

Dr. Anja Mayer, Lawyer, Wilhelm Rechtsanwälte, Düsseldorf, www.wilhelm-rae.de

No effective waiver of the right to avoid on the grounds of deceit in the D&O-insurance?

1. INTRODUCTION

A D&O-insurer can avoid insurance contracts on the grounds of deceit upon contract conclusion. The successful avoidance causes the ineffectiveness of the insurance contract ab initio. The insurer is then released from payment and can reclaim insurance indemnification payments from the policy holder. He may keep insurance premiums paid before and until the avoidance.

The avoidance has severe consequences for the insured persons. The insurance cover expires retroactively for all persons insured. This applies no matter if the insured persons participated in the deceit or knew about it or not.

In order to mitigate the consequences of the avoidance, D&O-insurers waive the right to avoid on the grounds of deceit in different ways in favor of the insured persons. The company (policy holder) concludes a D&O-insurance in favor of its board members and executives. The company is regularly represented by one or more authorized persons for the conclusion of the contract. Most insured persons are not involved in the contract conclusion. They have little knowledge about the contract conclusion or have little influence on the declarations made towards the insurers. The purpose of the waiver of the right to avoid is to ensure insurance cover for insured persons who were not involved in the deceit towards the insurer or who had no knowledge about it.

In two recent decisions, the Federal Court of Justice determined for a different kind of insurance for the account of a third party that the insurer may not waive the right to avoid on the grounds of deceit in advance (decision of 21st September 2011, File No. ZR 38/09; decision of 9th November 2011, File No. IV ZR 40/09).

Against the background of these new decisions, the question arises whether the waiver clause of the D&O-insurance is effective and whether insurance cover is ensured for the insured persons in case of avoidance on the grounds of deceit.

2. ARGUMENTATION OF THE FEDERAL COURT OF JUSTICE ABOUT THE INEFFECTIVENESS OF A WAIVER

In its decision, the Federal Court of Justice (decision of 21st September 2011, File No. IV ZR 38/09; decision of 9th November 2011, File No. IV ZR 40/09) declared that a waiver of the avoidance on the grounds of deceit contractually agreed in advance is irreconcilable with the protection of self-determination. The waiver of the right to avoid on the grounds of deceit is ineffective, if the deceit was committed by the policy holder himself or by a person who is not a third party according to sec. 123 para. 2 of the German Civil Code “BGB”) (decision of 21st September 2011, No. 27; decision of 9th November 2011, No. 20). It argued as follows:

2.1 Protection of the freedom of resolution

The right of avoidance according to sec. 123 German Federal Code (BGB) protects the freedom of resolution in terms of legal transactions. The declaring person surrenders itself to the arbitrariness of the contract partner and gives up its self-determination when excluding the right to avoid in advance. The deceiving party then has the chance to take advantage of the deceit without having to fear the rescission of the contract (decision of 21st September 2011, No. 28).

2.2 The same protection for legal persons (insurers)

Legal persons are entitled the same freedom of resolution in terms of legal transactions as natural persons. If the right to avoid is excluded in advance, the declaring party (the insurer) would surrender itself to the arbitrariness of the contract party (policy holder) and would completely cede his self-determination (decision of 21st September 2011, No. 29).

2.3 The same effect towards insured persons

The ineffectiveness of the waiver of the right to avoid would also apply towards an insured who enjoyed advantages of the waiver. Even if the insurer could refer to the right to avoid only towards the insured, the insurer would be at the mercy of the arbitrariness of the deceiving insured and would not be free in his self-determination in terms of legal business. The protection of sec. 123 German Civil Code (BGB) would have no impact if the obligation created by the deceit towards the insured remained existent (decision of 21st September 2011, No. 31; decision of 9th November 2011, No. 20).

3. IMPACTS OF THE DECISION ON THE D&O-INSURANCE

The decisions of the Federal Court of Justice were about the specie insurance as insurance for the account of a third party. The Federal Court of Justice argued without any reference to a specific clause in the insurance contract. The general explanations are transferrable to other insurances, including the D&O-insurance.

3.1 Ineffectiveness of waiver clauses

Clauses in D&O-insurance contracts which have the purpose to waive the right of avoidance on the grounds of deceit in advance, are ineffective.

3.1.1 Requirements for the ineffectiveness

The waiver clause is ineffective according to the Federal Court of Justice, if the right to avoid on the grounds of deceit by the business partner or a person that is no third person according to sec. 123 para. 2 German Civil Code is waived.

The business partner of the insurer is the company as legal person. The company acts towards the insured through its board members and representatives. These persons usually are the insured. A third person in accordance with sec. 123 para. 2 German Civil Code is a person not involved in the business. The jurisdiction interprets the term strictly in favor of an extended voidability. Thereafter, someone who participates in the conclusion of the contract is no third person when his conduct is to be comparable with the conduct of the opponent of the avoidance. This applies for every deceiving person whose conduct must be attributed to the recipient of the declaration on the grounds of an especially close relationship between the two or on the grounds of other special circumstances (Federal Court of Justice NJW 1996, 1051).

According to this interpretation, insured persons are not third persons according to sec. 123 para. 2 German Civil Code. They are attributed to be part of the insured company. They profit from the insurance coverage provided within the contract. The insured's conduct is attributed to the insuring company according to sec. 123 BGB. This implies that in D&O-insurance contracts every waiver concerning the right to avoid on the grounds of deceit committed by the insured person is ineffective.

3.1.2 Waiver clauses in D&O- insurance contracts

Current waiver clauses in D&O-insurance contracts are formed differently.

In some clauses, a general waiver of the right to avoid is combined with the exclusion of the insurance coverage for persons committing deceit:

Example 1:

„For persons committing deceit or those who had knowledge about it, no insurance cover is provided. Further, the insurer waives the right to avoid the contract in these case.“

Example 2:

„1. In the insured event, the insurer waives the right to avoid on the grounds of deceit committed before the conclusion of the contract or before the extension of the contract.

2. If the insurer is entitled the right to avoid on the grounds of deceit, which he may not make use of on the grounds of cypher 1, insured events resulting from claims or proceedings against insured persons who committed the deceit themselves or had knowledge of it , are excluded from the insurance cover.“

In other clauses, the insurer waives the right to avoid only towards insured persons who did not commit the deceit or had no knowledge about it. Such clauses may for example say:

Example 3:

„In case the insurer is entitled to avoid the contract on the grounds of deceit or in case the insurer is entitled to withdraw from the contract, the insurer waives the rights he is entitled to.

This waiver does though not apply with regard to those insured persons who

- a) have given occasion to make use of these rights or*
- b) had knowledge about the actions which would entitle the insurer to make use of these rights.“*

3.1.3 Ineffectiveness of these clauses

The clauses in examples 1 and 2 are ineffective according to the criteria named above under cypher 3.1.1. The insurer waives the right to avoid in general and in advance.

The clause in example 3 is ineffective as well. Beyond the decision of the Federal Court of Justice, there are doubts about the effectiveness of this clause.

With the clause, the insurer declares a general waiver which does not apply towards insured persons who were involved in the deceit. The right to avoid is though indivisible. Avoidance must be declared towards the policy holder. In case of an avoidance of a contract, the contract terminates in total. Avoidance against only selected insured persons is not possible.

3.2 Consequences of the ineffectiveness

The ineffectiveness of the waiver clause has severe legal and practical consequences for the insurance cover.

3.2.1 The insurer's right to avoid

The insurer may avoid the contract despite the agreement concerning the right to avoid in the insurance contract. This does also apply in case the insurer has included the right to avoid into his general terms and conditions towards the policy holder.

3.2.2 Practical relevance of the right to avoid

If the D&O-insurer does not wish to settle the insured event, he examines despite the waiver clause whether he has a right to avoid the contract on the grounds of deceit according to sec. 123 German Civil Code. The requirements for a right to avoid may easily be given in the D&O insurance.

Requirement for the right to avoid is that the policy holder – i.e. the representative of a company – deceived the insurer concerning risk related circumstances.

Before the conclusion of the contract or the contract extension, the insurer asks in text form, usually by means of a questionnaire, for risk related circumstances. Risk related circumstances are, besides economic key figures, among others existing damages. Concerning existing damages the insurer asks whether an insured person knows about any breaches of obligations or acts or omissions which might be regarded as possible breaches of obligations in connection with their exercise of profession; whether legal disputes exist or are announced with participation or possible participation of insured persons. Insured persons usually answer these questions whether consciously or not with “no” in order not to mention any of their own breaches of obligations. This may already be an act of deceit.

3.2.3 Omission of insurance cover for „uninvolved“ insured persons

In the consequence of avoidance on the grounds of deceit, (co-)insured persons (e.g. members of the boards, executive employees) lose their D&O-insurance cover even if they were not involved in the deceit or had no knowledge about the deceit.

If the insurance contract contains a clause which grants insurance cover for persons who are not involved in the deceit despite the avoidance, also this obligation will be ineffective. The contract becomes ineffective in total by the avoidance and thus all clauses in the insurance contract are invalid.

3.2.4 Possible damage claims

If the insurance contract was avoided, all indemnifications paid on the basis of the D&O-insurance contract must be reimbursed to the insurer. Insured persons, who were not involved in the deceit and suffer a financial loss due to the repayment, may be entitled to claim for damages against the company. A damage claim may especially be considered if the employment contract with the insured person contains an obligation to conclude a D&O-insurance contract.

Damage claims by insured persons against the company (policy holder) may also be considered if an insured event occurs after the avoidance which would have been insured under the original insurance contract.

The company claimed against might itself hold the person(s) liable who deceived the insurer.

4. PRACTICAL CONSEQUENCES

There is a need for action to ensure D&O-insurance cover for insured persons in case of avoidance of the insurance contract on the grounds of deceit. Insurance contracts should be adapted to the jurisdiction of the Federal Court of Justice.

Despite the decision of the Federal Court of Justice, there remains scope for a contractual retention of the insurance cover in case of avoidance on the grounds of deceit. The insurers could declare a waiver of the avoidance retroactively. It though appears questionable whether the insurer is willing to do so. Also there is the possibility to conclude agreements outside of the insurance contract that was avoided which oblige the insurer to grant insurance cover. The contractual construction must be prepared with due care.

Dr. Anja Mayer
Lawyer

Wilhelm
Partnerschaft von Rechtsanwälten
Registered office: Düsseldorf - AG Essen: PR 1597
Reichsstraße 43
40217 Düsseldorf

Telephone: + 49 (0)211 687746 - 24
Telefax: + 49 (0)211 687746 - 20

www.wilhelm-rae.de
anja.mayer@wilhelm-rae.de