Mandatory deductible in German D&O insurance

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Formerly, directors and officers (D&O) insurance seldom included deductibles borne personally by the members of a company's management board (*Vorstand*). The Act on the Adequacy of Management Board Compensation (*Gesetz zur Angemessenheit der Vorstandsvergütung* – 'VorstAG'), adopted on June 18, 2009 by the German Parliament, now makes this mandatory.[1]

The legal situation

VorstAG modifies the legal regime governing the compensation of members of the management board of German stock corporations and introduces a mandatory deductible for D&O insurance policies.

The new rules are intended to establish an 'adequacy' standard and bring clarity to previously 'customary' (*angemessen*) practices. Under the new law, the compensation of members of the management board will be structured in terms of long-term incentives designed to encourage the sustainable growth of the company. Simultaneously, new disclosure rules regarding executive remuneration specify that the supervisory board (*Aufsichtsrat*) must reduce the compensation of management board members in the event of any deterioration in the company's financial position and should undertake to prevent breaches of duty by management board members.

Of particular importance for the casualty insurance industry is the mandatory deductible which must be included in all D&O policies as of the day the Act enters into force. As a result, D&O protection will no longer be granted in full for members of the management board who commit breaches of duty or employment-related wrongful acts.

Impacts on D&O insurance

Pursuant to Sec. 93 para. 2 cl. 3 of the new version of the German Stock Companies Act (*Aktiengesetz – AktG*), if a company provides insurance cover to the members of the management board for risks resulting from their occupational activities, a mandatory deductible personally borne by the management board member must be included. The amount of the deductible ranges from a minimum of 10% of the damage up to a minimum amount of 1.5 times the annual base salary (*feste jährliche Vergütung*).

Two minimum requirements

The two requirements are called 'minimum' requirements to illustrate that the stock company is free to agree even on increased deductibles which would logically lead to an extended personal liability of its management board members.

The legislator of VorstAG intended a minimum deductible of 10% per damage which should be compensated at least by the affected management board member. However, with reference to legislative documents,[2] there should be a limitation up to a minimum amount of 1.5 times of the annual base salary in the case of one huge D&O loss or rather in the case that different D&O losses occur in one legal year. As a result, this might lead to an unequal treatment of management board members in relation to deductible compensation claims: those management board members who are compensated with variable salary components based on a lower base salary will profit. All in all, the legislator's decision to choose the base salary for a minimum requirement to regulate the extent of the deductible is not convincing.

Finally, it remains to be stated that, contrary to the D&O insurance in general, under Sec. 93 para. 2 cl. 3 AktG it is not the claims made, but the occurrence principle which is applicable for the question when the breach of duty has been committed.

Applicability of Sec. 93 para. 2 cl. 3 AktG

Sec. 93 para. 2 cl. 3 AktG is solely applicable to stock-capitalised German companies, so called Aktiengesellschaften. Explicitly not included are executives of other types of German corporations which are not stock-capitalised (e.g., limited liability companies (GmbH) or limited partnership with a limited liability company as general partner (GmbH & Co. KG)).

Sec. 93 para. 2 cl. 3 AktG is not applicable to supervisory[3] and advisory board members (*Aufsichtsrat und Beirat*) of German stock companies. However, it remains to be seen, if – in practice – deductibles will be agreed on for supervisory board members too. In a corporate structure it could be reasonable to bring insurance cover for all

'responsible' board members in line. If not, the result could be that in D&O cases the company will raise its claims firstly against the members of the supervisory or the advisory board who are not held liable personally.

Beyond that, as the new provision is incorporated into Sec. 93 AktG, there is a strong argument that the mandatory deductible is solely applicable for claims which are raised within the framework of Sec. 93 AktG. Hence, the mandatory deductible does not apply to the costs incurred to defend or appeal a claim made against a member of the management board, i.e., to cover defense costs in the event management board members are sued for wrongful acts while they were with that company.

A crucial question arises from the fact that a variety of German stock companies are subsidiaries of foreign controlling companies. In those cases, the controlling foreign company usually provides D&O insurance cover for the whole group under its particular foreign law regime. Consequently, the foreign law regime is prevailing German law. For that reason Sec. 93 para. 2 cl. 3 AktG does not apply to German co-insured subsidiary stock companies when the subsidiary is not the policyholder on its own behalf. To sum up, the deductible requirement is not mandatory for management board members of German subsidiary stock companies with foreign controlling companies.

The same question arises for German subsidiaries that are part of a German group structure (*Konzernstruktur*) in which the insurance cover is taken by the controlling company. In those cases, however, even though the legislature did not address subsidiary stock companies specifically, the underlying rationale of the VorstAG leads to the assumption that there should be no exemptions from the mandatory deductible requirement for German stock companies whatsoever. Thus, management board members of German subsidiary stock companies will fall into the scope of Sec. 93 para. 2 cl. 3 AktG.

Coming into force of Sec. 93 para. 2 cl. 3 AktG/consequences for current insurance contracts

For current insurance contracts (*Altverträge*), pursuant to Sec. 23 para. 1 cl. 1 of the Introductory Act of the German Stock Companies Act (*Einführungsgesetz zum Aktiengesetz – EGAktG*), there will be a one-year transitional period (until June 30, 2010) to allow for the implementation of this regulation. It is thereby not sufficient just to implement the mandatory deductible in an employment agreement with the management board member. Thus, current insurance agreements that do not provide for a mandatory deductible yet will have to be amended.

However, there is an exception clause in Sec. 23 para. 1 cl. 2 EGAktG. Thereafter, any German stock company will be allowed to fulfil a contractual obligation resulting from an individual employment agreement saying that D&O cover will be granted in full without any deductibles. This means that any company which has made such agreements with its management board members before VorstAG came into force will be allowed and forced to let the individual treaties expire without being obliged to switch coverage.

Private insurance cover for deductibles

It can certainly be assumed that management board members will attempt to minimise their personal liability.

Even before the enactment of the VorstAG, several insurance companies provided insurance cover for the remaining costs resulting from an agreed deductible. This was due to the fact that the non-binding German Corporate Governance Code (GCGC) gave a strong incentive that a deductible should be agreed. Some insurers even demanded such an agreed deductible in their general terms and conditions and excluded at the same time any private insurance cover for deductibles.

The reason behind such policy-making was quite the same as for the making of Sec. 93 para. 2 cl. 3 AktG in the context of VorstAG: it was supposed that any personal liability risk on the side of the management board would at the same time minimise risks taken in the name of the company.

However, in consideration of the freedom of contract the legislator finally decided against a debarment on private insurance cover for risks arising out of the mandatory deductible. But it should be pointed out that the legislature at the same time – in response to the current financial crisis – intended to create a new liability regime that emphasises responsibility and requires members of the management board to participate in the losses resulting from breaches of their duties. Although this intention might be undermined by allowing for insurance cover for deductibles, as mentioned before, it follows from the freedom of contract that such provisions are in accordance with the law.

As a result, the ranks of those criticising the benefit of the mandatory deductible are swelling. It is complained that a mandatory deductible does not serve its purpose if the members of the management board can minimise their personal liability by insuring their risks on a private basis. Nevertheless, this argument can be countered by the argument that even a German debarment could not avoid the conclusion of a deductible insurance contract under foreign law.

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To sum up, there is broad consensus that under the VorstAG the members of the management board are not barred from taking insurance cover on their own behalf. From a legal point of view, there are no convincing arguments that would prevent the purchase of such supplementary insurance contracts on a private basis.

Further implications of Sec. 93 para. 2 cl. 3 AktG

The existence of mandatory deductible insurance will make D&O claim settlements even more difficult as it was before. This follows from the fact that there could be two different insurers involved in one D&O case using different exclusion clauses. If the worst comes to the worst this might lead to gaps in coverage to the detriment of the management board member in question. To avoid such cases, it could therefore be highly advisable for the management board members to take private insurance cover against deductible risks at the same insurance company that is providing D&O cover for the whole company.

Besides, it needs to be further clarified what effect the mandatory deductible takes in cases of joint and several liabilities (*gesamtschuldnerische Haftung*). This is the case if the company raises a claim against various members of the management board. The insurer's interest in such a case – at least that one of the company's D&O insurer – would be to accumulate the separate mandatory deductibles to achieve a decrease in its own liability.

Unquestionably the company's D&O insurer would take a benefit from an accumulation of the mandatory deductibles: at its best, the insured event could be settled entirely by the accumulated mandatory deductibles. Under this premises, it is to be expected that in post D&O cases it will be in the insurers' interest to extend the liability to various management board members or rather to hold the entire management board liable.

Such a development might not have been intended by the legislator. On the contrary, one could therefore argue that the amount of all joint-deductibles is limited to 10% of the total damage. As a 'third' way, one could even argue that the individual mandatory deductible has to be reduced with reference to the individual rank of fault.

In conclusion, the question of joint and several liabilities remains unanswered: neither the VorstAG nor the legislative documents provide an informative basis concerning this point.

Summary

Despite criticism expressed from different sides during the legislative process, the German Parliament ultimately adopted a provision that might cause more problems than it solves. This is due to the fact that the German Grand Coalition of Conservatives and Social Democrats, with an eye towards the forthcoming elections in September 2009, felt compelled to convince the public of their determination in handling the financial crisis.

It remains doubtful if the aim of the VorstAG – i.e., to provide incentives for the sustainable growth of companies – will be achieved by obligating a regime of mandatory deductibles. The deductible may lead to an overly cautious business approach, as management board members presumably will become more risk-averse if they could be held liable for a minimum amount of 10% of the damage up to a minimum amount of 1.5 times the annual fixed salary.

Thus, it remains to be seen whether a mandatory deductible for members of the management board will alter decision-making processes (as intended) and lead to the sustainable growth of stock companies, or whether future executive remuneration will contain an additional element that provides insurance cover for deductibles. Those who profit most from the VorstAG may be those insurance companies that develop a new line of business selling German deductible insurance.

Notes:

1 Previously, even though the non-binding German Corporate Governance Code (GCGC) had recommended an appropriate deductible in D&O insurance contracts, most corporations and insurers did not comply.

2 Draft Bill, Bundestag Printed Paper No. 16/13433, p.17.

3 Nevertheless, pursuant to Art. 3.8 para. 2 cl. 2 of the revised non-binding GCGC and in contrast to the VorstAG, a deductible in the D&O insurance shall also be agreed upon for supervisory board members.

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