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D&O Insurance

Precise contract drafting is crucial

Against the background of large losses, stringent laws and a stricter jurisdiction regarding D&O liability, liability insurances for the management, so-called D&O insurances, come into focus. Most German companies today conclude D&O-policies for their executives. The drafting of contract though is full of pitfalls.

In Germany, D&O insurance becomes important when a company claims for damages against an insured member of the executive board (insured vs. insured). If there is no insurance coverage, managers, executive board members and members of the supervisory board are liable with their private assets. These will usually not be sufficient to satisfy the claims. Damages of large corporations often cause costs of hundreds of millions.

D&O insurance: not an ordinary insurance product

A particularity of D&O insurance is that it involves several parties. Policy holder of the D&O insurance is the company. The company has though no direct claim against the insurer. The manager is the insured person and thus owner of the coverage claim.

The D&O insurer provides the manager with two claims: At first, coverage of costs for the defense against claims, comparable with legal expenses insurance. Beyond that, there is a claim for indemnification from justified damage claims, i.e. for compensation of the damage by the insurer.

D&O insurance is a complex construct. The drafting of the D&O policy is of essential importance to avoid coverage gaps and conflicts during the damage settlement. The scope of coverage and possible exclusions have to be determined precisely.

Scope of coverage varies

The so-called „claims made"- principle applies for the D&O-insurance. This means that the insured event does not occur with the actual damage, but rather in the moment the claim is brought against the manager by the company. After expiration of the contract, insured events are still covered for a determined period of time ("extended liability period").

Problems may arise if the breach of duty was committed before the conclusion of the insurance contract and the company claims against the manager after the conclusion of a new insurance contract.

Retroactive cover is part of the D&O insurance contract. Still, collusions of special terms occur often in case of a change of insurers. It might then be disputed whether the new or the old insurer is liable. When concluding a new D&O insurance policy, respective clauses ("subsidiary clauses") of the old and the new contract have to be coordinated in order not to endanger the manager's insurance coverage.

D&O insurance only covers pecuniary losses. It does not cover personal injury and property damage. Costs for defense of the manager against the company in and out of court are part of the sum insured although the deduction of defense costs is currently legally disputed. Therefore, the amount of attorney fees covered should be clarified with the insurer in advance.

Managers who are in the public eye should make sure that their D&O-policy provides for a claim for reimbursement of costs to reduce reputational damages. If it is agreed in the contract, the D&O insurance covers costs for a PR consultant who supports the manager in avoiding defamatory reporting by the media.

Crucial for the scope of cover is the agreed sum insured. The sum insured should correspond with the turnover and risk situation of the company. Depending on the sum insured and the risk situation, several thousands and sometimes millions of Euros are payable each year as insurance premium.

Clear provisions for exclusions should be set

Insurance coverage is principally not granted if the insured person has committed the breach of duty with intent. Additionally, insurers usually exclude the so-called knowing breach of duty from insurance coverage. A knowing breach of duty is given if the manager knows about a specific duty and consciously violates it. Here it does not matter if he was of the opinion that he was acting for the good of the company. In crisis situations executive managers often try to save the company by risky, ad-hoc decisions – well aware that they hereby violate their duties. In these cases no insurance coverage is granted.

A limitation of insurance coverage also exists for fines. Fines are insurable only for specific constellations. Here it is decisive if the company suffered a pecuniary loss, for example when the fine is directly imposed upon the company. If an authority imposes a fine as a personal penalty directly upon a board member, no insurance cover is granted.

Usually first party losses are excluded as well. If an insured manager holds a participation in the company, the insurance does not include the part of damage corresponding to the amount of participation.

Depending on the risk situation and the ownership structure of the company, the above mentioned exclusions are often subject to critical review and contract negotiation. Clear provisions avoid conflicts in the insured event.

Rescission may not be excluded

The insurer may contest the insurance contract if he thinks that he was maliciously deceived during the conclusion of the contract. A malicious deceit would for example be given if a breach of duty had already been internally known, but the responsible persons waited with the disclosure until after conclusion of the contract. It is not relevant whether the company as policy holder or only an individual board member knew about the breach of duty and thus deceived the insurer. The conduct of the insured person is attributed to the company – and vice versa.

If the insurer successfully contests the contract, it becomes entirely void and payments already made have to be reimbursed by the insured persons. Insurance coverage becomes invalid for all insured persons, no matter if the insured person had knowledge about the fraud. The insurers often waive their right of rescission in advance. Such waiver is though ineffective according to recent jurisdiction.

Damage settlement often tedious

Complex facts and high damage amounts characterize the insured event in D&O liability. The damage settlement is challenging. Insurers often deny coverage at first.

It is disputed whether the manager may assign cover claims to the company to simplify the damage settlement. In 2008, the legislator created the possibility to assign the cover claim in liability insurance to the damaged party. Many insurers deny this possibility to assign in D&O insurance. They fear that the manager claimed against will cooperate collusively with the company in order to receive the coverage payment. Therefore it is important to ensure clear provisions for this in the contract.

The time aspect plays a crucial role. The damage settlement in D&O insurance takes years. In their own interest, the parties involved should seek a non-public, out-of-court settlement. Procedures such as mediation or arbitration reduce the personal pressure on the manager. Such procedures are comparably quick and confidential and costs are lower than in case of a court proceeding. The reconciliation of interests among all parties is in focus rather than legal questions. D&O cases usually are settled with an out-of-court agreement.

Consequences for brokers

Altogether, the complex product D&O insurance implies difficulties which have to be considered by brokers and agents already during the conclusion of the contract in order to prevent problems of the customer during a later damage settlement. The further development of the product by insurers as well as changes in jurisdiction are continuous challenges for policy holders and their advisors.

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