WILHELM

RECHTSANWÄLTE

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D&O-Insurance

Does D&O-insurance affect the standard of liability for authorized representatives and other executives?

1. INTRODUCTION

German labour courts increasingly focus on the question as to what extent D&O-insurance could influence liability of authorized representatives and other executives.

Recent decisions of the Federal Labour Court (Bundesarbeitsgericht – BAG) might be interpreted in such way that the mere fact of seeking D&O-cover by the company has the effect that authorized representatives and executives are no longer liable just to a limited extent (i.e. usually limited to a three months' salary in case of gross negligence). Rather, authorized representatives and executives could be held unlimitedly liable by the company. Such interpretation might restrict the basic principle in German liability insurance that cover always follows liability (and that liability does not follow cover).

2. CO-INSURANCE OF AUTHORIZED REPRESENTATIVES AND EXECUTIVES

In general, German D&O-insurance mainly covers losses of the company resulting from breaches of duty of its own managers (so called internal liability cases – insured vs insured). If the D&O-insurer considers the claim of the company against the manager to be unfounded, the insurer reimburses defence costs in order to reject the company's claim against the manager (mainly lawyer's fees). In contrast, the D&O-insurer settles the claim of the company if he considers the claim to be justified.

In the majority of German D&O-policies available on the market authorized representatives and executives are classified as insured persons – besides board members, directors and managers, supervisory board members etc. If authorized representatives / executives commit a breach of duty (wrongful act) to the detriment of the company and if

the company asserts damage claims against such person, the D&O-insurance is triggered for the benefit of the authorized representatives / executives. Some wordings contain special clauses that authorized representatives and executives are only insured in the scope „*of their personal liability according to labour court jurisdiction*".

3. STANDARD OF LIABILITY FOR AUTHORIZED REPRESENTATIVES AND EXECUTIVES

The question of liability of authorized representatives and executives towards the company is governed by contract law according to sec. 280 et seq. BGB (German civil code – Bürgerliches Gesetzbuch) in connection with the employment contract as well as in tort law pursuant to sec. 823 et seq. BGB.

In both cases the standard of liability for the authorized representatives / executives is determined according to sec. 276 para. 1 BGB. It follows from this rule that already slight negligence implies fault.

As a result even slight negligent fault of an authorized representative or executive might cause high (eventually harming existence) liability of the authorized representative / executive towards the company.

3.1 Principle of limited liability for employees

In order to avoid such consequence, the Federal Labour Court (BAG) developed a graded liability regime with different levels of fault (so-called principle of limited liability for employees - Arbeitnehmerprivilegierung).

The BAG mainly differentiates four levels of fault. Hereby, fault always has to be related to the breach of obligation and the occurrence of loss resp. the violation of a legally protected right – but not to the scope and the extent of the loss:

- The employee is not liable if the employee committed the breach of duty with slight negligence.
- The BAG assumes a "pro rata" liability (apportioned liability) if the employee acted with medium negligence. In case of higher losses, courts will generally limit the amount of damages to just a few monthly salaries of the liable employee.
- The BAG principally assumes full liability of the employee in case of gross negligence. In case of high losses, courts nevertheless tend to limit the amount of damages owed by the employee (e.g. reduction to twelve monthly salaries).

- A liability without limitation applies in case of deliberate misconduct of the employee.

3.2 Principle of limited liability for employees applies regardless of voluntarily established liability cover

According to jurisdiction, an employee will also be held liable according to the principle of limited liability for employees even in case he has established professional liability cover on his own account (on a voluntary basis), which also covers losses caused by him to the company.[1] If the employee voluntarily seeks insurance against the risk of his professional work, this shall not be to the advantage of the employer. Hence, in case the employee enters into a private liability insurance which is not compulsory, the D&O-insurer might only cover losses to the extent the employee is held liable according to the principle of limited liability for employees.

3.3 Principle of limited liability for employees not applicable in case of compulsory liability insurance

An employee is though unlimitedly liable for all losses occurred in case compulsory liability insurance is required by law (e.g. motor liability insurance, compulsory professional liability insurance).[2]

The request of such compulsory liability insurance implies that special risks exist which the legislator considers inherently risky and therefore does not want the employee to be without coverage. The legislator recognizes an increased risk potential resulting from the work performed and therefore ensures full compensation for losses suffered. The employee is protected, however, against the risk of being financially overburdened as there is cover provided under the compulsory liability insurance.

Accordingly, the principle of limited liability for employees does not apply.

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[1] Cf. BAG NZA 1998, 310, 311 at the end

[2] Cf. BAG, AP No. 36 ad sec. 611 BGB; BGH AP No. 68 ad sec. 611 BGB; BAG NZA 1998, 310, 311; cf. Schaloske in: Herbert Frommes Versicherungsmonitor, Legal Eye – Legal column dated 7 July 2014, who argues against compulsory D&O-insurance.

3.4 Principle of limited liability not applicable in case of comparable liability insurance

The principle of limited liability for employees might also be excluded if the employee seeks coverage on its own account or if the company seeks coverage for the account of a third party (for the authorized representative / executive) and if the cover provided is comparable to compulsory liability insurance.

In a decision dated of 28 October 2010, the BAG decided in an *obiter dictum* that voluntary liability insurance (e.g. D&O-insurance) is comparable with compulsory liability insurance, provided that

- Alternative 1: the employer requests from the employee to seek liability coverage – in order to cover the risk of the work to be performed – as a compulsory requirement in the employment contract, mainly if such requirement includes risk-related additional remuneration for the benefit of the employee, and / or
- Alternative 2: the employer assures the employee as part of the employment contract to seek professional liability cover on his account for risk-related issues in connection with the employment.

Considering the view of the BAG, the German principle of limited liability for employees may in particular be debarred if the authorized representative / executive agree with the company upon special clauses in the employment contract according to which D&O cover should be provided on a mandatory basis by the insured (p.a. that the insured will seek compulsory D&O-cover and receive an higher remuneration in return). The same would probably apply if the company enters a contractual clause in the employment contract in order to provide the insured with D&O-cover.

The principle of limited liability for the benefit of authorized representatives/ executive would assumedly be excluded in these cases. Authorized representatives/ executives would then be liable to an unlimited extent.

3.5 Principle of limited liability not applicable in case of missing knowledge of the authorized representative / senior executive about the existence of a D&O-insurance?

It remains questionable whether an authorized representative / executive could be unlimitedly liable if the company provides D&O-cover for the authorized representative /

executive when the matter of D&O cover was not subject of the employment contract or the existence of such cover is not even known or only unclearly known to the authorized representative / executive.

In such context it a questionable whether the existence of company D&O-cover could be comparable to compulsory liability insurance in the meaning of the jurisdiction of the BAG?

3.5.1 Arguments for the applicability of the BAG-judgment to this constellation

The following arguments can be submitted in order to establish unlimited liability of the authorized representative / executive.

3.5.1.1 The principle of limited liability is not statutory law

In principle, sec. 276 para. 1 BGB determines that already slight negligence implies fault. As a result, pursuant to statutory law, even slight negligence results in unlimited liability.

In contrast, the principle of limited liability for employees is based on case law, but not on statutory law. The principle of limited liability for employees developed by case law primarily serves the protection of the employee's financial freedom which should not be violated by work related risks. Therefore, the applicability of the principle of limited liability for employees requires the consideration of all circumstances. Those circumstances include the existence of insurable risks of the employer, including the existence of D&O-cover. If there is insurance cover for losses caused by the employee, there is no remaining reason for the employee to be privileged.

3.5.1.2 No difference whether employer seeks D&O-cover compulsory or on a voluntary basis

In its judgment, the BAG made clear that the principle of limited liability does not apply if it is a compulsory requirement according to the employment contract to provide liability cover for authorized representatives / executives. The same has even more to apply if the employee is not forced by contract to seek own liability cover, but instead the employer voluntarily provides liability cover for the employee. In both cases – at least in theory – the insurer covers the risks with regard to the extended liability of the authorized representatives / executives. The result is the same.

3.5.1.3 No gaps in cover in common D&O- policies

The wording used by some insurers in D&O terms whereby authorized representatives and executives are liable in accordance with “their personal liability based on labour court jurisdiction”, does not lead to a contractual limitation of the employee’s liability. The jurisdiction of labour courts is subject to continuous changes and is particularly to be interpreted in connection with above mentioned BAG decision (concerning the non-applicability of the principle of limited liability for employees). Regardless thereof, the wording "according to the labour court jurisdiction" might be ineffective with regard to statutory law with reference to general terms and conditions in the Civil Code.

3.5.2 Arguments against the applicability of the BAG judgment to this constellation

The following arguments can be submitted against the applicability of the BAG judgment to this constellation – thus, in order to uphold the principle of limited liability for employees:

3.5.2.1 The insurance law principle „coverage follows liability“ is violated

The so called German (insurance law) separation principle (“Trennungsprinzip”) leads to the differentiation between liability and coverage issues. The existence of insurance coverage therefore should not influence the liability situation of the authorized representative /executives. The applicability of the BAG decision would probably result in an unlimited management liability even on second or even third management level.

3.5.2.2 The D&O insurance would affect the opposite of what the contracting parties had in mind when entering the contract

With the co-insurance of authorized representatives / executives in the D&O insurance contract, the contracting parties aimed to cover liability risks with reference to the limited liability of employees (cp. wording: *“(…) their [the authorized representatives‘] personal liability according to labour court jurisdiction*”). However, by agreeing upon the insurance, the parties do not intend to extend the authorized representatives / executives’ liability towards the company.

3.5.2.3 The conclusion of a D&O-insurance contract by the employer has the same effect as the conclusion of a voluntary liability insurance contract entered into by the employee

It is established that voluntary liability cover sought by the employee does not indicate that liability follows the so existing coverage (see 3.2). As a consequence nothing else can apply if the employer enters into the (professional) liability insurance (by means of D&O-insurance) voluntarily for the account of its employee.

3.5.3 Own assessment

The courts have not yet decided the question whether the principle of limited liability for employees is excluded in case the company provides D&O cover for authorized representatives / executives (as insured persons). In our opinion, the more convincing arguments do not support the assumption that the mere existence of a company's D&O insurance generally establishes unlimited liability for authorized representatives and executives. This also follows from the fact that if the D&O insurer in coverage disputes – according to standard practice – raises objections (e.g. for alleged breach of pre-contractual duty of disclosure, for alleged intentional damage or due to other possibly relevant exclusions) , the authorized representative / executive could in the worst case have to bear the entire loss.

4. CONCLUSION

According to the current – not settled – case law of the BAG, the existence of D&O coverage provided by the company could result in unlimited liability in insured vs. insured cases (when the company made a claim against the authorized representatives/ executive). The German principle of limited liability for employees may in particular be excluded if the authorized representative / executive agree with the company upon special clauses in the employment contract according to which D&O cover should be provided on a mandatory basis. The same could apply in case the legislator in the future determines D&O-insurance as mandatory liability insurance. However, the principle of limited liability for employees should remain in force if the existence of the company's D&O-insurance is not known or only partly known to the authorized representative / executive.

Since the question of the applicability of the principle of limited liability for the benefit of authorized representatives/ executives in connection with D&O-insurance has not

finally been clarified by German (labour) courts, companies and insured persons should make sure that the D&O-insurer – in case a court would in fact decide the matter on the basis of unlimited liability of the authorized representative / executive – is not able to withdraw from coverage.

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