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Guest Post: The German Two-Tier Corporate Board Structure and its Impact on D&O Insurance Cover

By Kevin LaCroix on May 2, 2013
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The liabilities of corporate officials are a reflection of the laws of the jurisdiction in which the corporation is chartered. The jurisdiction's liability provisions in turn have important implications for the structure of the insurance put in place to protect the corporate officials.

In the following guest post, Michael Hendricks (pictured above left), the founder and head of the German D&O specialist broker HENDRICKS & CO GmbH and Burkhard Fassbach (pictured above right), licensed to practice law in Germany and standing legal counsel to the German operation of the London-based Howden Broking Group, take a close look at the particular need for separate D&O Insurance Cover for Supervisory Board Members in the German two-tier board system.

I am very grateful to Michael and Burkhard for their willingness to publish their post on this site. I welcome guest posts from responsible commentators on topics relevant to this blog. Any readers who are interested in publishing a guest post on this site are encouraged to contact me directly. Michael and Burkhard guest post follows:

Introduction

D&O Insurance Policies are widespread in Germany nowadays after initial adoption from its homeland in the United States. The product designation (Directors & Officers) directly refers to the American one-tier board system. If the German insurance industry would not have simply had assumed the American designation and had instead rather taken the German two-tier board system into account, the German product designation more precisely had better been labeled as Insurance for Supervisory and Executive Board Members – S&E rather than D&O Insurance.

Both, Members of the Supervisory Board and the Executive Board are "insured persons" under the D&O Company Policy and are subject to the potential liability of Board Members. Only the "insured persons" are entitled to the rights arising from the D&O Policy. However, the company is the sole Policyholder and pays the premiums. The insured event (Trigger) is foremost a claim made against an insured person due to alleged breach of duty.

In the framework of the liability regime set out by the German two-tier board system, the Supervisory Board is the competent corporate body in charge of triggering a claim against the Executive Board. The corporation (Policyholder) – represented by the Supervisory Board – takes legal action against the Executive Board due to alleged breach of duty.

The D&O claims experience gained in recent times clearly shows that significant conflicting interests occur because the D&O Insurance carrier cannot at the same time fulfill its fiduciary duty towards the Executive Board and the Supervisory Board. In particular, the problems arise in the event that the Executive Board – which has been sued by the company in the first place – issues a third-party notice towards the Supervisory Board in the court proceedings of the civil liability trial in order to take precaution for a later recourse against the Supervisory Board more precisely against individual former or current Members of the Supervisory Board.

For the sake of avoiding such conflicting interests – in particular in the event of third-party notices – it is of utmost importance that the corporation buys an independent D&O cover for the Supervisory Board and thereby ensures full harmony with the German dual two-tier board system. It is essential that the D&O Insurance cover for the Supervisory Board is provided by a totally separate Insurance carrier which is definitely not participating in the company's D&O Insurance program (Primary or Excess layers).

Twin Tower Model

In order to reflect the dual two-tier board system cleanly and properly in the concept of D&O Insurance programs the Twin Tower Model would be the best solution: Tower 1 by Insurance carrier A only covers the Executive Board Tower 2 by the Insurance carrier B only covers the Supervisory Board.

For reason of the „principle of equality of arms", both towers should have the same limit of cover (insured

amount). Any conflicting interests are destroyed at birth by implementing the Twin Tower Model. A powerful Supervisory Board should in any case explore such a solution. However, in a D&O market expected to become tougher the Twin Tower Model will only sell for high premiums. Therefore, the Two-Tier Trigger Policy for Supervisory Board Members outlined as follows is much more meaningful.

Two-Tier Trigger Policy

A special D&O Policy – only for the Supervisory Board – should solely align with the need for protection required by the Supervisory Board. The protection requirements shall tie in with the triggers (insured events). In contrast t the Twin Tower Model the Supervisory Board Members still remain insured persons under the Company's D&O Policy for the time being. The Two-Tier Trigger Policy only steps in whenever a conflict of interests arises. A presentation of the several Triggers is shown as follows:

Trigger 1: Exhaustion of the insured limit of the Company's D&O Policy

The first Trigger is the exhaustion of the insured limit of the Company's D&O Policy (Primary and Excess layers). In this respect the Two-Tier Trigger Policy is functioning like an excess D&O Policy (Following Form to the Company's D&O Policy). As a result an additional insured limit provided by a separate D&O insurance carrier is available exclusively to the Supervisory Board.

This Trigger in particular ensures the necessary independence to carry out the mandate of the Supervisory Board Member and this can be clearly shown by the following scenario:

As a general rule, claims in regard to breach of duty are foremost made against the Executive Board. Whilst asserting such claims the Supervisory Board runs the risk that the insured limit of the Company's D&O Policy is exhausted ("eaten up") by the Executive Board – perhaps only by defense costs – and the Supervisory Board is absolutely without any cover in the event of a later potential recourse litigation in the future. Should such a scenario become obvious, the defense lawyers of the Executive Board Members could solely by a tactical third-party notice served t the Supervisory Board demonstrate the defenselessness of the Supervisory Board. Thereby, the independence of the Supervisory Board mandate is concretely endangered. Individual Supervisory Board Members who are the recipients of a third-party notice could for their own personal interest – contrary to the company's interest – work towards a settlement deal, what they possibly would not do if they had cover provided by their own independent D&O insurance policy.

Trigger 2: Third-Party Notice

Besides the trigger of the exhaustion of the insured limit, an independent D&O Policy for Supervisory Board Members shall certainly have to provide the third-party notice as a trigger. This trigger shall already come into action

prior to the exhaustion of the insured limit of the company's D&O policy. In the event of a third-party notice signi icant conflicting interests arise in the framework of the two-tier board system, which can be clearly shown by the typical course of action and the dynamics of a D&O claim case:

In the course of the decision-making of the Supervisory Board moving to a resolution regarding asserting a claim against the Executive Board, the company's (claimant's) lawyer reviews the likelihood of success of a lawsuit. The company / Policyholder has a primary interest in balance sheet protection and therefore tries to push the D&O in surance carrier towards adjusting the claim.

The insurance carrier has a statutory option right between adjusting the claim or defending against the claim.

Usually and as a first step, out-of-court claims adjustment negotiations between the parties are conducted on the basis of a draft statement of a claim (writ of summons). Should the insurance carrier only offer a very low quota, then a negotiated settlement could in an extreme situation be regarded as breach of fiduciary trust by the Supervi sory Board, if the quota offered by the insurance carrier is disproportionate in relation to the amount of the assert ed claim. The more so, as the Supervisory Board basically meets the duty to assert claims against the Executive Board pursuant to the highest-court case-law in Germany and failure to act accordingly results into potential lia bility of the Supervisory Board.

Should out-of-court settlement negotiations fail, a civil liability trial at the ordinary courts of law – oftentimes ove the various stages of appeal – must determine if a negligent breach of duty occurred which has caused a financial loss.

In the event the Insurance carrier exercises its statutory option right and elects to bear the defense costs for the in sured persons (Executive Board), then the insurance carrier obviously has an own interest in successfully defend ing the claims.

More and more often insurance carriers take the approach of an active liability defense. By a collaborative defense which is set out by the insurance carrier the D&O insurer can steer the entire defense strategy and tries to limit ex ceeding lawyer's expenses. The defense lawyers can each present individual statements of the case on top of the basis of the collaborative defense. In the framework of an active liability defense the insurance carrier as an inter vener accesses the legal court-proceedings on the side of the defendants by the rules of legal intervention stipulat ed in the Code of Civil Procedure.

The company / the Supervisory Board perceive the defense litigation brief by the lawyer appointed by the D&O In

surer as rather strange, hence the insurance carrier is still the contractual party and pockets the insurance premiums even if the D&O insurance is by construction insurance for the benefit of third parties (insured persons).

The mistrust results into escalation at the latest in the event individual Members of the Supervisory Board are recipients of third-party notices issued by the sued Executive Board Members. With a view to potential future recourse litigation the defense lawyers advise to issue a third-party notice towards the Supervisory Board Members. They argue that the Supervisory Board shares liability, had knowledge of the alleged breach of duty and has supported or approved such breach of duty. In the event a judgment against the Executive Board becomes final and res judicata – contrary to the expectation of the defense lawyer – then recourse claims against the Supervisory Board arise.

In particular current Members of the Supervisory Board will not necessarily take the decision to intervene the lega court-proceedings on the side of the defendant. Obviously, it would be highly contradictory if a Supervisory Board Member who is responsible for asserting the claim would subsequently intervene the legal court-proceeding on th side of the defendant. Should they do so, they certainly need to think about resigning from the Supervisory Board with immediate effect. However, in individual cases an intervention on the side of the defendant may make sense for former Members of the Supervisory Board or for Supervisory Board Members who had been outvoted in the framework of the resolution regarding asserting claims against the Executive Board.

Under the company's D&O Policy the third-party notice is one of the triggers defined as an insured event. The Supervisory Board Members who are the recipients of a third party-notice will notify the occurrence of an insured event to the company's D&O insurance carrier.

Apparently, the Members of the Supervisory Board who are recipients of a third-party notice are in need of legal consultation regarding questions of intervention to the court proceedings, whilst taking potential future recourse litigation into consideration. The lawyer appointed by the Supervisory Board Member – who had received a third-party notice – in a first step needs to review the entire records of the court case which are often very voluminous and as a second step needs to argue scenarios of liability and recourse with his client and finally provide legal advice regarding intervention of the court proceedings.

Should an intervention on the side of the defendant not be viable due to the reasons outlined above the alternative of intervention on the side of the plaintiff or no intervention at all needs to be reasoned. An intervention on the side of the plaintiff may make sense if it definitely needs to be ensured that the Member of the Supervisory Board who is the recipient of a third-party notice is accommodated in the distribution circle of the judicial post of the liability trial (litigation briefs) and is thereby not cut-off from the flow of information. Individual Members of the Supervisory Board do not always have access to the entire records of the court case in particular in the event they have already left the Board.

The assessment of the prospect of success regarding potential recourse litigation against the Supervisory Board Members – who are the recipients of the third-party notice – is at the core of the legal advice.

Subsequent to a third-party notice the Member of the Supervisory Board needs to make a request to the company D&O insurance carrier for a confirmation of cover regarding legal expenses; whereas exactly the same D&O insurance carrier had beforehand sided with the defendants as an intervener in the course of active liability defense and may have possibly even supported the third-party notice towards the Supervisory Board issued by a defendant.

Here massive conflicting interests arise! The D&O insurance carrier of the company's policy cannot at the same time fulfill its fiduciary duty towards the Executive Board (Trigger: claims made / lawsuit) and the Supervisory Board (Trigger: Third-Party Notice).

Imagine the following case:

After the trigger of the third-party notice had been pulled, the affected Supervisory Board Member asked the company's D&O insurance carrier – who had sided with the defendants as an intervener beforehand – for a confirmation of cover. Firstly, the D&O insurance carrier was asked to bear the legal expenses related to the questions of intervention to the court proceedings. After having basically agreed to the principle of hourly rates for the lawyer's fees, the D&O insurance carrier wanted to limit the lawyer's mandate to only strategically reviewing the facts of the case rather than a full blown legal review. In view of a solid legal opinion covering the potential recourse which is requirement for the question of intervention to the court proceedings, the lawyer appointed by the Supervisory Board Members – who had received a third-party notice – has not agreed to limit the mandate to a strategic review due to his overall and extensive lawyer's duties towards his client.

The time-sheets of the lawyer included the time spent for the legal opinion in respect to potential recourse litigation. The D&O insurance carrier asked for a copy of the legal opinion (prospects of potential recourse litigation) and stated that the D&O insurance carrier is entitled to receive a copy of the legal opinion; otherwise the lawyer's bill would not be paid by the D&O insurer.

Due to the fact that the D&O insurer had in the first place sided with the sued Executive Board Members as an intervener, the lawyer appointed by the Supervisory Board Members – who received a third-party notice – has declined to hand over the legal opinion regarding the potential recourse litigation to the D&O insurer. Because of the active liability defense and the collaborative defense there was also the risk that confidential and sensible information from the legal opinion (recourse litigation) or significant contents hereof directly or indirectly leaked to the lawyers of the defendants, keeping in mind that the D&O insurer is steering the entire defense. A declaration by the D&O insurer whereas the contents of the legal opinion is subject to absolute confidentiality and are not shared

with the lawyers of the defendants was not enough to convince the lawyer of the Supervisory Board Members of such a “Chinese Wall."

If the mere intention of the D&O insurer had been to get clear certainty about the actual work time of the lawyer and the correctness of the time-sheets, then the inspection of the legal opinion by a neutral third party would have absolutely served this purpose. If a mutually recognized neutral lawyer had inspected the legal opinion about potential recourse litigation and had then confirmed towards the D&O Insurer that the time-sheets regarding the legal opinion are correct, then the D&O Insurer actually should have been in a position to pay the lawyer’s bill. However, the D&O insurer has not agreed with this proposal and rather insisted to receive a copy of the legal opinion about recourse litigation.

The lawyer of the Supervisory Board has strongly advised not to hand over the legal opinion – under no circumstances – to the D&O insurer who had been biased by the active liability defense.

Due to a severe conflict of interests the D&O insurer was not able to fulfill its fiduciary duties in the described situation.

The concept of the Two-Tier Trigger Policy for Supervisory Board Members takes up such conflicting interests and defines the event of a third-party notice as a trigger!

The special need for protection of a single Member of the Supervisory Board also derives from the following aspect: In such a scenario massive conflicting interests can arise within the Supervisory Board. Members of the Supervisory Board who are not recipients of a third-party notice may regard their colleagues in the Supervisory Board who are recipients of a third-party notice as biased. It has already been outlined that such affected member could for personal interests – contrary to the company’s interest – work towards a negotiated settlement. In order to avoid such conflicting interests within the Supervisory Board, the competence for asserting the claims against the Executive Board is assigned to a Claims Adjustment Committee within the Supervisory Board. Such members of the Supervisory Board who are affected by the third-party notices cannot become members of the Claims Adjustment Committee. The Claims Adjustment Committee has its own bylaws – and also has employee’s representatives as members – and the committee has a chairman who is steering the litigation strategy against the Executive Board with the plaintiff’s lawyer. Whereas – for the sake of avoiding conflicting interests – the Members of the Supervisory Board who are recipients of third-party notices need to seek their own independent legal advice regarding complex questions of intervention to the liability court-proceedings and potential future recourse litigation.

Trigger 3: Rescission

Another trigger is the rescission of the company's D&O policy. For instance, if a Member of the Executive Board had made false statements in the framework of a warranty statement towards the D&O insurer, there is a risk that the D&O insurer declares rescission of the entire D&O Policy with the effect that all insured persons – apparently also including the Members of the Supervisory Board – remain to stand unprotected without any D&O insurance cover.

Trigger 4: Special Representative pursuant to section 147 German Stock Companies Act

Further conflicting interests can arise in the event a special representative asserts claims at the same time against the Supervisory Board and the Executive Board.

Logically, conflicting interests between the Supervisory Board and the Executive Board arise, which derive from the different scope of functions and duties of both Boards in the dual two-tier board system, in particular in the event they are the target of a legal attack.

The dispute between both corporate Boards always centers on the core issue, if the Executive Board has informed the Supervisory Board or has provided sufficient or complete information (argument of the Executive Board) or if the Supervisory Board has not been sufficiently informed or even has been misled (argument of the Supervisory Board).

Future Triggers

The Two-Tier Trigger Policy shall always come into action if there is a need for the protection of the Supervisory Board and there is a conflict of interests between the Executive Board and the Supervisory Board, which has its origin in the dual two-tier board system. Certainly, the product is at an early stage yet and time will tell which additional triggers need to be defined as insured events in the future.

Individual-Policy

Last but not least an individual Member of the Supervisory Board may wish to have an individual D&O Policy. In this alternative the individual Supervisory Board Member is the sole Policyholder and has to pay the premiums out of his own pocket. For multiplayers this has the advantage that mandates in several Supervisory Boards of different companies – to be listed in the certificate of insurance – are covered.

Future-Outlook

Hopefully, a speedy distribution of the Two-Tier Trigger Policy for Supervisory Board Members will finally bring

the concept of D&O insurance programs in Germany in harmony with the dual two-tier board system. This will most certainly not cloud the trustful co-operation between Executive Board and Supervisory Board in times of sur shine with mistrust. Rather, the clear separation and borderline between the D&O cover with separate D&O insur ance carriers results in a strengthening of both mandates – Supervisory Board and Executive Board – and can therefore only be advocated in the light of “best practice“ and “Corporate Governance.“