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Insufficient sum insured and allocation procedure

Spurious arguments in claims settlement

1. INTRODUCTION

The following article discusses a problem which can increasingly be observed in the settlement of D&O claims in Germany (but also in other third party liability constellations):

If a company – or in case of insolvency of the liquidator – claims against several insured persons as joint and several debtors, D&O insurers more and more frequently argue that the sum insured is insufficient and refuse complete compensation under the insurance contract towards the insured persons. The problem is based on the following constellation:

At first, the insurers grant the insured persons preliminary coverage of defense costs. The insured persons commission defense lawyers, defend against claims and request reimbursement of the incurred costs of defense from the D&O-insurer. The D&O-insurer now refuses (complete) reimbursement of costs of defense arguing that the sum insured was not sufficient to cover all costs of defense and the release from asserted liability claims.

The sum insured should (somehow) be allocated, and even the compensation of costs of defense may only be provided proportionately. The consequence for the insured persons is that they are not only confronted with the pressure of the current liability proceedings, but will also be left to sit on that share of the costs which they paid to their defense lawyers.

Only recently, Gädtke explained that one of the major problems in the D&O-insurance not yet solved was the allocation of an insufficient sum insured among the insured persons.[1] Gädtke correctly sets forth that all of the criteria for the allocation of the sum insured are disputed, both with regard to its own basis and with regard to the appropriateness of the allocation principle.

Especially against this background it is questionable why D&O-insurers still refuse coverage with the objection of an allegedly insufficient sum insured.

The settlement practice described raises questions: May insurers in fact raise the objection of an insufficient sum insured which has to be allocated effectively towards the insured persons?

2. THE OBJECTION OF AN INSUFFICIENT SUM INSURED AS UNJUSTIFIED (PARTIAL) REFUSAL OF PERFORMANCE BY THE INSURERS

2.1 Usually no verifiably justification in law and in fact

If insured persons hand in invoices of their defense lawyers for reimbursement to the D&O-insurer, D&O-insurers more and more often argue with no verifiable reasons in law and in fact that the sum insured is insufficient and has to be allocated; costs of defense may not be reimbursed completely and there has to be an allocation proceeding. Some insurers for example claim that costs of defense may only be born “per capita” (if claims are made against three insured persons, only one third of the costs of defense of the individual insured person will be reimbursed).

The individual insured person as beneficiary party under the D&O-insurance (third party insurance / “Side-A-coverage”) does not receive any transparent, verifiable justification how many insured persons will be claimed against in which scope. Not to mention the insurer’s evaluation concerning the chances of success of the liability claims – thus the question, whether the insurer regards himself as obliged to exemption or (only) to defense. For the individual insured person it is not comprehensible according to which principles the insurer compensates and thus provides his main obligation (defense/release) to the materially entitled person under the insurance contract.

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[1] Cf. Versicherungspraxis 6/2016, page 9.

As Gädtke assumes, D&O-insurers possibly avoid contractual provisions also "to keep all options open"[2] for concrete allocation situations. Sometimes it may even seem that insurers use scope for interpretation at the expense of directly affected insured persons, e.g. in order to make liability and/or coverage settlement agreements and thus to limit their own exposure (settlement agreements are of cause expedient in individual cases. However, they usually imply concessions by the insured persons, e.g. through participation in liability settlement or bearing own costs of defense). But is there any scope of interpretation for the insurers at all? This significantly depends on the legal classification of the objection of an insufficient sum insured.

2.2 Economic and legal impact of the objection: (partial) payment refusal by the insurer

Economically, the objection regularly means a dilemma for the insured persons. The insured persons have to defend against the claim (for this the insurer – usually – grants coverage). This is often about de facto and legally complex matters. The effective defense against the claim is made by specialists. The reappraisal and defense may cause considerable costs of defense. If the D&O-insurer does not pay the entire costs of defense, this will usually constitute a significant financial burden for the insured persons.

In terms of coverage the objection of an insufficient sum insured requires that the insurer regards the coverage of individual insured persons as given. Legally, the objection of an insufficient sum insured/necessary allocation is a (partial) refusal of coverage of the insurer in terms of an objection or plea. As a result, the insurer claims not to owe the individual insured person (1) not more than (partial) performance [in the first plea] or (2) full coverage in general, but to be entitled to partial refusal in the concrete case.

3. NO CONTRACTUAL OR LEGAL BASIS FOR AN OBJCTION

There is no contractual or statutory basis for a payment refusal by objection of an insufficient sum insured and an alleged necessary allocation.

Market-standard D&O-insurance terms do currently not provide for any contractual allocation rules to determine the allocation or ranking among the insured persons.

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[2] Cf. reference as above, page 11.

There is also no statutory provision in insurance contract law. In particular, sec. 109 Insurance Contract Act („VVG“) does not concern the constellation discussed here, and a respective application of the provision is ruled out. The provision does not regulate the allocation of the sum insured to several insured persons as potentially injuring party, but the allocation of the sum insured to several injured parties, whose claims exceed the sum insured of the injuring party. Beyond that, it is disputed in liability insurance whether and how the provision of sec. 109 VVG shall be handled.[3.]

When trying to retrieve the allocation principle from legal criteria or evaluations, this is not sufficient as a basis for an insurer's partial refusal of payment. Also a supplementary interpretation of the contract aiming at the insurer having a partial right to refuse payment is excluded.

There might be a certain practical and economical interest in the objection of an insufficient sum insured / necessary allocation from the D&O-insurer's point of view – there is though currently no legal basis for this.

4. CONTRADICTORY SETTLEMENT PRACTICE – NO ALLOCATION AS LONG AS THE INSURER GRANTS DEFENSE COVERAGE

According to the view represented here, the alleged allocation problem resulting from an insufficient sum insured mainly results from the insurers' settlement practice.

Defense function and release function are generally assumed as specifications of a common coverage claim in the liability insurance according to sec. 100 VVG. Within the context of his contractual obligation to defend, the insurer first has to examine asserted liability claims. He will then have to decide whether the liability claims are unjustified and thus have to be warded off or whether they are justified and the insured person has to be released from the asserted claims.

Insurers usually don't take the decision about the form of performance, but they declare that they preliminarily grant defense coverage.

The question whether an asserted liability claim is in fact justified will due to the complexity of the cases often only be answered during the liability proceeding. This does

[3] Cf. about allocation proceeding according to sec. 109 VVG *Schultheiß*, VersR 2016, 497.

though not change the fact that insurers are responsible to take decisions whether liability claims must be warded off or whether the insured person must be exempted from it. As long as the insurer decides to grant coverage protection, the objection of an insufficient sum insured may usually not be considered from the outset. With its decision, the insurer rather expresses that he assumes that liability claims are not justified and that a release is (not yet) required. The exemption would though in most cases be a de facto requirement for the exhaustion of the sum insured. D&O-insurers though regularly raise the objection at a point of time when the costs of defense of the insured person do not nearly come close to the sum insured. The frequent settlement practice is contradictory. Consequently, the insurer has to grant entire costs of defense to (several) insured persons until the sum insured is exhausted or the case of release occurs.

According to statutory provisions, the priority principle applies for the costs of defense. According to sec. 101 para. 1 sentences 1 and 3 VVG, the insurer "shall advance the judicial and extra-judicial costs arising from claims asserted by a third party… at the policyholder's (insured) request". This means that every insured person has a right to legal protection as soon as a third party asserts an insured liability claim against him.[4] The insurers have to settle costs of defense according to the priority principle. According to the view represented here, the insurers have to reimburse costs of defense in the order they incur for the insured persons.

As set forth, there is currently no legal basis for the objection of an insufficient sum insured to be allocated. At least as long as the insurer grants coverage for the defense and the costs of defense have not exhausted the sum insured through de facto payment, there is no objection the insurer might raise towards the coverage claim of the individually insured persons.

According to the view represented here, the insured person may request reimbursement of costs of defense incurred from the insurer resp. if necessary claim for payment, until the insurer has in fact paid out the sum insured (either through payment of invoices of all defense lawyers or later through release or claims payment).

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[4] Vgl. m.w.N. *Lange*, VersR 2014, 1413, 1416.

5. WHICH COSTS CONSUME THE SUM INSURED?

If an insurer wants to invoke the (future) alleged exhaustion of the sum insured, he has to set forth (1) which costs have occurred or, if a prognosis is admissible, will most probably occur; and (2) that these costs have to be credited to the sum insured.

The question which costs will incur and eventually exhaust the sum insured significantly depends on the provisions and components of the D&O-insurance contract. Especially in a soft market, insurers promise to cover different cost positions such as for example preventive legal protection costs, supplementary criminal law protection or costs in connection with the avoidance of reputational damages. Via so-called order of payment clauses, the insurance terms partly regulate the order in which the insurer reimburses costs for individual cost components, but not the order of claims against several insured persons as in the case discussed here.

5.1 Costs of defense

It is still not clarified whether costs of defense may be credited against the sum insured or whether they have to be reimbursed beyond the sum insured. In so far it is questionable whether an agreement in the general terms on insurance deviating from the legal provision of sec. 101 para. 2 s. 1 VVG is effectively possible and if so, whether the cost allocation clause has in fact been effectively incorporated in the individual case.[5]

5.2 Costs of the insurer's fact finding

The fact finding is the liability insurer's task within the context of his contractual obligation to defend and is in the insurer's own interest. Costs incurring for the fact finding are not at the expense of the sum insured but are paid by the insurer in addition.

5.3 Costs for coordinated defense („Sockelverteidigung")

Also costs incurring in connection with the so-called coordinated defense through D&O-insurers, do not reduce the sum insured. If the insurer commissions lawyers with the coordinated defense, they will work in the interest of the insurer rather than in the in-

[5] In its judgment of 9th June 2011, the Higher Regional Court Frankfurt regarded a cost allocation clause as ineffective due to non- transparency and unreasonable disadvantage (file 7 U 127/0, VersR 2012, 432).

terest of the (individual) insured persons. The insured person's focus is on the legal protection function of the coverage. The insured persons won't have the same interests. Their interests are to be pursued individually by their respective defense lawyers. A coordinated defense does not replace this safeguarding of interests, but only follows the insurer's interests.

6. CONCLUSION

The discussion in connection with allegedly insufficient sums insured - which are also to be allocated - in the D&O-insurance is characterized by different interests of the parties involved (insured persons, policy holder / claimant, insurer).

Practice shows that there is uncertainty for all parties involved. Insurers may not dissolve this uncertainty at the burden of the insured persons by partly refusing to reimburse costs of defense. As long as there is no contractual or statutory basis, insured persons do not need to accept partial payments or an allocation of the sum insured, but may request full reimbursement of costs of defense according to the priority principle.

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