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Assignment of the right of recourse under the D&O insurance

1. INTRODUCTION

With the new version of the Insurance Contract Act ("VVG"), the legislator included the regulation of sec. 108 para. 2 VVG into liability insurance, whereby the user (usually the insurer) cannot exclude the assignment of the right of recourse to a third person in general terms of insurance („AVB"). The new regulation was provided into the exemplary terms of the German Insurance Association ("GDV") in liability insurance for directors and officers ("AVB-AVG") in sec. 10.2 s. 2. [1]

The so created „prohibition of assignment prohibition clause in general insurance terms" leads to controversial discussions in literature – especially with regard to the D&O-insurance.[2]

A majority of damages notified under the D&O-insurance relates to claims in insured vs. insured cases. Those claims of the company against its own board members (directors and officers) are subject to breach of duties at the expense of the company. The aggrieved policy holder is claimant versus the injuring board member.

The question arises whether, in case of such an insured vs. insured matter, the „injuring" board member may assign his right of recourse according to new legislation to the damaged company. By this means, the board member avoids a direct litigation against his company possibly followed by coverage proceedings on his behalf against the insurer. The injured company will rather directly approach the insurer.

This article raises the issue whether such an approach is useful and which advantages and disadvantage of the assignment of the right of recourse may arise for the company respectively the board member.

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[1] The regulation says: „An assignment to the damaged third party is admissible."

[2] Cf. further proofs in *Wandt* in Münchener Commentary about Insurance Contract Act, sec. 108, index: „Possibility to assign to policy holder as third party, D & O-insurance".

2. CONTENT OF SEC. 108 PARA. 2 VVG

2.1 No prohibition of assignment in general insurance terms

The introduction of sec. 108 para. 2 VVG aims to stop the usual practice of insurers to include general prohibitions of assignment in almost all general insurance terms (cf. e.g. sec. 7 No. 3 General Terms of Liability Insurance "AHB" 1986/2002).[3] With the new regulation, the injuring party is entitled to assign the right of recourse (without defense) to the injured third party, even if liability has not been clarified yet.[4] The consequence of the assignment is that the injured party can directly apply for compensation from the insurer.[5]

According to the official justification of the law, the injuring party may have an interest in „referring the injured party to the insurer in case the insurer questions liability that the injuring party does not want to refuse – probably due to the relationship to the injured party." [6] The maintenance of a good relationship between injuring party and injured party plays an important role in case an insured events occurred in the D&O-insurance. A legal dispute shall not put a strain on the relationship between injuring party and injured party. The board member remains an employee of the company (possibly with the same responsibility), even in the event the company asserted a claim against that board member.

2.2 Exemptions from sec. 108 para. 2 VVG

It must be noted that the regulation of sec. 108 para. 2 VVG solely rules out a prohibition of assignment in the general insurance terms. An individually negotiated prohibition of assignment is still possible, though, probably not practicable.

It is disputed whether a prohibition of assignment in the general insurance terms is legitimate in case it relates to major risks according to sec. 210 VVG (such as possibly in particular D&O-policies). Following the legislator's intention this seems to be possible.[7] In such cases, the prohibi-

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[3] RegE BT-Drucks 16/3945, page 87.

[4] *Langheid* in Römer/Langheid, Insurance Contract Act, 3. edition 2012, sec. 108 no. 16 with further references

[5] *Lücke* in Prölss/Martin, Insurance Contract Act, 28. edition 2010, sec. 108 no. 26.

[6] RegE BT-Drucks 16/3945, page 87.

[7] RegE BT-Drucks 16/3945, page 115.

tion of assignment through general insurance terms must comply with the legal control according to sec. 307 German Civil Code "BGB". In practice, such major risk-policies containing prohibition of assignment clauses will be difficult to sell since the "broker driven" D&O-insurance market is mainly characterized by high competitive pressure.

3. CONTRACTUAL DESIGN OF THE D&O-INSURANCE

The main issue with regard to the D&O-insurance is that a company concludes a D&O-insurance for its co-insured board members as an insurance for the account of a third party in accordance with sections 43 et seqs. VVG. The company itself is the policy holder while the board member is co-insured under the insurance contract.

Since D&O-insurance is an insurance for the account of a third party, basically, the policy holder is entitled to dispose of the insurance claims (sec. 45 para. 1 VVG), while only the insured person is entitled to benefits (sec. 44 para. 1 s. 1 VVG). The separation of formal (litigation) authorization and entitlement to benefits is though not practicable for the D&O-insurance. Therefore, in most D&O-policies, the regulation of sec. 45 para. 1 VVG is waived and the insured person is entitled to dispose of his rights resulting from the insurance contract. [8]

In insured vs insured cases (e.g. claims from secs. 43 para. 2, 52 Limited Liability Companies Act "GmbHG", sections 92 para. 2, 116 German Stock Companies Act "AktG"), as a consequence of this contractual design the insured person acts like the policy holder in "usual" liability insurance, while the policy holder is driven by the same interests as the damaged party in the classical liability insurance.

4. ASSIGNMENT OF THE RIGHT OF RECOURSE IN INSURED VS. INSURED CASES

When claims are asserted against an injuring board member by his company i, the question arises whether the assignment to the company's benefit (that is at the same time policy holder) is compliant to sec. 108 para. 2 VVG.

In literature, some authors argue not very convincingly that in such insured vs. insured cases, the claim cannot be assigned to the injured policy holder, since the policy holder is no (damaged) third party in the meaning of sec. 108 para. 2 VVG resp. sec. 10.2 s. 2 AVB-AVG. [9] Without referring to

[8] Cf. e.g. cypher 10.1 AVB-AVG 2008: „The execution of rights from the insurance contract applies exclusively for the insured person (…)."

[9] Cf. Summary in *Langheid* in Römer/Langheid, Insurance Contract Act, 3. edition 2012, sec. 108 no. 20.

these arguments it has to be stated that the legislator was aware of the D&O-insurance and the insurance for the account of a third party when revising and drafting the articles concerning liability insurance.[10] The legislator however did not restrict the scope of application of sec. 108 para. 2 VVG. The possibility that the policy holder and the injured third party might be identical had been discussed in the jurisdiction process at several stages.[11]

As a consequence, we understand that an assignment in the relationship between insured person and policy holder is possible (even before clarifying the question of liability).

5. CONSEQUENCES OF THE ASSIGNMENT

5.1 Direct claim of the company against the insurer

The assignment of the right of recourse in the D&O-insurance to the company has the consequence that the company can directly assert liability and coverage claims against the insurer.[12] The insured person's right of recourse is transferred into a payment claim of the company against the insurer.[13] With the assertion of such a claim by the company, the insurer is obliged to examine the liability question as a preliminary question. If the claim is brought to court, the court decides on both issues the coverage from the liability insurance as well as the liability of the board member. The separation principle, strictly separating coverage and liability proceedings, does not apply in this constellation.

5.2 Consequences of the assignment for the company

5.2.1 Board member becomes witness

The assignment of the right of recourse in the relationship between insured person and policy holder means that, in case of court proceeding, the „insuring" board member (insured person) is generally no party of the proceedings and may therefore be nominated as a witness from both parties. Depending on the relationship between the insured person and the policy holder (and whether respon-

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[10] Cf. RegE BT-Drucks 16/3945, page 85 (about D&O insurance).

[11] Cf. Federal Court of Justice insurance law 1986, 1010; Federal Court of Justice insurance law 2008, 1202, 1203 (about automobile liability insurance).

[12] Cf. *Langheid* in Römer/Langheid, Insurance Contract Act, 3. edition 2012, sec. 108 no. 16.

[13] Cf. *Langheid* in Römer/Langheid, Insurance Contract Act, 3. edition 2012, sec. 108 no. 16; *Wandt* in Munich Commentary of the-Insurance Contract Act, sec. 108 no. 84.

sibility for the breach of duty was taken by the insured person), this may be regarded as an advantage or disadvantage for the company.

In literature, it is often referred to an assumed danger of collusive behavior between the insured person and the policy holder due to the board member's witness position.[14] This is not convincing and contradicts the legislator's intention, who did not want any prohibitions of assignment. Rather the maintenance of a good relationship between the injured party and the injuring party[15], the continuation of the board member's employment with the company and the further (unburdened) cooperation, are the focus of the new version of sec. 108 para. 2 VVG. Further, the implications related to the board member's witness position are marginal. According to the Federal Court of Justice's jurisdiction, the party must be heard as witness if there is no other evidence for a private conversation.[16] This constellation often applies for D&O cases where solely the board member can witness breaches of duty.

However, there is no big difference in the assessment of the witness' trustworthiness by the judge, solely because of the circumstance that the board member who caused the damage is formally not party of the liability proceeding, but witness in the "direct proceeding".

Apart from that, a collusive behavior between the board member and the company requires a criminal conduct (insurance fraud etc.) of the participants – with all corresponding consequences - which cannot be assumed easily and will occur in practice only in exceptional cases.

Besides, even according to former legislation, there was a danger of a collusive behavior. In this context, the insurer could neither prevent that the board member in a liability case conceded facts with collusive intention according to sec. 138 para. 3 Civil Process Order "ZPO", in order to establish a binding effect and a negative impact on the insurer's obligation to pay.

5.2.2 Lowering the burden of proof under company law

For the injured company, the crucial question is whether in case of such "direct proceeding" the facilitation of the burden of proof under company law may apply. According to sec. 93 para. 2 s. 2

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[14] Cf. Overview in *Langheid* in Römer/Langheid, Insurance Contract Act, 3. edition 2012, sec. 108 no. 20.

[15] See above under 2

[16] Federal Court of Justice NJW-RR 2006, 61, 63.

AktG[17] the board member (but not the injured party) has to prove that he applied the due care. The company must therefore prove the occurrence and the amount of the damage, the wrongful of the board member claimed against and the causality between damage and wrongful act. According to sec. 93 para. 2 s. 2 AktG, the board member, however, has to the non-existence of a wrongful act resp. of a breach of duty. He must thus prove that he acted with due care and that the damage would also have occurred if he had acted according to the company's needs.[18]

From the company's point of view, the question arises whether it could refer to the lowered burden of proof requirements in the "direct proceeding" against the insurer. We understand that there cannot be a difference in the result regardless if the claim based on sec. 93 para. 2 AktG (resp. sec. 43 para. 2 GmbHG) is asserted directly against the injuring board member or if the breach of duty is examined in the context of a "direct proceeding" against the insurer.[19] The intended connection between the liability and the coverage proceedings does not have the result that the burden of proof revises in order to complicate the injured party's evidence requirements. In addition, the insurer does not suffer any disadvantage in applying the burden of proof such as, according to sec. 31 VVG, the insurer is entitled to request all relevant information from the insured person to light up the claim.[20] If the insured person does not respond to the request, the insurer can refer to a breach of obligations (possibly with the consequent release from payment).

As there is no settled jurisdiction in this matter, it remains a certain risk for the company regarding to the question of proof.

5.2.3 Further actions against the board member

Since the judgment in the „direct proceeding" against the insurer, according to sec. 325 ZPO, provides *inter partes* effects solely between the insurer and the company, the board member is not bound to the facts derived from this judgment. This may affect the mandatory deductible rule of sec. 93 para. 2 s. 3 AktG, other retentions agreed upon as well as an insufficient coverage. In such cases, the company may have to take further legal action in order to settle the damage entirely. The com-

[17] With relevance to the D&O liability according to sec. 43 para. 2 Limited Liabilty Companies Act, the regulation of the burden of proof of sec. 93 para. 2 s. 2 Corporation Act is applied analogically.

[18] Cf. Federal Court of Justice VersR 2008, 1355; *Lange* in Veith/Gräfe, The insurance proceeding, 2. edition 010, sec.16 no. 49.

[19] A.A. *Böttcher* NZG 2008, 645, 648, by trend also *Langheid* in Römer/Langheid, Insurance Contract Act, 3. edition 2012, sec. 108 no. 23.

[20] Cf. *Lange* r+s 2010, 185, 189.

pany, therefore, may possibly institute legal proceedings against the board member. In order to avoid further proceedings, the company should ensure, that the insured person is bound to the results of the "direct proceeding" (e.g. by third party notice towards the board member or by contractual agreement).

5.3 Consequences of the assignment for the insured person

5.3.1 Drafting of the assignment

The assignment of the right of recourse requires the consensus with the board member. The details of the assignment can therefore be negotiated by the board member with the company. The agreement should contain a regulation stating that the company will not assert any (further) claims against the insured person (assignment on account of performance) while asserting "direct" claims against the insurer. The assignment on account of performance has the effect that the company is obliged to compensate its damage first and forward with the assigned claim.[21] The assignment has, however, the advantage for the board member – nevertheless what will be the outcome of the direct proceeding – that he is not party to.

Further, the assignment should contain a regulation that settling or admitting in the "direct proceedings" excludes a further assertion of claims against the board member. For the benefit of the insured person, the same applies in case a court dismisses the claim in the direct proceeding based on coverage reasons what excludes the company to get compensation from the assigned indemnification claim.

In case coverage is, according to a first estimate, insufficient, or if a contractual or legal retention regulation applies (sec. 93 para. 2 s. 3 AktG), it must additionally be agreed upon that no claims will be asserted against the board member until the direct proceeding has come to an end. [22]

5.3.2 Point of time to agree on the assignment

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[21] It would be even more advantageous for the board member to conclude the assignment on account of performance. The company will though usually not agree hereto.

[22] If a board member concludes a so-called assignment policy in his own name, the cession of the resulting rights of recourse to the company is also considerable.

The assignment between the board member and the company can be concluded immediately after the occurrence of the insured event. The insured event in the D&O-insurance regularly occurs when claims are made by the company against the board member.

It does not affect the assignment and the severity of the claim if the board member relies on his statutory rights and negotiates with the company on the agreement. Such negotiations can also be held before claims are made, for example, when the assessment of the damage has not yet been completed by the company bit a claim though is possible.

6. CONCLUSION

With the assignment of the right of recourse in D&O insurance, new possibilities arise in insured vs. insured cases with reference to the injured company and the injuring board member. Direct proceedings between the participants can be avoided and a further unburdened cooperation is possible. Depending on the board member's willingness, an assignment of the right of recourse should, therefore, be achieved in order to bring a direct payment claim against the insurer (and possibly to rely on it in a "direct proceeding"). In every case it has to be reviewed carefully how to draft the assignment agreement, how to evaluate the witness ability of the board member as well as the possible loss of the facilitation of the burden of proof with regard to corporate law have to be examined in the individual case. From the company's perspective, it must be ensured that the board member will accept the outcome of such a "direct proceeding", especially if coverage might not be sufficient.

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