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RECHTSANWÄLTE

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D&O Insurance

The “should have known” of breaches of duty within the context of retroactive insurance

(Federal Court of Justice, judgement of 5 November 2014 – IV ZR 8/13)

1. INTRODUCTION

One major problem of the D&O insurance is whether or not the policyholder resp. the insured person have had knowledge about breaches of duty before the D&O insurance contract had been concluded.

As the D&O insurer provides retroactive cover for precontractual breaches of duty which are unknown to the policyholder resp. the insured person in the moment of contract conclusion, it is mostly important for the insurer to know, if the policyholder resp. the insured person had already notified these precontractual breaches of duty before signing the contract or before the contract has been renewed. This is due to the fact that in the case of knowing the facts, the insurer would be released from his obligation to pay indemnifications.

Against that background it is highly questionable, if the insurer can be released from his insurance obligation, when the policyholder resp. the insured person acted negligent and could have got knowledge about the precontractual breaches of contract even though they did not spend a thought on possible precontractual breaches of duties.

Concerning this question, the Federal Court of Justice handed down requirements for the policyholder's resp. insured person's knowledge in the judgement of 5 November 2014[1] which are essential for releasing the insurer from his insurance obligations.

In this article we classify the judgment to be a part of the German retroactive insurance system as well as its impacts on the D&O insurance.

2. RETROACTIVE INSURANCE

The retroactive insurance is mostly important for the D&O insurance, since it directly influences the occurrence of the insured event.

2.1 Retroactive insurance and claims made

In the German insurance market it is common for the contractual partners of a D&O insurance to agree upon the claims made principle. According to this principle, the insured event first occurs when the claim is made against the policyholder resp. the insured person.[2]

As a consequence to this principle, precontractual breaches of duty can also be included by the D&O insurance, although they are claimed after the contract has been concluded. They are often included into the insurance cover via retroactive insurance clauses.

2.2 Contractual provisions regarding retroactive insurance

The contractual provisions regarding the retroactive insurance are partly stricter than the statutory rule in sec. 2 para. 2 sentence 2 Insurance Contract Act ("VVG"). Hereafter, the insurer is not obligated to effect payment, if the policyholder knows (when submitting his contractual acceptance) that an insured event has already occurred.

For instance, clause 3.1 of the model conditions of the 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) describes as follows:

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[1] Cf. BGH, judgement of 5th November 2014 – IV ZR 8/13, VersR 2015 89.

[2] The prevailing majority of German D&O-cases are "Insured vs. Insured"-cases.

> *"The insurance also covers insured events based on breaches of duty committed before contract inception. This does though not apply for breaches of duty known by the insured person, the policy holder or an affiliate at contract inception. A breach of duty is assumed known when it is perceived objectively incorrect – even if only possibly – by the policy holder, an affiliate or insured person, or had been indicated, even if only conditionally, as faulty, even if no damage claims had been made, had been threatened to be made or had to be feared."*

According to this model condition, insurance cover is rejected, if the policyholder resp. insured person had actual knowledge about the breach of duty at the time the contract conclusion. The same applies when the policyholder resp. insured person should have got (objectively) knowledge about those breach of duty (identified as objectively false or described as false by others). Thereby, the connecting factor for the policy holder's resp. insured person's knowledge is a negligent lack of knowledge of an existing breach of contract.

Similar provisions for the retrospective insurance can be found in many other, especially anterior German D&O wordings.

3. JUDGEMENT OF THE FEDERAL COURT OF JUSTICE

The judgement of the Federal Court of Justice of 5 November 2014 with regard to the professional liability for architects constitutes the standards which are relevant for the policyholder's knowledge resp. the "should have known" of the precontractual breaches of duty.

The judgement is based on the following facts.

3.1 Facts

The plaintiff claimed against the defendant compensation and therefore referred to (potential) insurance cover of a liability insurance contract.

The plaintiff acquired several real estates, where he intended to build new houses. In 2006, the plaintiff commissioned the general contractor with this project. However, the general contractor's request for the building permission was refused by the competent authority. In addition, the plaintiff's opposition to the refusal was rejected in 2006.

In spring 2007, the defendant wrote liability insurance with the plaintiff *„free of known breaches*". Claims of the policyholder against coinsurers (such as the general contractor)

were included in that contract as well. In September 2007, the competent district office refused to approve the general contractor's further planning. This is why the plaintiff finally agreed upon a settlement with the state in order to end judicial disputes about the building permission.

The plaintiff claimed the general contractor's planning from 2006 and 2007 to be false. The plaintiff stated that in 2006 (refusal of the first building permission) and at the beginning of 2007 (conclusion of the liability insurance contract), he had not known that the general contractor committed breaches of duties. The plaintiff requested the court's approval that the general contractor should be provided cover from the defendant by reason of the incorrect application of the building permission in June 2006 and by reason of the incorrect planning in September 2007.

3.2 Legal assessment of the judgement of the Federal Court of Justice

The Federal Court of Justice defines the required standards which are relevant for the policyholder's resp. the insured person's actual knowledge in cases of retrospective insurance.

3.2.1 Actual knowledge required

The Court states that the insurer's release from his insurance obligation in the meaning of sec. 2 para. 2 sentence 2 VVG *"free of known breaches"*, prerequisites actual knowledge of the policyholder resp. the insured person.

The policyholder must have actual knowledge about the occurrence of the insured event or a committed breach of duty. The actual knowledge could not be replaced by the consideration that the policyholder resp. the insured person should have known the relevant facts.

The insurer would aim to prevent intentional manipulation by the policyholder concerning the insured risk when concluding the insurance. As long as the policy holder does not know about an already occurred breach of duty, the danger of an intentional manipulation does not exist. The negligent lack of knowledge of the policyholder would not be sufficient for releasing the insurer from his obligation due to a known breach of duty.

3.2.2 Knowledge of facts is not sufficient

It is not sufficient, if the policyholder merely knows about facts which allow the possible conclusion or even suggest that an insured event (breach of duty) might already have occurred. As long as the policyholder does not draw this conclusion by himself, he has no actual knowledge about the insured event. This might at best be a strong indication to negligent behavior but not to actual knowledge.[3]

3.2.3 New standards to apply

According to the Federal Court of Justice, the insurer's obligation to indemnify damages within the context of retroactive insurance will only be rejected, if the judge comes to the conclusion (beyond any reasonable doubt) that the policyholder in fact drew the conclusion of the nearby cause of damage. For that, the judge has to review the behavior of an average policyholder based on that particular case. To sum up, it is necessary that the policyholder has recognized that the damage resp. the breach of duty is based on facts which characterize an insured event.

The court of lower instances did not comply with this standard. The Court of Appeal, for instance, had only applied an objective standard of proof in asking which conclusions an average policyholder would have drawn instead of the plaintiff. However, the Court of Appeal did not refer to the case itself (Why exactly did the plaintiff in 2006 not assume a breach of duty by the general contractor?). The Court of Appeal should have investigated whether the policyholder subjectively came to the conclusion that an insured event was given. In particular, the court should have examined whether the policyholder sufficiently considered the cause of damage (missing building permission), or whether the policy holder did simply not draw the conclusion that the given damage was caused by a breach of duty committed by the general contractor.

3.3 Impact of the judgement

The judgement has impacts on the liability insurance, especially on D&O insurance. In the future courts will critically examine clauses, which are based on the policyholder's

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[3] According to sec. 19 VVG, the insurer would have to examine whether a (negligent) pre-contractual breach of the duty to disclose was given.

resp. insured person's "should have known" within the context of the retroactive insurance.

3.3.1 Model clause is questionable

Against this background the model clause 3.1. AVB-AVG (see above) has to be regarded critically. According to this condition, it is sufficient for the policyholder's knowledge that he has recognized a breach of duty as – eventually – being objectively false or that the breach of duty has been described as false by others – even if only conditionally duty (identified as objectively false or described as false by others).

According to the Federal Court of Justice it is though decisive that the policyholder in fact *subjectively* drew the conclusion about the obvious cause of the damage on the basis of the breach of duty. An objective standard of proof which considers an average policyholder is simply not sufficient.

3.3.2 Similar standard of proof compared to the exclusion clause „intentional breach of duty"

The standard of proof regarding "precontractual knowledge about breaches of duty" seems to be close to that for the exclusion of an „intentional breach of duty" in D&O insurance. In both cases the subjective and concrete perception of the policyholder is decisive for his actual knowledge.

The exclusion „intentional breach of duty" prerequisites that the policyholder acted on the one hand with a sense of duty (Pflichtbewusstsein) and on the other hand with a sense of breaching that duty (Pflichtverletzungsbewusstsein). A sense of duty is given if the manager realizes to be subjected to a duty, whereas a sense of breach of duty is given if the manager (intentionally) realizes to breach exactly that duty.

The Federal Court of Justice seems to follow this approach by requiring the (conscious) actual knowledge of the breach of duty within the context of sec. 2 Insurance Contract Act (re precontractual knowledge about breaches of duty).

4. SUMMARY

Especially anterior D&O or other liability wordings will often contain retroactive cover clauses which refer to a “should have known” of the policyholder resp. the insured person. Such clauses might be regarded more critically in the future.

According to the judgement of the Federal court of Justice, the insurer cannot easily assert that the policyholder resp. the insured person could hardly miss the respective circumstances and thus should have known them.

The insurer who refers to the policyholder’s actual knowledge of precontractual breaches of duty will prospectively rather has to prove that the policyholder resp. the insured person in fact drew the allegedly obvious conclusion about the cause of damage. For this purpose, the insurer has to present concrete facts which suggest that the policy holder resp. the insured person subjectively drew such conclusion that a breach of duty was given in the case at hand.

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