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Guest Post: The 101 of Litigation Funding in the German D&O-Claims Arena

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One of the most significant recent developments in the litigation environment has been the rise of third-party litigation funding. However, as I noted in a recent post, the impact of litigation funding has varied from jurisdiction to jurisdiction based on differences in the local law. In the following guest post, Burkhard Fassbach, a German attorney and D&O Advisor to the Frankfurt-based MRH TROWE Brokerage Group, and Carsten Wettich, a founding partner of Berner Fleck Wet tich, a Dusseldorf-based corporate law firm, take a look at lit gation funding environment in German and its impact on the D&O claims arena there. I would like to thank Burkhard and Carsten for their willingness to allow me to publish their article as a guest post. I welcome guest post submissions from responsible authors on topics of interest to this blog's readers. Please contact me directly if you would like to submit a guest post. Here is Burkhard and Carsten's guest post.

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Only a handful of litigation funders have gained a foothold in the German market. The business strategy could no be any more straightforward: By virtue of litigation funding, a plaintiff may shift to the funder the entire risk of having to bear the costs of the action. In Germany, these costs encompass the defendant's attorney's fees, too, since it has a "loser-pays" rule. As consideration for shouldering the litigation costs, the funder will be entitled to a share of the amount in controversy if the plaintiff prevails. Customarily, such share comes in the range of 20 to 30 percent of the amount in controversy. The increase of Court and attorneys' fees is degressive so that costs decrease with the increase of the amount in controversy. For the funders it is rather undesirable to finance a case for which the chances of success are smaller than or equal to the chances of having to bear its costs. Therefore, the amount of controversy regularly has to amount to at least € 100.000. Additionally, the defendant has to be sufficiently credit worthy so as to render the claim recoverable.

It has only been since recently that D&O insurers have become a target of litigation funders in Germany. According to the aforesaid, in cases where damages amount to millions, manager liability actions promise to be a lucrative business. Most D&O insurers' current practice of settling claims provides an ideal breeding ground for the demand for litigation funding.

The need for litigation funding in the D&O-claims arena

According to the German Federal Supreme Court a D&O policy's component of satisfying claims rests on equal footing with its component of defending against such claims. In practice however, one gets the impression that insurers seek to fight off even meritorious claims. As a consequence, litigation with their managers is virtually thrus upon the companies. Companies typically lack the perseverance of litigating through the court system. Fatigued b litigation the damaged companies surrender on the lower court level. As a result, the D&O insurance policy has in effect transformed into litigation expense insurance that often does not provide but for a small pot of money to se tle the case. The major part of payouts goes to lawyers, experts, and courts. The rule of thumb is this: An insuranc sum of € 1m is offered in the market for an amount as low as € 1,000. Is such a premium level solid enough for an effective handling of claims? The obvious answer – no, it is not – presents the unpleasant corollary that the plaintiff companies have precious little choice than to accept derisory settlements.

Settlement regrets as a trigger for litigation funding

Unlike in the U.S., in Germany it is the company, not its shareholders, that typically brings claims against its man agers. In a stock corporation, the supervisory board pursues the claim against the executive board members on be half of the company and represents it in litigation. Indeed, a general duty is incumbent upon the supervisory boar to pursue viable claims against the executive board members. The German Federal Supreme Court in its landmar ARAG/Garmenbeck ruling imposed this duty on the supervisory board as part of its duty to monitor the executive board.

In the majority of cases, these manager liability proceedings wind up being settled. While companies increasingly claim higher damages, the amounts settled remain low. Pursuant to the German Stock Corporation Act, the liabili ty settlements that the company concludes with the defendant executive board members and the coverage settle- ments that the company concludes with the consortium of D&O insurance carriers are subject to the following cor ditions precedent: (1) The shareholders' meeting has to consent to those settlements and (2) no minority whose aggregate holding equals or exceeds one-tenth of the share capital may record an objection in the minutes. Atten- tion must also be paid to the fact that a settlement may not be concluded prior to the expiration of three years afte the claim has arisen.

Consequently, the supervisory board will regret the "lousy" settlement that it has previously negotiated and pro- posed to the shareholders, if the shareholders' meeting does not consent and, thus, the settlement does not give rise to contractual duties, or if the supervisory board is virtually "punished at the polls" through miserable voting results. In both cases, there is a great potential for concomitant negative press coverage that can bring about con- siderable reputational detriment to the supervisory board members. By the same token, the pressure on the super visory board to settle the action can increase in light of the fact that "the wheels of justice turn slowly" and that liti gation in court stretching over multiple years invariably leads to attorneys' fees ballooning. Additionally, it might be questionable whether the imponderables of the disposition of the action still warrant the action being proceed- ed with. Nine times out of ten, a liability claim involves highly complex legal and economic issues, many of which the German Federal Supreme Court ultimately decides. Thus, in the course of settlement negotiations, the superv sory board, while being counseled by the plaintiff company's lawyers, always has to assess whether or not the clai is fully enforceable throughout the court system. To that end, it has to evaluate legal and evidentiary issues that o tentimes require judgment calls.

As if this were not enough in terms of pressure and responsibility on the part of the supervisory board members, another point compounds the plight they find themselves in. In the event the shareholders find that the superviso ry board, by prematurely settling a meritorious case, has breached its duty to bring viable claims against the execu tive members who have allegedly inflicted damage on the company, these shareholders, invoking a separate exper opinion, could lodge claims against the supervisory board members. With such claims they could demand the difference between the amount of the actual settlement and what could have potentially been adjudicated against th executive board members, had claims been brought against them. Moreover, in such a situation the supervisory board members are in danger of being charged with embezzlement and abuse of trust. Thus, a misguided settlement can be a road to financial perdition for them, particularly since the insurance proceeds most likely have bee used up by now. But then again, the rejection of a settlement offer harbors the risk of liability, should the subsequent adjudication of the matter turn out to be more unfavorable in terms of the amount of damages awarded tha the settlement offer.

Consequently, when assessing the adequacy of a settlement the supervisory board invariably has to deal with the issues of its duty to pursue viable claims and the risk of embezzlement and abuse of trust charges in case of the insurer's merely offering an untenably small settlement amount. For that matter, the supervisory board can best secure itself against settlement regrets by retaining full-fledged experts who not only possess the expertise to thoroughly assess the basis and enforceability of the liability claim but who also have at their disposal the requisite financial means to pursue meritorious claims to the bitter end of the court system. It is at this juncture where the litigation funders come into play.

Litigation funding as a means to escape the settlement pitfall

In the absence of a litigation funder, a damaged company has to finance the legal enforcement of its claims at its own expense. In the true sense of the word, the company has to throw good money after the bad. Given that D&O insurance is a form of liability insurance against financial loss, the assessment of the merits of a manager liability claim forms the basis of the litigation funder's decision whether to finance the claim or not. A positive answer will not ensue until a thorough and independent "due diligence" has been performed. The chances of success have to amount to at least 70 percent. Otherwise, the litigation funder could just as well try its luck at a casino.

The assessment of the validity of the claim focuses on questions like the applicability of the business judgment rul and issues of burden of proof. In the event that litigation funders, having scrutinized the case, should come to the conclusion not to take the risk of providing the financial means, this should equally serve as a red flag for the dam aged companies. Consequently, a screening function can be assigned to litigation funding. The chaff is sifted from the wheat, and the insurers' money coffers provide for an expeditious and noiseless settlement of such cases as promise sufficient chances of success.

Conclusion

In the context of manager liability, the supervisory board and the shareholders of the damaged company should explore the possibilities of litigation funding. Litigation funders potentially operate as a counterbalance vis-à-vis the D&O insurers. Damaged companies should not give in to the insurers' dragging them by their nose ring across the circus arena. On the contrary, consistently bringing valid claims against management will make insurers keep their promise to effect payments in damage cases. In the absence of an effective damage settlement practice, D&O insurance carves out a miserable existence and stands to be at risk of extinction. But then, the protection of species is in the very interest of industrial insurers, too. Above all, the latter should treat damaged companies as clients and account them the payers of premiums.