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Management Liability

Corporate Compliance, Executive Liability and D&O Insurance in Germany

Corporate Compliance

The German Corporate Governance Code presents essential regulations for the management and supervision of German listed companies. It contains, in the form of recommendations and suggestions, standards for good and responsible Corporate Governance. With regard to Corporate Compliance, in Section 4.1.3 the Code stipulates: "The management board ensures that all provisions of law and the company's internal policies are complied with, and endeavours to achieve their compliance by the group entities (compliance). It shall also institute appropriate measures reflecting the company's risk situation and disclose the main features of those measures. Employees shall be given the opportunity to report, in a protected manner, suspected breaches of the law within the company, third parties should also be given this opportunity."

In a Keynote Speech at the German Institute for Compliance in summer 2016, Rolf Raum, presiding judge of the first criminal senate of the German Federal Supreme Court, summarised the requirements for an adequate Compliance Management System (CMS). First, pursuant to the principle 'tone from the top', the organisation's general ethical climate should be established by its senior management and be felt by the employees as a result. Creating such an environment by having a 'tone at the top' helps prevent fraud and other unethical practices. Second, a whistleblowing system or ombudsman is an indispensable component of a CMS. Finally, it is important that misconduct and noncompliance shall be penalised.

As best practice guidelines, "The Ethics & Compliance Initiative" (ECI) issued a Report "Measuring the Impact of Ethics and Compliance Programs" (ECI Report). The report lists the following objectives for companies to strive towards:

- Leaders are expected and incentivized to personally act with integrity.
- Values and standards are clearly communicated.
- Leaders create an environment where employees are empowered to raise concerns.
- All employees are expected to act in line with company values and are held accountable if they do not.
- Employees are provided guidance and support for handling key risk areas.
- Disciplinary action is consistently taken against violators.
- Investigations are objective, consistent and fair to all parties.
- The organization provides broad and varied avenues for reporting.
- The organization appropriately discloses wrongdoing with authorities.
- Key risk areas are identified through a robust assessment process.

In the landmark Siemens/Neubürger judgement, the District Court Munich addressed in detail the requirements for a compliant organization, as well as the related obligations of the management board. The management board's responsibility in the event of suspected compliance cases coming to light can be described as a 'threefold obligation'. First, the obligation to clarify the case (detect). Second, the obligation to put an end to unlawful behaviour. Third, the obligation to impose appropriate sanctions in response to violations that have been discovered.

In Germany, executive and supervisory board members oftentimes appoint law firms as outside counsel to conduct internal investigations as part of the overall Compliance Management System (CMS) once there is reasonable suspicion of corporate or individual misconduct. The wide repertoire of an internal investigation covers document review, email screening, interrogation of employees, the implementation of an amnesty programme, etc. Subsequent to the investigation, the executive board takes care of optimising the CMS so that similar noncompliance events are prevented in the future.

Audit reports from certified public accountants review the appropriateness and efficiency of the CMS. In Germany, such CMS audits are conducted on the basis of the standard IDW 980 issued by the Institute of Public Auditors (IDW). On the basis of this standard, the auditor reviews the CMS to establish: (i) if it is suitable to detect significant noncompliance events; and (ii) if it can prevent such noncompliant conduct from occuring (assessment of appropriateness), as well as if the CMS has been effective over the course of a specified period of time (effectiveness review). Particular fields of compliance covered by the audit report are the subject of the auditor's engagement letter (e.g. anti-bribery, cartel or anti-money laundering (AML) compliance). In addition, the geographical country scope of the audit needs to be defined. So far, mainly listed companies and large private corporations in Germany have appointed auditors to review their CMS.

Executive board members and supervisory board members can become targets of recourse litigation by the company for an insufficient CMS leading to financial losses due to administrative penalties and costly internal investigations. The German Federal Supreme Court assesses the adequacy of a CMS on a case-by-case basis (ex-ante approach), and adherence to the IDW or ISO standards is not necessarily a 'carte blanche' for executive board members' defence in litigation. However, the observance of the IDW standard can contribute significantly to defence, in particular with regard to the required documentation.

Dr. Burkhard Fassbach
Howden Germany GmbH

Executive Liability

Introduction

In the area of management liability, Germany is one of the most litigious countries in the world behind the United States and Australia. In almost no other jurisdiction are the risks for managing directors higher. The dot-com crash and the financial crisis led to a number of spectacular civil and criminal court cases against managers with high public profiles. These developments have arguably caused the courts to interpret the existing laws very strictly and have motivated the legislator to further increase the duties that managing directors – but also members of the supervisory board – need to fulfill.

In the following report, we will discuss some aspects of German law, which contribute to the high risks managing directors are facing nowadays. We will focus on the liability of board members in stock corporations, so-called AGs, and limited companies, GmbHs.

External liability v. internal liability

A fundamental difference of management liability under German law compared to, for instance, the United States is that, in most cases, damage claims are not brought by third parties like employees or shareholders but by the company itself. In conducting business, the board members owe a duty to the company to employ the care of diligent managers. Board members who violate their duties are jointly and severally liable to the company for any resulting damage.

The AG raises its claims against the management board through the supervisory board. Vice versa, claims against members of the supervisory board are to be pursued by the management board. If in a GmbH no supervisory board exists, the company is represented by its shareholders.

In AGs, the members of the supervisory board are legally obliged to pursue viable liability claims against the managing directors. If the supervisory board members fail to do so, they can be subject to damage claims themselves. This was stipulated by the Federal Supreme Court in its famous ARAG/Garmenbeck decision in 1997 and has just recently been confirmed in a decision issued in September 2018 (BGH, judgement dated 18.9.2018, II ZR 152/17).

Full liability

The liability of board members is generally unrestricted. Board members' private assets are subject to liability for the full damage they have caused, even in cases of only minor or slightly negligent breaches of duty. A single moment of inattention can financially ruin a board member. This is significantly different than the liability of ordinary employees, who enjoy far-reaching limitations of liability. The difference between board members and employees does not always appear fair, in particular if an employee of the parent company is ordered to serve as a managing director in an affiliate as part of his employment, possibly even without additional remuneration.

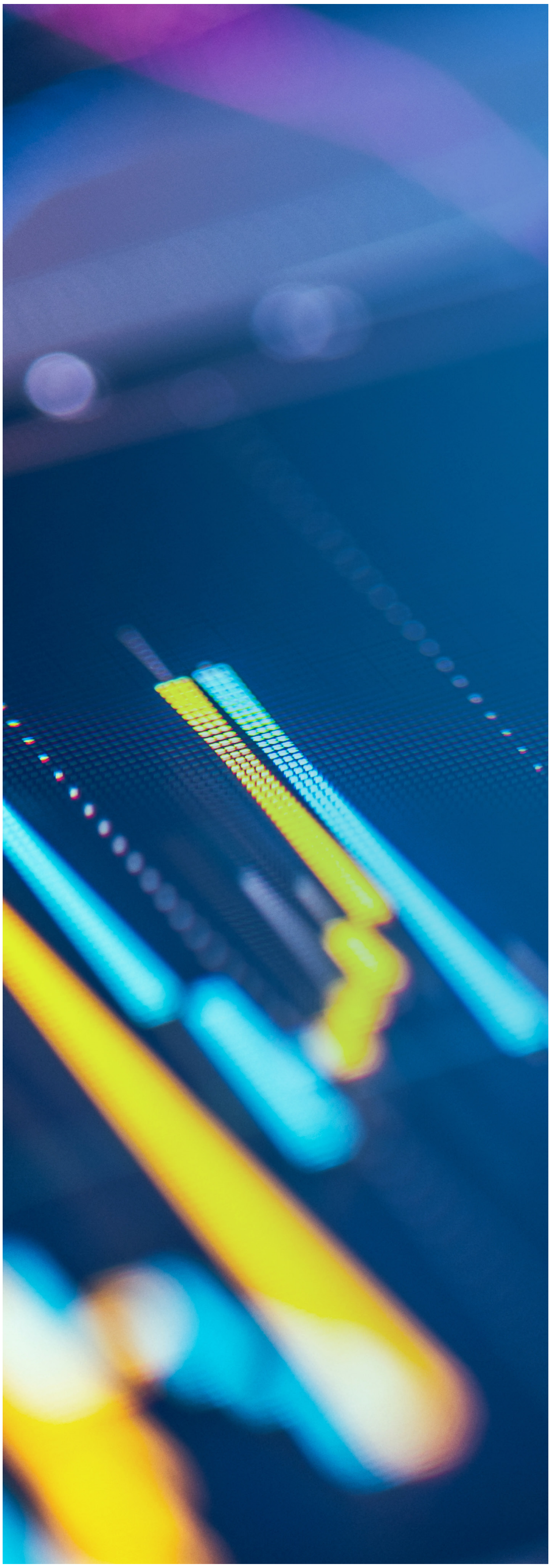
A possible defense for board members may be the 'business judgment rule'. However, at first, the business judgment rule is only applicable to discretionary business decisions and does not apply to acts or omissions that are required by law.

Moreover, the board members may rely on the business judgment rule only if they can demonstrate and prove that they carefully considered the options, took all relevant factors into account and arrived at a decision that appeared to be reasonable at the time.

Burden of proof

This brings us to another important risk factor: the burden of proof. The burden of proof factor heavily plays out in favor of a company that pursues damage claims against its actual or former management. The company only has to show that it suffered damage that was caused by an act or omission of the management. Then it is for the management to prove that it did not breach any duty or at least did not act culpably.

This is not an easy task for the board members, in particular if the alleged breach of duty occurred several years ago and the defendants have left the company in the meantime. German civil law does not allow for discovery. While it is accepted that a certain level of disclosure duties exists, scope and preconditions are highly controversial. Therefore, it might be impossible for the former management to obtain the information it requires in order to prove its innocence.



Limitation of liability and settlement

This leads us to the question if, and to what extent, the management can limit its liability. Here, one has to differentiate between AGs and GmbHs.

In a GmbH, the managing directors must follow instructions from the shareholders. If the managing directors act in line with such instructions, they cannot be held liable if the decision turns out to be detrimental to the company. Moreover, in a GmbH, the shareholders are, for the most part, free not to pursue damage claims against the managing directors or to agree on a settlement. Last but not least, the GmbH can agree on limitations of liability with managing directors in their service agreements. It is only the liability for intent that cannot be limited in advance.

In contrast, limitations of liability within an AG are hardly permissible. In the service agreement, the liability cannot be limited at all. Even settlements after the damage has occurred can only be concluded under very limited circumstances. Namely, only three years after the claims have arisen and only if such limitiation is approved in the general meeting and no minority whose aggregate holding equals or exceeds 10% of the share capital records an objection.

Like in a GmbH, the members of the management board cannot be held liable if they have acted in line with a lawful resolution of the general meeting. The management board can request the general meeting to resolve certain management decisions. In contrast, the approval of the supervisory board is not sufficient to exclude the management board's liability.

In the light of these risks, it is not surprising that board members regularly request D&O insurance from their company.

Dr. Ulrike Binder
Dr. Jan Kraayvanger
Mayer Brown LLP

D&O Insurance

Introduction

For the last 15 years, D&O insurance has been a tough market in Germany. This has led to extremely comprehensive insurance cover thanks to a wide range of coverage clauses. Recently D&O insurance has exploded with more than 50,000 German companies holding D&O policies today. And, as there are more than 50 D&O insurers competing for D&O contracts, D&O insurance pricing overall has declined in recent years. Claims ratios for most D&O insurers are just short of catastrophic.

Whether or not D&O insurers' deteriorating results will translate into comprehensive price increases remains to be seen. Given the continued abundance of insurance capacity, insurers pushing for rate increases will be facing some powerful headwinds. Recent important changes to the wording of D&O policies are the exceptions. Cover is often restricted in relation to the recovery of damages after payment of administrative fines against the company, antitrust violations, corruption and, most recently, 'fake president fraud'. Insurance brokers are bound by a duty to provide the best possible advice and must advise their clients that it is not just about getting the highest level of cover at the lowest premium. It is far more important to ensure support in the event of a claim.

The greatest objective must always be to achieve fast completion, often through settlement, so as to remove the individuals involved from the line of fire. The importance of D&O insurance in Germany is more and more frequently dawning on executive board members as a result of increasingly public liability proceedings. While executive boards in the past did not concern themselves with the perusal of their D&O policy until the emergence of a claim scenario, they are nowadays increasingly anxious that they be afforded with contractual assurance of the best possible D&O insurance cover prior to accepting an appointment to the board. The following parameters are of paramount importance for effective protection:

Insurance Sum

A risk-orientated, sufficiently high insurance sum is a crucial factor. A distribution problem arises as soon as the fixed insurance sum proves to be insufficient. The insurer's duty to pay proceeds within the insurance period is limited to the documented insurance sum per insurance case and for all insurance cases in the aggregate. Oftentimes, a very substantial sum of money is in dispute, and the sued director can only hope that the insured limit of the D&O insurance cover is sufficient to settle the asserted claim. In particular, because of the high legal expenses required to defend the claim are credited against the insured limit. The situation gets even worse if claims are made against several directors who have access to the insured limit of the same D&O Insurance cover.

Network of D&O-Expert Attorneys

The insured persons should ideally have immediate access to high-quality lawyers in whom they trust. There is, however, no free choice of lawyers in liability insurance. The selection must be made in unison with the D&O insurer. High-quality D&O conditions therefore provide that the choice of counsel and the fee agreement do not hinge on a consensus with the D&O insurer, as long as the lawyer is retained via a highly specialised lawyers' network. The insurer's fee guarantee should be tantamount to the usual hourly rates of prestigious lawyers in the field. Ordinarily, such lawyers will not render services within the scope of the Lawyers' Compensation Act.

Arbitration Proceedings

It needs to be borne in mind that the proceedings before the public civil courts (District Court up to the German Federal High Court) can last for many years and can be a massive burden for the parties involved. It takes an average of three-and-a-half years for medium-sized companies and five to seven years for large companies for a manager liability claim to run its course. The costs of these liability disputes already average 70% of the overall payments made by D&O insurers. Good D&O Policy Wordings stipulate that the insured person can request that the issues of Executive Liability and coverage disputes are subject to an arbitration proceeding and thereby avoid the publicity of a court proceeding and media adverse attention. New practical rules of arbitration tailored to the needs of executive liability cases will help to reach a decision on complex disputes in less than 12 months.

Highly qualified arbitrators are essential for the swift and cost-effective solution of D&O disputes. The arbitration award is legally binding and cannot be appealed. And, because the D&O insurer also participates in the multiparty procedure, the insurer must recognize the arbitral award and pay accordingly.

Cover in the event of set-off

Evermore frequently, policyholders have begun to declare that claims relating to employment contracts, in particular salaries and pension benefits and claims that arise from severance and termination agreements, are to be offset against liability claims that would be insured within the scope of the terms of the D&O Policy. This can result in severe financial liquidity problems on the part of the insured persons.

Therefore, good D&O Policy Wordings include provisions that enable continuing salary payments and assume severance payments.

Guarantee of Continuity

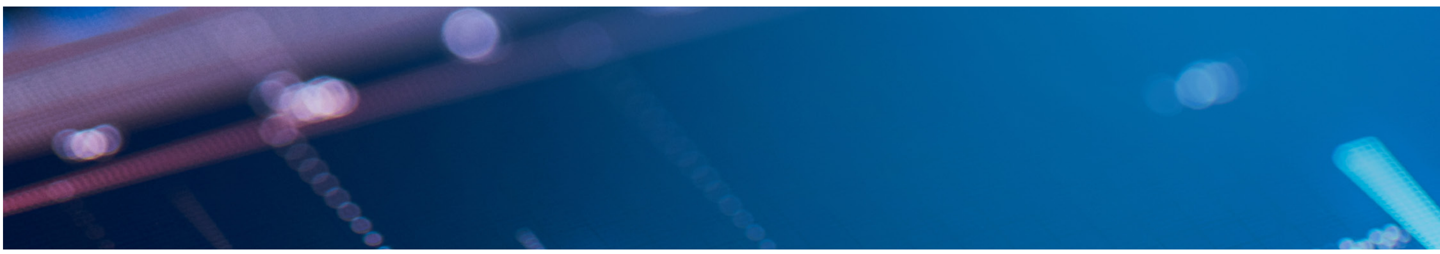
D&O policies are based on the 'claims made principle'. The timing of the first written claim is indicative of the determination of the insurance sum and the insurance conditions of an insured event. Accordingly, the time of the breach of duty is irrelevant. When an insurer demands coverage exclusions in the course of the annual insurance renewal extension (e.g., for corruption or antitrust violations), then this decrease in insurance coverage applies retroactively to any breach of duty. Subsequent compensation claims running afoul of such retroactive exclusions do not partake of coverage. Good policies offer a continuity guarantee and thereby exclude the retroactive effect that blights cover so that insurance exclusions only bear implications for the future. The guarantee of continuity provision stipulates that old liability remains covered and that, if the policy is continued with restrictions on its conditions and/or a reduced limit of indemnity then, with regard to breaches of duty committed prior to the amendment, the original scope of cover applies as agreed immediately prior to the restriction of cover and/or reduction in limit of indemnity.

Extended Reporting Period

The executive board members and managing directors have to keep in mind that they will be leaving the company – for whatever reason – at some time in the future. On the last day in office, they can still commit a breach of duty. Management liability claims for Managing Directors of a limited liability company and executive board members of a stock company become time-barred and lapse in five years. In the event the company is listed on the stock exchange, the claims lapse in 10 years. Claims made by financial institutions against its directors also lapse in 10 years. It is noteworthy that the period of limitation begins to run once the financial loss, which is caused by the breach of duty, occurs. In the event the policy is terminated, the Extended Reporting Period needs to be sufficient. The best corporate D&O policy wordings stipulate a 144-month extended reporting period. If the insurance relationship ends, claims remain insured that are made within 144 months after the ending of the policy if corresponding breaches of duty were committed during the policy term.

D&O Contract Law Protection Policy

D&O insurers oftentimes attempt to refuse insurance coverage by including exclusion circumstances or asserting pre-contractual breaches of notification obligations regarding the warranty statement about known issues. D&O contract law protection helps in this situation. The legal expenses in relation to the pursuit claims for coverage against the insurer are generally equivalent to the costs of legal expenses to defend the D&O claim in the liability proceeding under civil law so that there is an increasing risk that the legal expenses are doubled, with the effect that the insured persons are fighting a war on two fronts.
Supplementary D&O Contract Law Protection Policy is almost compulsory.



Two-Tier Trigger Policy

Separate D&O insurance for supervisory boards is downright essential in the German two-tier board system. In liability proceedings, an executive board tends to react according to the motto: “to attack is the best form of defence”. This approach threatens the supervisory board with recourse claims for contribution predicated on connivance and co-responsibility. As the monitoring of management rests with the supervisory board, any mistake made by the management can theoretically be converted into a mistake by the supervisory board. Between supervisory board, executive board and D&O insurer, this leads to extensive conflicts of interest. In the case of third- party notices, the D&O insurer shall refrain from simultaneously representing the opposing interests of defendant executive board members and notified supervisory board members. To understand this, just imagine a legal case in which the lawyer represents both the plaintiff and the defendant. It’s simply an impossible situation. The separation of management and monitoring calls for a separation of D&O policies. Ancillary to an existing policy for executive (and supervisory) board members, a company should put up a protective umbrella for the supervisory board members via separate supervisory board D&O insurance coverage with an independent insurer to resolve the conflict of interests (two-tier trigger policy).

D&O insurance at one’s own expense

Personal D&O insurance, which is also called individual D&O, has revived the German D&O insurance market in recent years. When considering Personal D&O insurance, there is one important reason for doing so, namely, the failure of the corporate D&O policy. This has become particularly evident in what happened around Siemens, when the liability of board members was reasoned in connection with allegations of corruption and the proof of a lack of compliance in the organization. For the first time, the demand for substantial own contributions of the concerned board members was made by the company Siemens itself and by the D&O insurers.

The need for personal D&O insurance is most understandable in the worst case scenario with the consumption of the D&O insurance limit. If, in previous years, the complaints usually corresponded to the insured amount of coverage, we now see more complaints that sometimes clearly exceed the insured amounts. Multiple maximizations of the limit are still rare so that hardly any protection can be offered with the consumption of the maximum annual limit. Especially managing directors from corporate groups with numerous subsidiaries recognize the problem and make arrangements with individual D&O policies. Depending on sectors and company sizes, exclusions are increasingly included in the corporate D&O insurance policy wordings.

The reluctance of insurers to cover claims from corruption and antitrust proceedings is widespread. Especially with claims-burdened policies, bargaining process with the insurer is often futile. Personal D&O cover, on the other hand, is usually granted without such exclusions. Private D&O insurance is secondary to the insurance cover of the company policy. Personal cover is therefore always used when the insurer of the company refuses to provide cover - for whatever reason. The personal D&O insurance can be extented to the statutory D&O deductible for management board members. Therefore, a joint cover with a uniform insured amount is provided, which should be at a multiple of the statutory excess amount.

Corporate D&O policies shall provide for a deductible of no less than 10 per cent of the damage up to at least an amount equal to 1.5 times the fixed annual compensation of the managing board member. For supervisory board members, it is possible to extend coverage for several mandates in different companies via a single personal D&O policy. With regard to the policy wording, the known rules of the game are applicable (i.e., exclusion only for wilful intent, no further coverage restrictions, precautionary legal advice in all its facets, unrestricted retroactive insurance cover and at best an unlimited extended reporting period).

Marcel Armon
Howden Germany GmbH

Contacts

Mayer Brown LLP

DR. ULRIKE BINDER
Partner, Mayer Brown
E: ubinder@mayerbrown.com
T: +49 69 7941 1297

DR. JAN KRAAYVANGER
Partner, Mayer Brown
E: jkraayvanger@mayerbrown.com
T: +49 69 7941 2271

Howden Germany GmbH

MARCEL ARMON
CEO, Howden Germany
E: marcel.armon@howdengroup.de
T: +49 211 940 83 35

DR. BURKHARD FASSBACH
Legal Counsel, Howden Germany
E: fassbach@fassbach.de
M: +49 152 54386727

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