Published By: **Kevin M. LaCroix**

THE D&O DIARY

A PERIODIC JOURNAL CONTAINING ITEMS OF INTEREST FROM THE WORLD OF DIRECTORS & OFFICERS LIABILITY, WITH OCCASIONAL COMMENTARY

Guest Post: Marshall Plan for D&O Policies in Germany

By Kevin LaCroix on September 21, 2015
Posted in International D & O

Burkhard Fassbach

Niklas Rahlmeyer

This blog's primary focus is on developments in the directors' and officers' liabilit and insurance in the United States, but we do also try to cover important developmen elsewhere. In the following guest post, Burkhard Fassbach, who is Of Counsel wit the Dusseldorf based D&O-Specialist Law Firm Hendricks, and Niklas Rahlmeyer, who is an attorney in the corporate practic group of the Dusseldorf office of Field Fisher Waterhouse LLP provide their perspective on the German D&O insurance marketplace and discuss their views on the important insurance coverage issues there.

I would like to thank Burkhard and Niklas for their willingness to publish their article on this site. I welcome guest post submissions from responsible authors on topics of interest to this blog's readers. Please contact me di rectly if you would like to submit a guest post. Here is Burkhard's and Niklas's guest post.

****

The following post sheds light on some of the latest topics of D&O insurance that keep the German market busy. I depicts the concept of manager liability and D&O insurance in Germany, reprimands the German insurers' practice of settling claims and outlines a catalogue of important issues the policyholder and insureds should keep a wary eye on when taking out D&O insurance coverage.

Unlike in the U.S., in Germany it is the company, not its shareholders, that typically brings claims against its man agers. The supervisory board pursues the claim against the managers 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. A breach of that duty may render the supervisory board members themselves liable to the company. Accordingly, the supervisory board seldom hesitates to lodge viable claims against the executive board members.

"Don't hesitate to sue!" That is what served as a headline in the June 18, 2012 issue of Süddeutsche Zeitung, a renowned German newspaper. The number of companies that demand substantial amounts of money from their managers and insurers for alleged wrongdoings is steadily increasing. According to estimates, approximately 600 manager liability actions with 2 or 3 defendants on average are currently placed on German court calendars. The major part of those actions involve middle class companies. On July 28, 2015, the newspaper DIE WELT, in an ar ticle headed "Who bears the costs of managers' mistakes?"' published a chart of publicly known manager liability cases that featured three parameters. These were: (1) amount of damages, (2) insurance sum of the D&O policy, and (3) D&O insurer's payouts under the policy. The figures listed under these parameters should be alarming for the damaged companies. For the most part, the companies were dramatically underinsured, meaning that the amount of damages by far exceeded the insurance sum available under the D&O policy. Further, the insurer's eventual payout of the proceeds consisted of but a fraction of that insufficient insurance sum. Thus, D&O insurance policies have virtually become legal expense insurance for the companies' managers, merely providing tiny pots of money for submissive and lousy settlements. According to estimates, 60 to 70 % of an insurer's payouts ar not used so as to satisfy the claim for damages but rather to pay the fees of lawyers, accountants, expert witnesses and courts. It is the residual owners, the shareholders and company members of mid-sized companies, who eventually have to pick up the tab for such squander of company assets. The affected companies are indignant at the value of D&O policies under which scarcely a dime is paid out for the purpose of settling claims.

Leaving out emotions stemming from the claims' handling practice for a second, one has to visualize both the idio syncratic construction of D&O insurance and the insurer's promise of performance under a D&O policy: It is not the manager who is the policyholder of a D&O policy, but the company that also pays the insurance premium. In the event of damage, the rights and benefits under the policy, however, inure exclusively to the manager as insure person. Contemplating this D&O insurance concept through the lens of vehicle insurance, it would be as though the crash victim, acting in its own name, was to conclude a vehicle insurance contract and pay the insurance premium for the benefit of the opposing party who is also the perpetrator of the accident.

One of the primary promises embodied in the D&O insurance contract is the insurer's promise to defend against claims. To that end, the insurer fights side by side with the defendant managers. In case the company's claim turn out to be valid, the insurer releases the insured managers from their obligation by satisfying the company's claim. According to German case law, the insurer's promises to both defend and indemnify are conterminous and based on equal footing. This legal precept, however, does not necessarily comport with the understanding of insurers. Underwriters calculate premiums on an actuarial basis as though D&O insurance were mere legal expense insurance. The current rule of thumb in the market is this: An insurance limit of EUR 1m is obtainable for EUR 1000. I is a foolproof conclusion to draw that the insurer's promise to indemnify is a hollow one. Litigation is virtually thrust upon the companies. Indeed, there is no such thing as extrajudicial satisfaction of claims. The reality is tha companies, in most cases worn down and fatigued from litigating, surrender at the trial stage and accept lousy set tlements. There is a good case to believe that the following factors provoke this situation:

Plaintiff companies refrain from litigating through the entire court system because of the risk of having to bear the gargantuan amount of court costs and attorneys' fees in the event of defeat.

Where the amount in controversy is EUR 30m and there are three defendants, each of whom is assisted by counsel, the risk of litigation costs incurred after having proceeded from the first instance to the German Federal Supreme Court, totals, taking as a calculatory basis the statutorily prescribed costs and fees, EUR 5m. For the sak of clarification: Unlike in the U.S., where the payment of attorney's fees is governed by the American rule, the situ ation in Germany is governed by a "loser pays" concept. Accordingly, it is the defeated party in a lawsuit that has t bear the entire costs of litigation, i. e. including the prevailing party's attorney's fees and expenses for expert witnesses etc. Thus, the risk of litigation costs is far more pressing an issue to take into account by the plaintiff company in Germany than in the U.S.

The members of the supervisory board, who represent the plaintiff company in manager liability litigation, risk of being in the line of fire, too.

Along the lines of “offense is the best defense”, the defendant members of the executive board, by means of filing third-party notices, accuse the members of the supervisory board of having been well-informed of the breaches of duty in suit as well as of having backed and endorsed the decisions the members of the executive board made.

Companies are anxious to avoid reputational damages as a consequence of negative litigation press releases.

A publicly staged battle will work to the detriment of the company’s reputation and will keep alive a subject best kept buried.

As a result of the miserable practice of settling claims in Germany, D&O insurance runs the risk of having to fight losing battle against insignificance. In the interest of the damaged companies, the insurer’s promise to indemnify must be reinvigorated. Absent the benefit of actual asset protection, the company-subsidized D&O insurance policy is pointless for the companies and also jeopardizes the principals of good corporate governance. Thus, there is urgent need for action.

A Marshall Plan for D&O insurance in Germany should contain the following agenda items:

1. **Litigation committees**

Organizing and composing the supervisory board should be performed in a way that makes the supervisory board adequately appreciate its duty to pursue corporate wrongdoing. To that end, it is advisable to install in the superv sory board a liability or litigation committee in which independent and experienced members take office.

2. **Third-party litigation funding**

In the context of manager liability, litigation funding becomes increasingly important. The supervisory board should ascertain whether there are options for litigation funding. Litigation funders potentially operate as a counterbalance vis-à-vis the D&O insurers and, by creating a level playing field for the parties in a litigation scenario, potentially bring about indemnification. By virtue of litigation funding, the company is able to pass along to the litigation funder the litigation costs that are enormous where the amount in controversy is substantial. The funders have a lot of staying power and will not have themselves fobbed off with derisory settlement amounts offered at trial. The funders do not issue a cover note for the costs until having performed a thorough and independent "due diligence" on the merits of the claims. Liability and insurance coverage issues will be scrutinized. Since the litigation funder fully finances the claim at its own risk, the company does not have to waste any money and can utilize that liquidity elsewhere in the company. As consideration for the bearing of the risk of litigation costs, the litigation funder will be entitled to a share of the amount in controversy if the plaintiff company prevails. In case the funder, subsequent to its scrutinizing the merits of the claim, decides not to fund it, then that should serve as a red flag for the supervisory board. Thus, the concomitant effect of litigation funding is to separate the wheat from the chaff so that ultimately, the company will not lodge a claim unless it is meritorious. That serves to protect the community of insureds in that there will be more money available in the insurers' coffers for the settlements of actual damages. Notwithstanding, the general duty of the supervisory board to pursue claims against the executive board members, the above-mentioned legal principle that the German Federal Supreme Court in its landmark ARAG/Garmenbeck ruling imposed on the supervisory board as part of its duty to monitor the executive board, continues to govern management liability scenarios.

3. **Two-tier trigger policy**

Shareholders have an intrinsic interest in the supervisory board's being unbiased when it comes to its duty to pursue claims against the executive board members. By virtue of separate insurance coverage taken out with a separate insurer, the supervisory board will be capable of living up to that duty. The conventional D&O policy, under which executive and supervisory board members are jointly insured, does not do justice to the company's constituents and provokes unsolvable conflicts of interest among the parties involved. As a means of improving cover age, policies for the executive board members on the one hand and policies for the supervisory board members or the other should be concluded separately from each other. The insurer that insures the supervisory board members must not be identical with the one insuring the executive board members so as to avoid conflicts of interest. The supervisory board members' entitlement to separate insurance coverage should be moored in the company's bylaws. As a prerequisite, a resolution to that effect has to be adopted by the shareholders' meeting.

4. **Arbitration**

Since trials in Germany are public, court-adjudicated liability potentially causes massive reputational damage to a company. In addition, running through the court system is time-consuming. An alternative that only exists since recently in Germany is the arbitration of manager liability cases. Where the parties have concluded an arbitration agreement, the case will be tried behind closed doors. Top-quality D&O insurance policies allow arbitration and render the arbitrator's decision binding on the insurer. The supervisory board should press for the integration of such a clause in the employment contracts of the executive board members.

Conclusion and Outlook

American shareholders are in the driver seat to make the "Wind of Change" happen. Theatre of operation to question the potential hazard and peril of "Toxic Waste" D&O-insurance coverage in Germany is the annual proxy season. Due to the fact that the majority of shares in the blue chip German Share Index (DAX) are owned by U.S. institutional investors, American shareholders are in the front line to protect their assets in Germany. For the sake o good Corporate Governance, giants like BlackRock and proxy advisors such as ISS and Glass Lewis are called upo to address the Marshall Plan in order to recover and to reinstate the intrinsic value of D&O policies in Germany ir the annual shareholders' meetings. Proxy guidelines and voting recommendations for Germany need to be adopted accordingly. In the D&O claims arena the ultimate choice for shareholders is literally "to have lunch or to be lunch." For the future one can only hope that shareholders in their annual meeting will begin to challenge the value of the D&O policies currently in place. In essence, the issue is one of asset protection and shareholder value maximization.