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EXPERT GUIDE 2023

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GERMAN D&O INSURERS

AVOID COVERAGE OF DIRECTORS' LIABILITIES IN INSOLVENCIES

By Dr Michael Malitz & Dr Leopold Bauer

On 7 December 2022, the European Commission published its proposal for an EU directive harmonising certain aspects of insolvency law (COM/2022/702 final). The proposal contains a directors' duty to submit a request for the opening of insolvency proceedings no later than three months after the directors become aware, or can reasonably be expected to have been aware, that the company is insolvent. Member States shall ensure that directors are liable for any damages incurred by the company's creditors as a result of their failure to comply with their filing obligations.

The proposal explicitly allows stricter national rules on directors' liability, and German insolvency law has always been stricter than the proposal requires. Under German law, company directors have a statutory duty to file for insolvency no later than three weeks after the company has become insolvent and no later than six weeks after it has become over-indebted (§ 15a (1) German Insolvency Act). Notwithstanding this – in both cases, very short – filing period, the directors are personally liable for any payment they make after the cash-flow insolvency or over-indebtedness occurred, unless they can prove that they acted with due and reasonable care (formerly § 64 German Limited Liability Companies Act, now § 15b (4) German Insolvency Act).

The directors' liability for payments made after the company has become insolvent or over-indebted is one of the greatest financial risks which a director can face during insolvency proceedings. Even in small and medium-sized enterprises, the damages claimed can easily reach seven-digit dimensions, which makes reliable D&O insurance cover a vital interest for almost every company director. Creditors and insolvency administrators, on the other hand, have come to identify D&O insurance policies as a welcome opportunity to increase the recovery value, whereas German D&O insurers have stepped up their efforts to avoid their duty to indemnify.

For a couple of years, insurers had been surprisingly successful at arguing before the lower courts that claims based on § 64 German Limited Liability Companies Act did not fall within the scope of German D&O insurance contracts at all. This was until the German Federal Court of Justice (*Bundesgerichtshof*) clarified, in November 2020, that standard terms and conditions of German D&O insurance contracts do cover this directors' liability. Since then, many D&O insurers have tried to find new ways to avoid cover.

Filing for insolvency: A major directors' duty?

One common argument of D&O insurers, which was approved by the Higher Regional Court of Cologne (*Oberlandesgericht Köln*) in November 2021 (9 U 253/20) and which has gained momentum in the legal debate ever since, is that a director commits a "knowing breach of duty" by making payments after the company has become insolvent or over-indebted. Usually, the insurer bears the burden of proof of any contractual exclusion of coverage such as demonstrating a knowing breach of duty. In this case, however, the court held that the payments made by the director had been in breach of a "major directors' duty" and there was, therefore, a rebuttable presumption of a knowing breach of duty.

In German case law, a rebuttable presumption of a knowing breach of duty is generally acknowledged if highly educated professionals such as architects, lawyers, tax consultants, or public notaries act in a manner which is contrary to the fundamental rules and regulations of their profession. The duty at stake must be part of the elementary knowledge which can be expected from each member of the profession. If that is the case, the German Federal Court of Justice uses the notion of a "major professional duty" (*berufliche Kardinalpflicht*) to indicate the rebuttable presumption of a knowing breach of duty. According to the Higher Regional Court of Cologne, the directors' duty to file for insolvency fits into this concept, even though becoming a company director does not require any professional training and even though directors in Germany do not act under the authority of a supervisory body (professional chamber) as architects, lawyers, tax consultants or public notaries do.

It remains to be seen whether other courts are willing to follow this lead. It may be difficult for an insured director (or an insolvency administrator) to rebut the presumption of a knowing breach and show that the director did not act knowingly. The lack of knowledge is a negative fact and therefore difficult to prove. If one party bears the burden of proof for a negative fact, the German Federal Court of Justice generally requires the other party to produce evidence for the positive fact first. Then, the party bearing the burden of proof for the negative has to show why this evidence is not convincing.

In any case, directors should meticulously document their efforts to monitor the company's financial situation and seek professional advice to fend off claims for damages and to secure their insurance's coverage.

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