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D&O insurance

Do D&O insurers really need to conduct litigation and to intervene into proceedings as a third party?

1. INTRODUCTION

Claims triggering German D&O insurance are usually made by the company against one or several managers. By default, the D&O insurer grants (provisional) defense cove for the (insured) managers to defend against liability claims of the company. The insurer, thus, indemnifies, similar to legal expenses insurance, attorney fees incurred on behalf of the manager. So far, so good.

In fact, the formal situation of the insured person in D&O insurance is weaker than those of a policy holder who triggers his legal expenses insurance. The D&O insurer is authorized to make use of intervention rights agreed upon in the contract. The insurer can take out-of-court settlement decisions at its own discretion and conduct the liability case according to its own ideas.

The D&O insurer does though not only make use of his intervention rights according to the insurance contract. Besides, the D&O insurer often intervenes as a third party in the liability proceeding by joining the case in support of the (insured) manager. As a consequence of such third-party intervention, the legal expenses risk of the company increases. If the company loses the liability proceeding against the insured manager, the company has to indemnify i.a. additional statutory “RVG” fees (Rechtsanwaltsvergütungsgesetz – German Statute on Professional Fees of Lawyers) for the lawyer of the intervening D&O insurer.

In the following, we clarify the scope and extent of settlement and litigation clauses in D&O insurance (under 2.). The article further highlights the fact that the D&O insurer's possibilities to conduct litigation and to effectively associate with the insured in the defense do not constitute an – automatic – legitimate interest of the D&O insurer to intervene the proceedings as a third party (under 3.).

2. SCOPE OF SETTLEMENT AND LITIGATION CLAUSES

D&O insurance terms often provide the insurer with settlement and litigation authorities having effect for the insured manager.

2.1 Example clause

For example, clause 4.4 AVB-AVG (General Insurance Terms – German Insurance Association)[1] „*Material scope of insurance cover*" reads as follows:

> *„The insurer is authorized to make all declarations on behalf of the insured person which he considers useful for the claims settlement or the defense against claims. If an insured event leads to legal proceedings regarding claims for compensation against insured persons, the insurer is authorized to conduct litigation. He conducts litigation in the name of the insured person."*

According to this clause, the insurer has the authority to agree upon out-of-court settlements. As a consequence, the insurer can make all declarations in the name of the insured person which he considers useful to settle the claim or to defend against the claim. In case of liability proceedings, the insurer, in addition, is also authorized to conduct the case at its own discretion in the name of the insured person or to choose and instruct the defense lawyer of the insured person.

2.2 Conferment of authority ineffective

It is questionable whether authority can be conferred in an effective way from the insured person (the manager claimed against) to the D&O insurer by means of contractual clauses.

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[1] German Insurance Association „GDV" General Terms and Conditions for D&O insurance for members of the supervisory board, board members and executive managers (AVB-AVG), May 2013.

The contracting partner in D&O insurance is the company rather than the insured persons. The insured persons are mostly not even aware of all the details concerning D&O insurance and are not listed by name in the contract. A person not involved in the contract can though not automatically be a principal but has to confer authority by separate declaration (cf. sec. 167 BGB). This leads to the assumption that the "automatic" conferment of authority as provided in general insurance terms could be ineffective. In literature, this problem is sometimes handled with and arguments are brought forward that the insured person may not confer authority based on the contract between insurer and policy holder (company). However, in order to solve the problem it is argued that the clause should be interpreted in an open way so that it contains at least the obligation of the insured person to confer authority to the insurer.[2]

These arguments are not convincing. On the one hand, the regulation in clause 4.4 AVB-AVG is referred to as "*Material scope of insurance coverage*". Thus, it stands on the level of risk description (and not on the level of obligations and warranties). If the conferment of authority is argued to be an obligation of the insured person, clause 4.4 AVB-AVG should then be listed in the special section referring to obligations in accordance with clause 7 AVB-AVG (*Duty of disclosure, Increase of risk and other obligations*). On the other hand, the regulation (clause 4.4 AVB-AVG in relation to insured persons) does not comply with the semi-mandatory requirements in secs. 28, 32 Insurance Contract Act (Versicherungsvertragsgesetz-VVG).

Just to mention that the clause could unreasonably restrict the right of the insured person to choose a lawyer freely (sec. 3 para. 3 Federal Lawyer's Act "BRAO")

In consequence, all the aspects taken into consideration contribute towards the ineffectiveness of such "conferment of authority clauses" (obligation of managers to confer authority to D&O insurers) as provided in D&O-terms.

3. EFFECTIVE CONFERMENT OF AUTHORITY

In case that such conferment of authority clauses – contrary to our opinion above – would be effective with respect to the insured persons or if such authority is even con-

[2] Voit in Prölss/Martin, 28th edition, clause 4 AVB-AVG no. 14.

ferred explicitly by declaration to the insurer, severe consequences arise, especially with regard to the insurer's right to conduct litigation.

3.1 Extensive decision-making power of the insurer

The D&O insurer is then entitled to decide about the procedure and strategy concerning the defense and handling of the claim. All writs to the court as well as the entire content of arguments in court proceedings are subject to insurer's approval. In fact, the transfer of litigation measures to the insurer also implies that the insured person has little influence on litigation strategy and is generally not even allowed to appoint a lawyer at his own discretion.[3]

3.2 No legitimate interest for third party intervention

The power of the D&O insurer to conduct litigation could have the effect that there is no remaining legitimate interest to intervene as a third-party in support of the manager (re liability proceedings of the company against the manager).

This assumption is based on the following considerations:

3.2.1 Insured vs. insured cases in D&O insurance form a special constellation

Contrary to „ordinary" liability proceedings where the insurer intervenes as a third party in support of the policy holder in order to defend against claims of an allegedly injured third party, the situation is different in D&O insurance. The effect of the third-party intervention of the D&O insurer is that the company (the policyholder and injured party) does not only have to deal with the manager (the injuring party), but also with his own contract partner, the insurer. Pursuant to German civil procedure law, the third party (the insurer) is then acting on the side of the insured person (the manager) and is not allowed to any declarations and actions in opposition to the declarations made and actions taken by the insured person (cf. sec. 67 Code of Civil Procedure "ZPO"). Such constellation, however, can only occur in D&O- but not in "ordinary" liability cases. This follows from the circumstances of internal (corporate) liability of the board member to-

[3] Koch/ Hirse VersR 2001, 405

wards the company and the design of D&O insurance as insurance for the account of a third party.

3.2.2 Argument of binding effect in subsequent cover dispute not convincing

The argument that the legitimate interest of the insurer for intervening into liability proceedings as a third party would be justified as the liability proceedings may have a binding effect for a (potential) subsequent dispute on cover issues is not convincing.

The binding effect of the liability proceeding in subsequent cover disputes sometimes referred to in literature[4] is based on the decisions of the Higher Regional Court of Hamm dated 29 April 1996 (NJW-RR 1997, 157) and the Higher Regional Court of Cologne dated 5 June 1998 (OLGR 1998, 384). Both decisions do though not deal with insurance for account of a third party – as it is the case with D&O claims: In the case handed down by the Higher Regional Court of Hamm, the insurer joined the legal dispute as a third party in support of the policy holder. This was, however, not a liability proceeding between the policy holder and the insured person (in contrast to the vast majority of D&O cases). The decision of the Higher Regional Court of Cologne, however, was on a matter where the policy holder cooperated collusively with the allegedly injured party at the expense of the insurer.

Based on such jurisdiction, the legitimate interest of the D&O insurer to intervene the dispute as a third party in support of the insured person only arises if it is obvious that a faked resp. false insurance case has been arranged, in which the company collusively cooperated with the accused manager (insured person) so that this fact could become crucial for subsequent cover disputes.

3.2.3 Wantonness and acting against good faith

D&O insurer's intervention as a third party despite the exertion of the right to conduct the case could be wantonly and against good faith.

Wantonness is generally given if an objective party would not exercise such right in the respective situation.

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[4] Vollkommer in Zöller, ZPO (Code of Civil Procedure), 26th edition, sec. 66 no. 13

In D&O cases, it is often not required that the D&O insurer exercises all possibilities (thus to conduct litigation and to intervene into the case as a third party). The D&O insurer rather has to limit his actions to a reasonable level. In contrast to that, the intervention of the D&O insurer as a third party causes higher procedural risks for the company (the policy holder).

Third-party intervention of the D&O insurer is, thus, not reasonable as the interests of the D&O insurer are sufficiently protected by commissioning, instruction, and guidance of the defendant's attorney. The D&O insurer is already entitled to receive all documents, protocols, and reports etc. in advance which have to be transferred by the manager's lawyer (who the insurer has probably chosen). It is not understandable why the D&O insurer should, in addition, commission his own attorney in order to intervene as a third party into the dispute.

3.2.4 Principle of economy of procedure

The D&O insurer who joins the dispute as a third party (despite the exertion of the right to conduct the case) could contradict the principle of economy of procedure.

The principle of economy of procedure requests from the parties to refrain from legal actions for which the procedural economical purpose is not reachable.[5] The possibility of joining the dispute as a third party according to sec. 66 Code of Civil Procedure supports the principle of economy of procedure as far as it avoids subsequent legal action.[6] It is, however, not clear which subsequent litigations may be avoided by the third-party intervention of the D&O insurer. If the court dismisses the liability case no subsequent litigation will take place as the manager has no reason to proceed against the D&O insurer. If the case is admitted by the court, it is solely at the discretion of the manager whether to claim or not to claim against the D&O insurer in order to achieve compensation of the loss.

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[5] Cf. Vollkommer in Zöller, ZPO, Introduction, no. 96; Baumbach/Lauterbach/Albers/Hartmann, ZPO, 68th edition, Grdz sec. 128 no. 14 with further references.

[6] Baumbach/Lauterbach/ Albers/Hartmann, ZPO, 68th edition, Übers Sec. 64 no. 2.

4. SUMMARY

Settlement and litigation clauses in D&O insurances that authorize D&O insurers to confer litigation and to settle claims on behalf of the insured manger need to be critically reviewed in every individual case. As managers are generally not involved in the conclusion of the D&O-contract (managers are not party of the contract) any conferment of authority needs to be approved separately by the manager.

If the D&O insurer provides defense cover by referring to his right to conduct litigation in order to fight-off the claim on behalf of the insured, there is generally no legitimate interest in additional intervention as a third party. A legitimate interest may only be taken into account if the manager and the company cooperate in a collusive way to the detriment and at the expense of the D&O insurer. If it comes, nevertheless, to third-party intervention of the D&O insurer, the "honest" company could file a petition with the court to deny leave to the third party to intervene in support of the manager (pursuant to sec. 71 Code of Civil Procedure).

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