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RECHTSANWÄLTE

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D&O Insurance

# D&O insurance policies: is a deduction of defense costs from the sum insured ineffective?

## 1. INTRODUCTION

In case of D&O damages due to alleged breaches of obligations, the asserted claims and the costs for defense against these claims (defense costs) often exceed the manager's assets by far.

Insurers seek to limit their obligation to perform in case of D&O cases amongst others by deduction clauses. By means of deduction clauses, the insurer deducts the defense costs from the agreed sum insured.

The following article discusses whether the designated deduction of defense costs from the sum insured is effective.

## 2. FUNCTIONALITY OF THE D&O INSURANCE

In case of an insured event, the D&O insurer is liable to defend damage claims and/or to indemnify the insured person from damage claims made by the claimant.

### 2.1 Defense coverage

The insurer grants defense coverage by rejecting the damage claim towards the claimant. Further, the insurer pays for fees of a lawyer specialized in liability defense as well as for other costs of the litigation on behalf of the insured person.

### 2.2 Indemnity coverage

If the insurer regards the asserted claims as legitimate, the insurer grants indemnity coverage. The insurer pays the asserted damage claim to the claimant. The insurer thus indemnifies the insured person from the damage claim.

Defense costs do not arise if the insurer indemnifies without defense.

## 3. SUM INSURED AND DEFENSE COSTS

The deduction of defense costs from the sum insured provided for in D&O insurance contracts (cf. quoted clause in 4.2) deviates from the legal regulation of the Insurance Contract Act.

For D&O insurance contracts, the regulations for liability insurance contracts of the Insurance Contract Act apply (secs. 100-112 Insurance Contract Act). If D&O insurers conclude contracts including their General Insurance Terms (AVB), the agreed clauses have to fulfill the legal requirements of secs. 305 et seqs. German Civil Code.

### 3.1 No legal deduction of defense costs from sum insured

The legislator regulates in sec. 101 para. 2 Insurance Contract Act that defense costs are not to be deducted from the sum insured:

> "If a sum insured has been determined, the insurer shall also reimburse the costs of a legal dispute conducted at his instigation and the costs for defence […], insofar as they exceed the sum insured plus the insurer's expenses for indemnifying the policyholder."

If the insurer decides to grant cover to the insured person by defending against damage claims, no deduction of defense costs from the sum insured applies according to sec. 101 para. 2 Insurance Contract Act. The insurer has to pay defense costs in addition to the indemnification from the damage claims if the defense remains without success. This does also apply if the amount of defense costs and damage claim together exceed the sum insured. Thus, according to sec. 101 para. 2 Insurance Contract Act, defense costs do not reduce the coverage sum available for the indemnification from the damage claim, as the following example 1 shows.

Example 1: In a D&O insurance contract, the D&O insurer and the policyholder agreed on a sum insured of EUR 50 million. A deduction clause is exceptionally not agreed.

A claimant claims against the insured person for damages in the amount of EUR 50 million due to a breach of obligation. The D&O insurer regards the damage claim as unjustified. The insurer grants defense coverage to the insured person. For defense, costs in the amount of EUR 5 million arise for lawyers, court fees and experts. The insured person loses in the liability litigation, the defense remains without success.

*Results:* The insurer must pay for the damages on behalf of the insured person in the amount of EUR 50 million (indemnification) and has to reimburse defense costs in the amount of EUR 5 million. The insurer pays in total EUR 55 million for the damage.

### 3.2 Deduction clauses in D&O insurance contracts

D&O insurance contracts regularly contain deduction clauses. By means of deduction clauses, insurers deviate from the legal regulation of sec. 101 para. 2 Insurance Contract Act (cf. result in example 1). The deduction clause shall provide for a deduction of defense costs from the sum insured.

D&O insurers regularly apply the following (or similar) clauses in their terms and conditions:

> *"Cypher x*
>
> *For the scope of the insurer's payment, the sum insured as specified in the insurance policy is the maximum amount for each insured event and for all insured events combined which occur within one insurance year. Costs according to cypher y are included herein* (underlining by authors).
>
> *Cypher y*
>
> *Costs are: lawyers', experts', witnesses' and court fees, expenses for the avoidance or minimization of the damage in the course of or after the occurrence of the insured event as well as costs to examine the damage, including travel expenses incurring not to the insurer himself. This does also apply if the costs incur on request of the insurer."*

Example 2: A D&O insurer and its policyholder agreed on a sum insured in the amount of EUR 50 million. The general terms and conditions contain a deduction clause according to cypher x.

The claimant successfully enforces the damage claim in litigation against the insured person. Defense costs amount to EUR 5 million. The defense costs and damage claim together amount to EUR 55 million.

The insurer pays EUR 45 million under reference to the deduction clause. The indemnification sum would have been reduced due to defense costs by EUR 5 million.

If the deduction clause had been effectively agreed, an uninsured damage (cover gap) of EUR 5 million existed which would have to be paid by the insured person.

## 4. INEFFECTIVENESS OF DEDUCTION CLAUSE ACCORDING TO GERNERAL TERMS AND CONDITIONS LAW

According to the Higher Regional Court Frankfurt on the Main, the deduction clause is ineffective.

From the perspective of the Higher Regional Court Frankfurt on the Main, the following arguments (4.1 to 4.3) are indicative of the ineffectiveness of such deduction clauses.

### 4.1 Ineffectiveness due to non-transparency

General terms and conditions clauses have to be transparent to be effective (according to sec. 307 para. 1 sentence 2 German Civil Code), in other words they have to be clear and understandable. The D&O insurer has to formulate the rights and obligations of his contract partner (policyholder) clearly, simply and precisely (according to the Federal Court of Justice: NJW 2008, 1438). The financial disadvantages and burdens have to be clearly recognizable for the average contract partner as far as can be expected with regard to the circumstances (according to the Federal Court of Justice: NJW 2011, 1801). According to the Higher Regional Court Frankfurt on the Main, insurers do not fulfill this transparency requirement with the deduction clauses used so far (also Säcker, VersR 2005, 10 [14]).

At the time of the conclusion of the insurance contract, defense costs that are supposed to be deducted from the sum insured are not sufficiently foreseeable according to the Higher Regional Court Frankfurt on the Main.

Defense costs arise amongst others for the instructed defense lawyers. Defense lawyers experienced in D&O liability (only) work on an hourly basis. Already because of varying hourly rates, the defense costs to be deducted are not foreseeable.

The costs arising for the defense against a claim depend on the time needed by the defense lawyers. The time needed for the defense against the claim depends on the complexity of the damage. Therefore, the defense costs cannot be assessed at the time of the conclusion of the D&O insurance contract.

The policyholder does thus not foresee at the time of conclusion of the insurance contract in which amount defense costs may arise in the insured event. For that reason, the policyholder also does not foresee in which amount the indemnification payment will be reduced by defense costs. The policyholder is not able to assess the cover gap caused by the deduction clause although he knows the amount of the agreed sum insured.

Therefore, clauses which regulate a deduction of defense costs from the sum insured are not transparent and thus ineffective according to sec. 307 para. 1 sentence 2 German Civil Code (cf. Higher Regional Court Frankfurt on the Main of 9th June 2011, Az. 7 U 127/09 in r+s 2011, pages 509 ff.).

### 4.2 Ineffectiveness due to unreasonable disadvantage

Deduction clauses would also be ineffective because they place policyholders and insured persons at an unreasonable disadvantage in the meaning of sec. 307 para. 2 German Civil Code (Higher Regional Court Frankfurt on the Main loc. cit.; Lücke in Prölss/Martin, Commentary to the Insurance Contract Act, 28th edition, sec. 101 Insurance Contract Act recital 33).

According to sec. 307 para. 1 sentence 1 German Civil Code, a clause in general insurance terms is ineffective, if the clause places a contract partner at an unreasonable disadvantage.

The unreasonable disadvantage due to deduction clauses would emerge because the D&O insurer decides at his own discretion whether defense costs arise or not. The policyholder has hardly any influence on the decision whether the D&O insurer grants defense or indemnity coverage (cf. Ihlas, D&O Directors and Officers Liability, 2nd edition, 2009, page 393). The insurer causes the defense costs in addition to the justified indemnification possibly by his misjudgment on the justification of the damage claim. The policyholder would have to bear the reduction of the sum insured through defense costs which result from this misjudgment. The policyholder would thus have to suffer the consequences of a mistake of the insurer.

Therefore, the deduction clause leads to an unacceptable imbalance between the rights of the insurer and the policyholder's obligatory tolerance. Deduction clauses thus place policyholders at an unreasonable disadvantage in the meaning of sec. 307 para. 2 German Civil Code according to the Higher Regional Court Frankfurt on the Main.

### 4.3 No effectiveness of the clause trough legally granted freedom of disposition

According to the Higher Regional Court Frankfurt on the Main, D&O insurers cannot justify the unreasonable disadvantage of the policyholder by referring to sec. 112 Insurance Contract Act which has the following wording:

*"Section 112: Deviating agreements*

*Agreements deviating from section 104 and section 106 to the detriment of the policyholder shall not be permitted."*

From sec. 112 Insurance Contract Act might follow that it is possible to deviate to the detriment of the policyholder from norms of liability insurance law not mentioned in sec. 112 Insurance Con-tract Act (e.g. from sec. 101 Insurance Contract Act).

But only because the legislator grants liability insurers such freedom of disposition, this does not release them from compliance with the legal requirements for general terms and conditions according to secs. 305 et seqq. German Civil Code (cf. Lücke, loc. cit. recital 33). The freedom of disposition resulting from sec. 112 Insurance contract Act is therefore not qualified to justify the unreasonable disadvantage.

### 4.4 Legal consequence of ineffective deduction clauses

The legal consequence of the ineffectiveness of deduction clauses is that the legal regulation of sec. 101 para. 2 Insurance Contract Act replaces the ineffective clause (cf. sec. 306 para. 2 German Civil Code). The D&O insurer has to pay the defense costs in addition to the indemnification even if the defense costs and indemnification together exceed the sum insured.

### 4.5 Review of the decision of the Higher Regional Court Frankfurt on the Main

The presented decision of the Higher Regional Court Frankfurt on the Main engendered criticism (cf. Langheid, Verswirtschaft 2012, 1768, 1771):

#### 4.5.1 No judicial review due to principal obligation

The deduction clauses would contain a regulation which described details of the principal obligation of the insurer. As such a regulation, the deduction clause would not be subject to the judicial review with regard to general terms and conditions law. The Higher Regional Court Frankfurt on the Main did not deal with this question but referred to the essay by Säcker (VersR 2005, 10 [14], in which Säcker affirms the judicial review).

If the opinion of the Higher Regional Court Frankfurt on the Main and of Säcker was wrong and a judicial review was not possible, deduction clauses would be effective.

#### 4.5.2 Disproportional premiums

Beyond that, in case of ineffectiveness of the deduction clause, the D&O insurance premium would not be proportional with the assumed risk. Insurers had calculated the premiums relying upon the agreement of deduction clauses since decades. The sum insured should be the maximum payment of the insurer.

This purely economic argument of the insurer can though not lead to the deduction clause's effectiveness, but may only cause a recalculation of future premiums.

## 5. CONCLUSION

The deduction clauses currently applied by D&O insurers are ineffective according to the Higher Regional Court Frankfurt on the Main. The sum insured would be available in the full amount to compensate for damages, if the damage claim is proved to be justified in the liability proceeding.

If this judgment gains acceptance, further consequences will arise.

In the future, insurers will examine the justification of damage claims more carefully and grant indemnification accordingly to avoid unnecessary defense costs.

Insurers will probably react on the ineffectiveness of the deduction clause when concluding new D&O insurance contracts or renewing existing D&O insurance contracts.

Insurers will possibly use reworded deduction clauses. It is uncertain whether these new clauses will be effective.

Furthermore, D&O insurers will possibly request higher insurance premiums. It is questionable whether higher premiums are enforceable in the currently weak insurance market.

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