

# KIRKLAND ALERT

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## German Court Ruling Denies D&O Coverage for Run-of-the-Mill Director Liability Claim

In a ruling that could have wide repercussions for, among others, German portfolio company management, the Appellate Court of Düsseldorf (*OLG Düsseldorf*) recently held<sup>1</sup> that a D&O insurance policy did not cover most claims asserted against a director under Germany's "wrongful trading" regime. Pursuant to sec. 64 of the German Limited Companies Act (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung* "GmbHG"), directors of German companies are personally liable for payments made by their companies after onset of insolvency to the extent such payments are not made with "due care," an exacting standard that has been held, for instance, not to apply to employee salaries. Claims against German directors and officers under sec. 64 can reach into the hundreds of millions of euros in larger cases, making the Düsseldorf court's opinion particularly relevant.

**The court denied D&O coverage for the most relevant claims against directors of a German company in a restructuring.**

While the court ruled based on an interpretation of the specific D&O insurance policy at issue in the case, that policy, on its face, provided for coverage for any "damages claims" made against a director. The court held that a "wrongful trading" claim under sec. 64 was not a "damages claim" (even though the amount to be recovered from the director is meant to compensate the company for harm suffered), but instead a claim "of its own kind" (*sui generis*) not covered by the terms of that policy.

If other courts were to follow the Düsseldorf court's holding, then absent explicit coverage in German D&O policies for claims brought under sec. 64 GmbHG German directors will face a massive increase in their risk exposure. Indeed, claims brought by insolvency administrators under sec. 64 are arguably the most relevant (based on frequency of assertion) and most significant (based on the amounts asserted) for German directors of troubled companies. Not having coverage for these claims would increase substantially the already significant exposure of German management in distressed situations.

### Background

In the case at hand, an insolvency administrator, as the court-appointed representative of the estate of an insolvent company with limited liability (*Unternehmergesellschaft, UG*, similar to a GmbH) had asserted claims based on sec. 64 GmbHG against that company's director in an amount of €221,801 in an action brought before the District Court of Mönchengladbach (*LG Mönchengladbach*). The amounts asserted were on account of certain unspecified cash transfers, after the alleged onset of the insolvency of the company but before the director had filed the company for insolvency. The lower court ruled for the administrator, ordering the director to pay the amount claimed to the insolvency estate.

Subsequently, the director submitted her claim to the company's D&O insurer, seeking indemnification of the amount owed to the estate. The insurer denied coverage, arguing, *inter alia*, that the director knowingly (*wissentlich*) violated sec. 64 sent. 1 GmbHG, thus triggering the D&O policy's denial of coverage provisions. The Düsseldorf appellate court ruled against the insurer on the "knowing violation" issue. Ultimately, however, it ruled against *the director* based on the terms and conditions of the policy itself. Specifically, the D&O policy provided for coverage for any "damages claims" (*Schadensersatzansprüche*) on account of financial loss (*Vermögensschaden*), asserted by the policyholder (i.e., the company) or a third party, including an insolvency administrator, against the director. The Düsseldorf court ruled that a claim under sec. 64 sent. 1 GmbHG does not constitute a "damages claim." The court based its interpretation on the argument that the purpose of sec. 64 sent. 1 GmbHG is not to compensate the company for actual damages suffered, but instead to preserve the estate for the benefit of creditors. Moreover, per the court, a claim under sec. 64 sent. 1 GmbHG would exist even if the company had not suffered any damage at all (given that the payments at issue to be recovered from directors presumably were made to satisfy due and payable obligations of the company). The court also noted that the German Supreme Court (*Bundesgerichtshof*) itself had held in other contexts that claims under sec. 64 sent. 1 GmbHG are claims *sui generis* and not "damages claims."

**The Düsseldorf court ruled that a claim under sec. 64 sent. 1 GmbHG does not constitute a "damages claim."**

The Düsseldorf court refused leave to appeal its judgment to the German Supreme Court. It remains to be seen whether the director will file an appeal against the denial of leave to appeal (*Nichtzulassungsbeschwerde*) and whether the German Supreme Court ultimately will take up the case.

### Claims under sec. 64 sent. 1 GmbHG

Under sec. 64 sent. 1 GmbHG managing directors of a German limited liability company (*GmbH*) are required to compensate their companies for any payments or reductions of assets made after the onset and discovery of the occurrence of cash-flow insolvency (*Zahlungsunfähigkeit*) or balance-sheet insolvency (*Überschuldung*).<sup>2</sup> Equivalent provisions apply to managing directors of stock companies (*Aktiengesellschaft*).<sup>3</sup> Negligence generally suffices to trigger liability. The company itself (or more specifically, the company's estate in an insolvency process) — and not the company's creditors — is the beneficiary of any recovery obtained from directors and officers. These claims, for practical purposes, are almost always asserted by insolvency administrators. German courts interpret the term "payment" broadly: it encompasses, for example, the offsetting of claims with company debts, the granting of loans to a shareholder or a third party, even if they seem recoverable, and the granting of collateral.<sup>4</sup> While the director has a defense to liability to the extent the relevant payments were (in light of the circumstances, including the circumstance of insolvency), "consistent with the due care of a prudent businessman"<sup>5</sup> this exception is interpreted narrowly by the German courts and the director bears the burden of proof.

Frequently, the dispute over liability turns on when actual insolvency occurred. In the case at bar, the company had filed for insolvency on 9 November 2011. The insolvency administrator argued that insolvency had already occurred on 2 August 2011. The lower court sided with the administrator. As a result, the insolvency administrator successfully recovered from the managing director of the company nearly all payments made by the company between 2 August and 8 November 2011.

### Precedent from the Celle Appellate Court

The Düsseldorf court relied extensively on a decision of the Appellate Court of Celle from April 1, 2016.<sup>6</sup> The Celle court had held that claims under sec. 64 sent. 1 GmbHG, as a general matter, are not covered by D&O insurance. The Celle court did not provide any reasoning on the issue, referring only to a legal treatise on insurance litigation.<sup>7</sup> Similar to the terms and conditions in the policy at issue in the Düsseldorf case, the terms and conditions in the case before the Celle court provided coverage for damages claims arising from financial loss.

**Directors would face an enormous personal liability exposure if D&O policies were held, as a general matter, not to apply to these claims.**

### The Implications of the Court's Ruling on Corporate Governance in German Restructurings

In almost any German restructuring transaction, German directors will be focused on whether their companies have a “going concern”, since the existence of a going concern will negate any balance sheet insolvency that may exist and absolve the directors from their obligation to file the company for insolvency. The going concern test requires a prognosis. Specifically, the director must demonstrate an overwhelming likelihood that the company will remain cash flow solvent during the current and subsequent business year. In any subsequent insolvency of the company, the insolvency administrator will undertake a rigorous review of and may challenge the director's going concern determination on an ex-ante basis. Typically, the administrator will seek to show that the company's going concern had ceased to exist — and thus that the director's filing duties had been triggered — at a much earlier point in time, with a view towards recovering from directors a significant portion of the payments made by the company between such earlier point in time and the actual filing date. In many high-profile German restructurings, this sort of approach has resulted in multimillion-euro clawback claims under sec. 64 sent. 1 GmbHG being asserted against directors and officers. As a result, D&O coverage for such potential claims against directors is essential for the continuation of a business during its restructuring. Claims under sec. 64 sent. 1 GmbHG are not only the highest, but also among the most frequent claims that insolvency administrators assert against directors. Directors would face an enormous personal liability exposure if D&O policies were held, as a general matter, not to apply to these claims.

### Critical Review of the Court's Ruling

As noted, the Düsseldorf court denied the director leave to appeal, and it is unclear whether the German Supreme Court would even allow such an appeal to proceed (though given the significance of this ruling, there are strong arguments that it should). Moreover, there are equally strong arguments that the Düsseldorf court's opinion should be overturned and, in any event, that other appellate and lower courts should not follow it.

First, the court's interpretation of the terms and conditions of the relevant D&O policy was inappropriate. At a basic level, under German law, contracts are to be interpreted in accordance with principles of good faith, in particular in consideration of the facts and circumstances known to the parties at the time the contract was entered into and in consistency with the purpose of the agreement. Here, the parties were well aware that claims brought under sec. 64 sent. 1 GmbHG are *the* most relevant claims assertable against a director in an insolvency scenario. The

court's subtle differentiation between "damages claims" and "claims sui generis" pursuant to sec. 64 sent. 1 GmbHG is therefore a distinction without a difference. Given the fundamental objective of D&O insurance policies in Germany — to protect the director against the often draconian consequences of Germany's liability regime — holding that standard policy terms are not meant to apply to the most frequently asserted and financially relevant basis of D&O liability would defeat the purpose of the taking out a D&O policy in the first place. In light of these circumstances, it is not unreasonable to expect from D&O insurers, to the extent they believe their policy does not or should not cover sec. 64 claims, that they explicitly exclude such coverage from the policy.

Second, the Düsseldorf court's interpretation of sec. 64 sent. 1 GmbHG was unconvincing. Contrary to the court's assertions, a director can submit exculpating evidence that a payment made subsequent to onset of insolvency did not actually reduce the corpus of funds available to creditors, and thus, cannot be recovered under sec. 64.<sup>8</sup>

Third, the court failed to consider that a director (or alternatively, and more importantly, the D&O insurer, to the extent it covers the liability) is subrogated to any sec. 64 claims recovered from the director, meaning that the insurer ultimately can recover at least a portion of any amount paid out by way of assertion of a general unsecured claim against the estate. The Düsseldorf court's argument that insurers cannot reasonably be expected to pay out such large amounts is thereby weakened.<sup>9</sup>

Fourth, contrary to the court's assertions, defenses to sec. 64 claims are not necessarily "limited" as compared to (other) "damages claims," undermining the Düsseldorf court's view that "damages claims and *sui generis* claims" are distinct categories for D&O insurance purposes.

Finally, the terms and conditions of the D&O policy itself explicitly provided for coverage of damages claims brought by third parties, *including insolvency administrators*.

## Conclusion

Directors of German companies — which include German portfolio companies of private equity and other funds — should immediately review the terms of their D&O policies and make appropriate changes to account for the Düsseldorf court's ruling. Moreover, any future policies should likewise account for the court's ruling to protect German directors going forward. The court's opinion is highly relevant for any director of a German company, in particular in any restructuring or distressed situation. To the extent other courts follow the Düsseldorf ruling and to the extent the ruling is not overturned on appeal, directors will lack protection with regard to some of the most frequent and highest liability claims currently asserted by insolvency administrators in litigation or out-of-court settlements. Although the precise terms of specific D&O policies may differ from the terms at issue in this case, a non-insignificant risk remains that future courts will take a similar approach for D&O policies that cover "only" financial loss and "damages claims" without explicit reference to claims under sec. 64 sent. 1 GmbHG.

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- <sup>1</sup> Appellate Court Düsseldorf, judgement dated July 20, 2018, ref. 4 U 93/16.
- <sup>2</sup> Under German insolvency law, directors are obligated to file a company for insolvency without undue delay, at the latest within three weeks of insolvency having occurred. A violation of this statutory obligation can trigger civil and criminal law penalties.
- <sup>3</sup> Sec. 92 (2), 93 (3), no. 6 Public Companies Act (*AktG*).
- <sup>4</sup> Cf. Haas, in: Baumbach/Hueck (eds.), *GmbH-Gesetz* (21st edn., C.H. Beck 2017) sec. 64 sent. 1 GmbHG, para 67.
- <sup>5</sup> Sec. 64 sent. 2 GmbHG; sec. 92 (2) 2 AktG. The exception would apply for example to payments made from an account with a debit balance, however, only if the the company has not provided collateral to the bank to secure debit amounts. In these cases, the creditor who receives payment would be subrogated to the claims held by the bank. The insolvency estate is not reduced, cf. German Supreme Court, July 4, 2017, ref. II ZR 319/15, NZI 2017, 809, no. 13. The exception also applies to the payment of employee withholding taxes, due VAT and VAT advance payments, the payment of employees' contribution concerning social security or the returning of privileged property to the provider secured by property. It also applies to payments for which adequate consideration has been provided and payments necessary to avoid the immediate collapse of the company.
- <sup>6</sup> Appellate Court Celle, order dated April 1, 2016, ref. 8 W 20/16, no. 38.
- <sup>7</sup> Oliver Lange in: Veith/Gräfe/Gebert, *Der Versicherungsprozess* (the insurance court process), 3rd ed., part E, no. 90-95.
- <sup>8</sup> German Federal Court, judgement dated November 11, 2014, ref. II ZR 231/13, no. 9.
- <sup>9</sup> German Federal Court, judgement dated January 25, 2011, ref. II ZR 196/09, no. 30.

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If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

Dr. Bernd Meyer-Löwy  
Kirkland & Ellis International LLP  
Maximilianstrasse 11  
80539 Munich  
Germany  
[www.kirkland.com/bmeyer-loewy](http://www.kirkland.com/bmeyer-loewy)  
+49 89 2030 6160

Dr. Josef Parzinger  
Kirkland & Ellis International LLP  
Maximilianstrasse 11  
80539 Munich  
Germany  
[www.kirkland.com/jparzinger](http://www.kirkland.com/jparzinger)  
+49 89 2030 6057

Carl Pickerill  
Kirkland & Ellis International LLP  
Maximilianstrasse 11  
80539 Munich  
Germany  
[www.kirkland.com/cpickerill](http://www.kirkland.com/cpickerill)  
+49 89 2030 6066

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