

Fraud – liability and insurability under German law and its impact on reinsurance

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Fraud in corporations is an ever increasing subject, mainly – but not only then – increasing steadily by the financial crisis and its effects. That is the case in practically all countries. The following article will deal with the problem and its insurance solution as well as its impact on reinsurers in Germany.

Sample losses

Losses are numerous, mainly in the first decade of this century. They are manifold, and they reach from forging balance sheets (cf. Enron, 2001) via snowball systems (cf. Flowtex, 2005), corruption (cf. Siemens, 2006) as big examples for large losses reaching billions of dollars or euros, down to computer crimes and finally the simple stealing of money.

The remedies under insurance law

The potential of losses and their excessive volume can be met by Fidelity Insurance and D&O-Insurance.

Fidelity Insurance has existed in England since the 19th century as 'Infidelity Insurance', however with very limited sums insured and applicable to expressly named persons only.

In this shape it arrived in Germany in the middle of the 20th century only, and since then its importance has increased considerably. German criminal statistics show amounts per year of €4bn to €5bn, just caused by own employees or managers of corporations.

The development of Fidelity Insurance in Germany

Fidelity Insurance in Germany is offered by only a few specialised companies which are active in the field of either industrial or credit insurance. At the same time the experience of those specialised insurers is a useful tool in the examination of what to cover in a special corporation, and it can very well complement the security measures taken by the insured corporation.

The coverage has been extended continuously, and it comprises now as a standard all willful acts committed by employees, relating to physical stealing of monies and goods, computer and systems manipulations, but also to losses caused by hacking computer systems by outsiders.

Insured are financial losses caused by 'white collar' crime, theft, embezzlement, fraud (including computer fraud), unauthorised transfer or use of trade secrets and other willful – thus not just negligent – acts.

This also includes financial losses of third parties, and normally the sums insured comprise to an extent

between 5% and 20% the reimbursement of loss detection and legal costs.

While this refers mainly to losses caused by own personnel, losses caused by outsiders are covered as well. Those are typically data misuse by third parties, losses by outside hackers, robbery, theft, forging of payment orders, credit card fraud and the like.

Specialties of fidelity policies in Germany

While all policies available in the German market contain a provision that the subject crime must have constituted a willful violation of law, an important difference lies in the timing of the loss event. Some policies insure merely losses which are committed and discovered during the policy period, and in addition they offer an additional run-off period of mostly up to three years in which a loss still may be discovered – while the crime was committed during the insurance period.

Other policies do not grant the run-off period, however they grant retroactive cover. This means that the crime may have been committed at any time before the policy period, as long as it is discovered during the policy period itself.

The ideal solution for the insured corporation would be a combination of both, and it is offered occasionally – however at a price, i.e., additional premiums.

Another crucial point is the series of losses clause. Here one finds all kinds of variations offered in the policies available in the German insurance market. It is essential to have a clause which covers, in particular and in an undoubtful manner; snowball systems and other perpetual crimes which are increasing in number by size and loss. This can be done by describing certain crimes which may particularly affect an insured corporation; it may also be achieved by a general clause referring to the time or economic context and the typical pattern of the crime to be insured.

The D&O-Insurance in the context of fraud

One may wonder about the mentioning of D&O-Insurance in the context of fraud crimes, as these can

by definition only be committed by willful acts while D&O-Insurance excludes such willful acts.

Nevertheless, both Fidelity Insurance and D&O-Insurance may tie in with respect to fraud which had been committed by crimes which were possible because the mandatory control and security systems failed or even were not in place at all. If such failure or lack of security systems has its reason e.g., in an improper organisation for which the directors (Executive Board, *Vorstand*) are responsible and these persons violated their respective duties negligently – and in no way willfully or intentionally – this is a matter for the D&O-Insurance.

D&O-Insurance in Germany

D&O-Insurance in Germany has existed since 1986, when it was introduced by two US-insurers. Resistance by German insurers and supervisors was strong at that time, and D&O-Insurance was regarded unnecessary due to the specialties of the German legal system.

This has changed in the light of jurisprudence and legislation, particularly in the last decade of the 20th century, but a specialty remains insofar as the typical D&O cover in Germany is not a third party cover, but a cover insured vs. insured (*Innenverhältnisdeckung*).

There it ties in that the German Fidelity Insurance protects a corporation against willful acts of its employees and certain outsiders; the German D&O-Insurance, however, protects the corporation against failures of its directors which caused financial damage to the corporation, but not based on willful or intentional acts or omissions.

Furthermore, under the Germany Fidelity Insurance the insurer has a right to subrogate against the direct tortfeasor on one hand, however the insurer may also turn to the directors of the corporations for subrogation, if these had negligently violated their organisational duties, thus making the fidelity crime and loss possible.

In order to avoid extensive subrogation litigation and negotiations it therefore appears feasible to corporations to combine fidelity and D&O-covers with the same insurer.

Implications for the reinsurance industry

Reinsurers must be aware of the above mentioned implications as their risk in respect of fraud losses is increasing. This mainly is due to the number and size of fraud claims. This is, however, also geared to the increasing tendency to insure fidelity risks at increasing sums insured. In the past, fidelity losses ranged in relatively narrow loss amount areas, mostly due to theft and other physically committed crimes. With the increasing amount of computer criminals and their possibilities this has changed drastically. If by pressing just one button millions may be moved away from their rightful owners into criminal hands and channels, the losses increase, and with them the risk of reinsurers. The corporations are aware of that and adjust their fidelity coverage accordingly. If then, as mentioned before, subrogation is faced with the fact that fidelity and D&O-covers tend to be insured more and more with the same insurer, and bearing in mind that D&O-covers do not open the avenue to subrogation against the failing director, it is obvious where the risk ends up: with the reinsurer.

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