed such a “paper war” will most certainly not like to repeat this procedure after changing their insurer. Therefore, D&O insurers may regard well set up international insurance programs as a measure of de facto customer retention.

Local policies that are not embedded in the framework of an international insurance program come with a severe disadvantage: the maximum limits of cover that are offered for a local policy are only a fraction of the amount of the limit for the German Master Cover. Generally, local policies in China only have limits as low as USD1 million to USD2 million (exchange value in Chinese currency CNY), whereas the limit of a German DAX company can easily reach EUR500 million. Such high limits of indemnity are provided by a consortium (underwriting group) of several D&O insurance carriers in a layer structure with a primary insurer and several excess insurers. Alternatively, the insurance program can be structured as an open co-insurance, where multiple insurers jointly write one limit, but each insurer has an individual capacity and only pays the percentage of the loss that is commensurate to the percentage of the premium that it is entitled to according to its capacity. Such a co-insurance solution has the clear advantage that the policyholder has to deal with only one insurer and one claims officer in the event of a claim, whereas in a layer structure with one primary insurer and several excess insurers the policyholder has to deal with multiple claims officers of multiple insurers. In the co-insurance model, by the use of a strict leadership clause, only the leading insurer makes decisions with regard to the claim. The co-insurers should abide by the decisions made by the lead insurer. An insurer with a proven track record for claims handling should take the leading role.

The policyholder is interested in having high limits of cover so that compensation for high financial losses can eventually be effected by the D&O insurer. Its contractual promise undertaken in the D&O policy wording is twofold: for one thing, the insurer promises the defense against unfounded claims; for another thing, it promises to indemnify and compensate the company for its damages. The compensation for financial losses mirrors the policyholder's interest for balance sheet protection, the fulfillment of which hinges on sufficiently high limits of indemnity.

Generally, D&O claims are a major loss risk. High amounts of financial losses arising from typical areas such as cartel fines, corruption, miscalculation, failed projects, accommodation of loans, failure to observe time-limits, contract design, organizational and supervisory duties more often than not exceed the limits of Chinese D&O Policies. Whether or not such cartel fines translate into a D&O claim remains to be seen. In the German D&O claims practice similar cases play a significant role.

Because of the high increase in D&O claims, experts forecast a tough D&O market. In the short or long term, cartel and corruption risks will most likely be excluded from D&O policies. One has to bear in mind that D&O policies are based on the claims-made principle. In order to ascertain the limit of indemnity and which policy wording applies, the date a claim is initially made in writing is the dispositive point in time. The time the duties have been breached (occurrence principle) is irrelevant. The amount of the limit of indemnity is a question of "life or death" for the individuals involved. In a D&O damage event the problem of how to equitably distribute the insurance proceeds will arise if the limit of the D&O policy is not sufficient. The insurer's obligation to indemnify is limited to the insured amount as documented in the policy for each insured event and for all insured events in the aggregate.

A corollary of the above-illustrated problem, i.e. that local policies in China provide comparably scant amounts of indemnity limits, is that a major local D&O claim in China cannot be covered but through the framework of an international insurance program where the German Master Cover policy covers the so-called "balance sheet loss". This solution is also referred to as "Financial Interest Cover" (FINC). The contractual details are stipulated in an addendum to the Master Cover policy. The local Chinese limit can be an integrated limit of the overall limit of the Master Cover or a "stand alone" limit. Usually, local policies in China are offered with integrated limits in the framework of international insurance programs.

What exactly does it mean when we refer to the insurance/cover through the framework of an international insurance program of the “balance sheet loss” suffered by a German policyholder in the so-called non-admitted countries such as China? The leading German D&O Insurer, Allianz Global Corporate & Specialty, defines the “balance sheet loss” as (a) the payment effecting indemnification or (b) in the event indemnification is not permitted the internal liability share as it is determined in a settlement. The coverage of damages for which indemnification cannot be granted is considered a major innovation in the market. With respect to fully consolidated companies the insurer covers the entire local loss irrespective of the shareholding quota. In the majority of policies, the shareholding quota that the German policyholder holds in the local joint venture company in China is the dispositive factor in identifying the extent of the coverable damage.

As shown above, the balance sheet loss can reach astronomical amounts that can easily exceed the limit of the primary insurer in the German Master Cover. If the primary insurer guarantees the coverage of the balance sheet loss in an addendum to the policy, and the excess insurers in a high-rise D&O tower are “following form” to the primary insurer’s wording with no exclusion, then the entire limit of the D&O tower will be available to cover the “balance sheet loss”. It remains to be seen whether the rigid approach by Chinese authorities towards foreign companies with regard to cartel offenses bears the potential to cause the D&O tower of the German Master Policy to sway.

Some German policyholders – primarily in the small and medium-sized enterprises (SMEs) sector – are still reluctant to install local policies in non-admitted countries such as China, and insist on the principle of worldwide cover which they say is the insurers’ contractual promise. In practice, however, it can be observed that some German insurers cover the balance sheet loss under the Master Cover policy irrespective of local policies not having been installed in the non-admitted country. From a compliance perspective (local regulatory requirements in the non-admitted country) such a practice is more than questionable and also very problematic in light of tax law, an issue we shall now examine.

Allocation of Premiums

Irrespective of the non-admitted problem, insurance tax for local risks has to be paid. For the purposes of tax allocation, the policyholder in Germany has to allocate the premium to all subsidiary companies worldwide. The insurance tax rate widely varies from country to country. Until May 1, 2016, the average insurance tax rate in China used to be in the region of 6%. This was not an insurance tax as it is understood under German tax law, however; the rate comprised business tax, stamp duty and municipal tax surcharge. Most likely the rate diverged in the various Chinese provinces. On March 23, 2016, China pressed ahead with its biggest tax overhaul in more than two decades – the incremental transition from liability to business tax (BT) to liability to value added tax (VAT) in the financial sector. The Ministry of Finance and the State Administration of Taxation jointly released the Caishui [2016] No. 36 (‘Circular 36’, Notice on Comprehensively Promoting the Pilot Program of the Collection of Value-added Tax in Lieu of Business Tax) which provides implementation guidance with respect to the further rollout of the VAT reform in sectors such as construction, real estate, financial services and lifestyle services. It took effect on May 1, 2016, and broadens the ambit of the VAT pilot regime to include the financial sector. Supplementing Circular 36, the Ministry of Finance and the State Administration of Taxation then, on April 29, 2016, jointly issued Caishui [2016] No. 46 (‘Circular 46’) to further particularize policies for the finance sector. It also came into effect on May 1, 2016. The applicable VAT for almost all financial services is now uniformly 6%. The details of how the collected VAT is to be allocated among the central government and states are not elaborated yet.

Because of the illustrated non-admitted problem, a tax and premium allocation for such countries can cause severe trouble with local tax authorities, particularly where local polices have not been installed and there is no international insurance program in place. Most likely, there is an exchange of information between the Chinese tax authorities and the CIRC, which exacerbates the situation in light of the CIRC’s comprehensive sanctioning powers. Where a policyholder (i.e. its directors and officers) that is responsible for the payment of the insurance tax pays its dues to a country not entitled to the tax, or omits to pay the tax altogether, the policyholder commits tax evasion. Tax evasion is punishable by monetary fines, long term prison sentences, and, in some places (such as China), the death penalty.

The first time the importance of the allocation of premiums in the European Union surfaced was through the landmark Kvaerner judgment by the European Court of Justice (ECJ). In this case, the issue was whether the Dutch tax authorities were permitted to levy insurance tax on a UK-incorporated parent company under its local tax laws, relating to the part of premiums repaid to it by a Dutch-incorporated sub-subsidiary for cover for risks linked to the parent company’s business operations to the extent those risks were situated in the Netherlands. The ECJ ruled that Dutch tax authorities were permitted to levy the tax explaining that “making the place where the risk is situated the criterion for determining the state having the power to tax is apt to eliminate disturbances of competition between the undertakings of different Member States offering insurance services [and] allows the danger of double taxation to be avoided as well as the possibility of tax avoidance, since there is an establishment, and therefore a Member State, corresponding to each risk.” The rationale is simple: “On the one hand, no risk can correspond to several establishments and accordingly there can be no double taxation. On the other hand, a policy-holder cannot avoid tax liability in a particular Member State, since the existence of an establishment and an insured risk relating to that establishment is linked to objectively verifiable factors.” Invoicing and payment of the premium are subjective criteria that “cannot affect the determination ... where the risk is situated”.

Naturally, viewed through the lenses of a corporation conducting its business globally, i.e. outside of the European Economic Area (EEA), the guidance the judgment provides is of limited use, since it is not authoritative with respect to the levy of tax through countries outside the EEA. The situation is exacerbated by the complete lack of uniform international rules for the procedure of premium allocation. The tax authorities in one country can take the view that the share of turnover of the local non-EEA subsidiary company is relevant in determining the correct tax amount. But then, tax authorities in the non-EEA home country of the parent company may be inclined to hold that the balance sheet total is the dispositive benchmark. Against this backdrop, allocating tax correctly is a virtually impossible task. This is unsatisfactory, not only because of the risk of severe administrative and/or criminal sanctions in case the allocation is blundered, but also because accurate tax allocation reflecting accurately localized risks potentially, on balance, reduces or even extinguishes tax liability. As was indicated above, where a subsidiary company is located in a non-admitted country like China without taking out a D&O policy with a local insurer, there is a great likelihood that tax authorities in the non-admitted country will have a tin ear for an EEA-located policyholder arguing that, since the “balance sheet risk” is situated in the home country, it does not have to pay additional tax in the non-admitted country.

Conclusion

In summary, the following should be observed: China is a non-admitted country. With regard to compliance (tax and regulatory law), the best insurance solution seems to be the installation of a local policy in China as part of a framework of an international insurance program. It is remote from certain that coverage for a “balance sheet loss” via the German Master Cover is fully compliant with Chinese regulatory law. Since the insurer compensates the balance sheet loss in Germany by effecting direct payment to the German policyholder, however, such practice should be beyond the ambit of Chinese Insurance Law and beyond the jurisdiction of the CIRC. Policyholders may rest assured that, at least for the time being, the approach of installing local policies in China as part of the framework of an international insurance program is the best solution to satisfy Chinese compliance requirements.

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