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Exclusion of the D&O-retroactive-insurance only in case of positive knowledge

(Higher Regional Court Koblenz as of 18th June 2010 – 10 U 1185/09)

1. INTRODUCTION

For the D&O-insurance, opposite to usual liability insurances, the so-called Claims-Made-Principle applies. The insured event occurs with the claim against the insured person.[1] It is no precondition for the insurance cover that the board member committed the violation of an obligation at the point of time the D&O-insurance had already been concluded. It is rather decisive that the claim was made during the insured period of time.

1.1 Retroactive insurance

The D&O-insurance thus grants insured persons insurance cover also for violations of obligations that were committed before the conclusion of the concrete insurance contract (retroactive insurance). The regulation of the retroactive insurance is therefore important in case of new contracts of D&O-insurances or a change of the D&O-insurer for violations of obligations. The managers' breaches against obligations and their consequences often become evident and can be claimed on after several years. Claiming against board members for violations of obligations in the past often occurs with a change in management or a crisis of the company.

1.2 Exclusion in case of knowledge of the violation of the obligation

The timely unlimited retroactive insurance for violations of obligations in the past is limited in the general terms and conditions by the insurer. According to the general terms and conditions those claims are excluded from insurance coverage which the policy holder or the insured person knew about when signing the insurance contract or assessed as possibly wrong.

If the insured person claims for coverage of an insured event after changing the D&O-insurer or after signing a new D&O-contract, the insurer might object that the insured board member knew about the violation of the obligation already when signing the insurance contract.

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[1] See also *Steinkühler/Kassing*, VersR 2009, 603.

It is therefore questionable, under which conditions the „knowledge of a violation of an obligation" is at hand. The Higher Regional Court Koblenz dealt with this question with its decision of 18th June 2010 (File No. 10 U 1185/09).

The not yet effective[2] decision of the Higher Regional Court Koblenz is based on the following facts:

2. FACTS

A GmbH (policy holder) entered into a D&O-insurance for its executive manager (insured person), effective from 7th October, 2005.

The D&O-insurer granted insurance cover for the damages claimed during the insurance period. Section 3 No. 2 letter b of the agreed general terms and conditions limited the retroactive insurance as follows:

> *„For those damage claims caused before the beginning of the insurance contract period, this applies only in so far as the policy holder's violation of an obligation justifying the damage claim was unknown when the insurance contract was signed. A violation of an obligation is referred to as known, if it was assessed as objectively wrong by the policy holder or the insured person – even if only possibly – or was named, even if only in a limited way, wrong, even if no damage claims had been filed nor threatened or feared."*

The policy holder supplied the company B for 25 years with goods granting a commercial credit line. In 2004, company B asked the policy holder for an extended credit line. The policy holder demanded respective securities. Company B then ceded its contractual fee receivables from public customers to the policy holder in written form and confirmed – falsely – to have not agreed on any other cessions. The managing director of the policy holder extended the credit line of company B in March 2005 without a former evaluation of the recoverability of the ceded receivables.

From June 16th until November 21st 2005, company B did not pay for outstanding invoices and became insolvent. Receivables of the policy holder against company B were omitted.

On December 1st, 2006, the policy holder claimed against its executive manager for damage compensation due to a violation of an obligation in the amount of the omitted receivables. The policy holder accused the manager for not having taken sufficient security measures and for having relied upon the oral statements concerning the protection of receivables.

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[2] The law suit is pending at the Federal Supreme Court under file number IV ZR 153/10.

The executive manager notified the insured event to the D&O-insurer and requested insurance cover. The insurer denied the cover on the grounds that there was on the one hand a conscious violation of an obligation. The executive manager allowed the delivery beyond the existing credit line, unauthorized and consciously. There was, on the other hand, no retrospective insurance cover. The violations of obligations had been known, or at least noticeable, to the executive manager when signing the insurance contract.

The executive manager claimed for declaration of the insurer's obligation to provide cover.

3. REASONS FOR THE DECISION

The Higher Regional Court Koblenz decided in favour of the executive manager.

3.1 Effectiveness of sec. 3 No. 2 lit. b GCI

At first, the court determined subsequent to the Higher Regional Court Munich [3], that sec. 3 3 No. 2 lit. b GCI bears up against a terms and conditions check and is effective.

The clause limits the risk of an unlimited retrospective insurance. Damages known about already before signing the contract, should not be covered by the insurance. A policy holder should not expect insurance cover by means of the retrospective insurance with a new contract for violations of obligations that had already become known

3.2 Exclusion only in case of positive knowledge

According to the Higher Regional Court Koblenz's perception, sec. 3 No. 2 lit. b GCI requires positive knowledge about an illegal action for the exclusion of a retrospective insurance. A sole "must-know" is though not sufficient.

3.2.1 Requirements for positive knowledge

According to sec. 3 No. 2 lit. b GCI, positive knowledge requires that the violation of an obligation was perceived as – possibly – objectively wrong or referred to as – even though conditionally – objectively wrong by others.

3.2.1.1 Knowledge of de facto conduct insufficient

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[3] Higher Regional Court Munich VersR 2009, 1066; see also *Staudinger* VP 2009, 138.

According to the Higher Regional Court Koblenz, the knowledge of a violation of an obligation does not result from the knowledge of the de facto conduct. It must rather be perceived that the conduct is violating obligations. Further, this knowledge must exist at the point of time the contract is signed.

3.2.2 No positive knowledge in the case at hand

In this case at hand, there was no positive knowledge about the violation of an obligation at hand according to the Higher Regional Court Koblenz

The illegal conduct was the objectively missing check of the recoverability of ceded receivables. The violation of the obligation by this omission was positively not identified by the executive manager. Also the conscious act (omission) of a person does not imply the knowledge that the conduct might possibly be illegal.

The executive manager relied on the one hand on the long-term business relationship, the recoverability of the ceded receivables from public customers and the commitments about the missing ulterior cession. The delayed payment of company B was no evidence of a knowledge about the violation of an obligation since it is well known that public customers often pay long time after the performance.

3.2.3 Analogy to conscious violation of an obligation

The requirements of the Higher Regional Court Koblenz on the existence of positive knowledge are similar to the requirements of a conscious violation of an obligation with regards to content. A conscious violation of an obligation excludes the existence of an insured event.

A requirement for a conscious violation of an obligation is conscientiousness and a sense for the violation of obligations. The conscientiousness is given if the board member is aware of being subject to obligations. The sense for the violation of obligations is given if the board member is aware of having violated such obligations. A conscious violation of obligations thus requires the (conditional) intent with regard to the violation of an obligation.

The Higher Regional Court Koblenz does not demand anything different if it refers to positive knowledge of a violation of an obligation according to sec. 3 para. 2 lit. b GCI. The precondition is that the board member knows that he had obligations in the past and might possibly have violated those when signing the D&O-contract.

3.3 „Must-Know“ not sufficient

Consequentially to the requirements of positive knowledge, the Higher Regional Court Koblenz clarifies in its decision further that knowledge of a violation of an obligation is not already given with the sole "Must-Know" of the violation of an obligation.

3.3.1 Nullity of GCI when referring to negligent lack of knowledge

The court in so far refers marginally to the fact that a GCI-regulation, which ties the exclusion of the retrospective insurance already to a "Must-Know", would not bear up against a legal examination of the GCI and might therefore be ineffective.

If the insurance cover was also excluded if the policy holder or the insured person had negligently staid unaware of the violation of an obligation, the retrospective insurance would only have little effect according to the Higher Regional Court Koblenz.

3.3.2 Compensation of the Claims-Made-Principle through retrospective insurance

The court follows with its arguments the Higher Regional Court Munich[4]. According to the court's view, the unlimited retrospective insurance serves as a compensation for otherwise inappropriate disadvantages of the pure Claims-Made-Principle. This namely has the consequence that violations of obligations committed during the contract term which are assessed *after* the termination of the insurance contract (and after the end of the extended coverage period) do not underlie insurance cover[5].

3.3.3 Effectiveness of GCI in case of gross negligent ignorance?

In order to avoid the consequences of the judgment, insurers could in their GCI change to excluding the retrospective insurance also in case of gross negligent ignorance of the violation of an obligation. It is questionable whether such clause would be effective.

With its considerations about the ineffectiveness of GCI, the Higher Regional Court Koblenz equates the "must-know" in general with "negligent ignorance". This shows that the GCI could also be ineffective if the insurer tied the exclusion of insurance cover to gross negligent ignorance. This

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[4] *See footnote* 3.

[5] *Koch* VersR 2011, 295, 298 f. and *Graf von Westfalen* VersR 2011, 145, 148 indicate that the retrospective insurance cannot represent a compensation of the claims-made-principle on its own, but its disadvantages must in addition be compensated by appropriate terms for the announcement of facts or the retrospecitve announcement of facts.

would imply a severe limitation to the retrospective insurance which could not sufficiently compensate for the disadvantages of the claims-made-principle.

3.4 Burden of explanation and proof

The court explicitly left the question unanswered who had the burden of documentation and proof for the knowledge about the violation of an obligation – the insured person or the insurer.

The insurer in so far argued in the proceeding that sec. 3 No. 2 lit. b GCI was no fact of exclusion but an expansion of the insurance cover.

The burden of documentation and proof ought to be with the insurer, against the insurer's argument. The unlimited retrospective insurance is a direct consequence of the claims-made-principle. If the basically existent insurance cover (retrospective insurance) is limited in favor of the insurer, a fact of exclusion is at hand. As this is a condition in favor of the insurer, the insurer must prove the underlying facts. Since the knowledge is an inner fact, the insurer must present respective indicators and proofs.

There are no hints for a reversal of the burden of proof at the expense of the policy holder. An explicit legal regulation of the burden of proof is missing. The burden of proof is thus with the insurer.

The insured persons might though have increased burden of documentation (secondary burden of proof) why they were of the opinion at the point of time the contract was signed, that their conduct was not violating obligations.

4. CONCLUSION

The Higher Regional Court Koblenz strengthens the insured person's position. The court determined that the retrospective insurance is only excluded in case of positive knowledge of the insured person or the policy holder about violations of obligations in the past. A "must-know" (negligent ignorance) is not sufficient. GCI which tie the exclusion of the retrospective insurance hereto, should be ineffective. This should also apply in case of a tie to a gross negligent ignorance of the violation of an obligation. The Federal Court of Justice's decision about the legal dispute is pending.

Policy holders should in case of the occurrence of a retrospective insured event always examine how the facts of exclusion are regulated in the GCI and if necessary assert their ineffectiveness. The insurers bear in case of ineffectiveness of the corresponding GCI the risk to provide unlimited insurance cover.

In order to get a complete insurance cover, the policy holders and insured persons should examine the possibility of an extended liability agreement with the former D&O-insurer when changing the D&O-insurer. As ultima ratio the insured person can make a circumstance declaration. By this, a possible violation of an obligation causing damage is indicated to the former D&O-insurer even without a concrete claim request. In so far it must though be considered that the insured person admits a (possible) violation of an obligation with the declaration of a circumstance.

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