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# D&O Insurance and Arbitration

Katica Tomić, Ph.D, LL.M

*Rechtsanwälte BVM, 1010 Vienna, Austrija, katicatomic123@gmail.com*

ABSTRACT: Directors and officers ("D&O") are required to act in a good faith and in the best interests of the corporation and to ensure that, the corporation is managed in accordance with the corporation's articles of incorporation and internal by-laws. D&O are personally liable for actions committed by the corporation within their scope of authority, and their own personal assets are at the risk in the event of a lawsuit against the corporation and its management or corporate insolvency. Today's complex business, legal and regulatory environment have increased the number of disputes involving the personal liability of D&O and D&O insurance, and the option of the more efficient, flexible, expert, and enforceable dispute resolution mechanisms, becomes the substantial interest of the parties involved. In this article, we discuss the general principles of D&O liability and D&O insurance, and relevant court cases concerning D&O liability and insurance coverage disputes in EU Law. Having in mind basic characteristics of modern insurance regulations, in particular, the need to protect a policyholders' interests and insurance customers and the premise that classic (commercial) arbitration is not *a priori* suitable for D&O insurance disputes, the author advocates introduction of specific integrated arbitration proceedings for D&O insurance cases. By assessing arbitration proceedings in D&O insurance, this analyze allows us to draw conclusion on whether the resolution of D&O insurance disputes by means of arbitration should be considered more often, or court litigation is more suitable for D&O insurance cases.

KEYWORDS: D&O liability insurance, EU Law, arbitration provisions, insurance companies, insurance coverage, integrated arbitration proceedings

## Introduction

Directors and Officers (D&O) liability insurance represents a type of property and casualty coverage for the corporate authorized representatives and executives, and include board members, directors and managers, and supervisory board members (Drave and Herdter 2018, 9). D&O liability insurance serves for two purposes: it protects the cooperation from some of potentially sizable losses resulting from breaches of duty by its own directors' and officers' (so called „internal liability cases") and it protects the insured directors and officers directly from claims against them in person for certain losses against which the cooperation does not or cannot indemnify them (Sagalow 2000, 5).

The legal nature of the D&O liability policy is complex. The contract is concluded for the insured person who is responsible for or involved in important decision-making for the corporation, or for the organization(s) itself, and it provides insurance in respect of claims made against an insured during the policy period (Vojković 2008, 1025). If insured persons commit a breach of duty (wrongful act) to the detriment of the company, and if the company asserts damage claims against such person, the D&O insurance is triggered for the benefit of the insured person. According to the Austrian law, the liability of managing directors or members of the supervisory board is based on corporate law and D&O must conduct the affairs of the company with the standard care and diligence of a prudent businessman complying with applicable laws and adhering to the internal rules and regulations of the company (Sec. 64(2) Austrian Limited Liability Company Act).

The D&O liability insurance was created and developed as a products tailored to the needs of cooperation practice especially as a result to executives' integral role in the day-to-day business and the detrimental consequences any breach of duty may have on the company, companies and their shareholders. Most D&O policies in EU insurance market cover claims of the insured company *vis-à-vis* an insured person (for example, claims for damages of a company against a manager based on his or her breach of duty) and third-party claims against insured manager or executive (Wagner 2015, 74; Spann 2018, 853).

Litigation has been the forum of choice for disputes concerning D&O liability and insurance coverage in EU countries over the past 20 years. The most commonly litigated disputes could be divided into two types. First type are differences in interpretation of insurance policies (for example, insurance policy language can be considered ambiguous if the language has more than

one reasonable interpretation) and second, factual circumstances material to the possibilities for action on the insurer's side (for example, cases were the insurer prove that the policyholder violated its pre-contractual duty to disclose).

The terms and conditions of D&O insurance policies offered by insurance companies or insurance intermediaries often include a „pre-dispute arbitration clause" which requires that any disputes that the parties have will be handled not in a court system, but through binding arbitration (Rohrbach 2011, 36). Many scholars and practitioners opinion is deeply divided on this issue but the frequency, volume and value of disputes involving the personal liability of company directors and officers and D&O insurance are steadily expanding (Duve 2009, 196). D&O claims are presumed to rise in the years to come and the choice of effective dispute-resolution mechanism becomes an increasingly important issue for the companies and insurers.

In the following chapter, we will introduce advantages and disadvantages of arbitration proceedings in disputes involving the personal liability of company directors and officers and D&O insurance.

**Directors and officer's liability insurance and arbitration**

D&O Insurance Market in Europe was rather limited before financial crises and economic recession started in 2009. According to current economic constraints of the financial crisis and financial pressures on reducing insurance operating costs, deregulation and liberalization of the insurance market, technological progress and social trends have increased competition amongst insurance players. The number of European countries have implemented changes in their legal systems that make it easier for aggrieved shareholders to collectively bring actions against directors and officers (Advisen Ltd 2014, 2).

Litigation has been the forum of choice for dispute resolution in EU insurance industry for many years. Most disputes arising from insurance contracts, unit-linked life insurance contracts, disputes involving the personal liability of D&O and D&O insurance are resolved in a court of law and rarely in another formal setting, such as arbitration (Döring 2010, 50). There are a relatively small number of papers, which have been published in the field of arbitration proceedings in D&O insurance while disputes regarding insurance coverage, reinsurance contracts, often contain an arbitration clause (Noussia 2013, 1). Although, insurance arbitrations are held on an *ad hoc* basic, nevertheless many organizations (ARIAS·U.S, LCIA, ICC) provide rules for the conduct and administration of such arbitrations (Zelst 2016, 35).

When parties find themselves in disputes arising from D&O policies, general or special business liability insurance, professional indemnity policies as well as international personal injury insurance, there is often a lot at stake and the interests of many can be affected (Tomic 2016, 542). D&O litigation frequently involves complex cases, class action allegations and/or alleged violations of unfair trade practices (UTPs) under EU competition law. Bearing in mind that D&O claims can result in corporate and personal reputational and financial damage, regulatory investigations and prosecutions, D&O disputes are often handled strictly confidentially and often settled out of court (Duve 2009, 179).

The decisions regarding whether to include an arbitration clause in a D&O liability insurance policy and what provisions to put in it, as well as whether to take advantage of arbitration once a dispute arises, are very challenging. The popularity of arbitration for D&O cases is not based just on large number of its advantages (speed, cost-efficiency, primacy of party autonomy; free choice of arbitrators with legal/technical/commercial expertise; finality of the award; facilitation of amicable settlement; worldwide enforceability of the award under New York Convention), but upon the hope of the parties to the contract that by employing arbitration they can maintain confidentiality of the proceedings and a degree of control over the intensity of the dispute and the methods used to resolve it (Berger 2015, 284).

Notwithstanding the above advantages, there are certain disadvantages of using arbitration for D&O insurance cases over the judicial system. While speed and cost-efficiency have been regarded as advantages of arbitration, users today increasingly complain that the arbitration frequently turns

out to be extremely complex in practice. This is only relatively true because the time-and cost efficiency in arbitration depends on the parties, their representatives and the arbitrators themselves (Welser 2013, 1279). Generally, arbitration proceedings will result in quicker dispute resolution than in the court system if the parties, their representatives and the arbitrators truly aim at conducting efficient proceedings. This, in turn, reduces the costs of reaching a resolution even in disputes, which involve the personal liability of company directors and officers and D&O insurance (Lachmann 2008, 45).

In Germany, directors' and officers' liability has peculiarities and disputes regarding the personal liability of company directors and officers often end with early settlement of a dispute. Under Sec. 278(1) of the German Civil Procedure Code the judge is expected, throughout the proceedings, to look out for opportunities for an amicable solution of the dispute and this represents the advantage of arbitration and effective way of minimizing cost and cycle time in dispute resolution (Ehle 2010, 80). Moreover, where stock corporations (germ. *Aktiengesellschaften*) are involved, the provision in Sec.93(4) German Stock Corporation Act has to be taken into account. According to this provision, the members of the management board shall not be liable to the company for damages if they acted pursuant to a lawful resolution of the shareholders' meeting and the company may waive or compromise a claim for damages not prior to the expiry of three years after the claim has arisen. Thus, in individual cases at least, may seem the perfect tool if both parties have interest to postpone arbitral decision but it will not itself hinder an award.

D&O liability and insurance disputes often involve complex legal and factual relationships on insurance coverage, which appear in many different forms and often rotate around matters of interpretation and/or the scope of coverage between the insurance company and the insured. In D&O cases, arbitration proceedings above all come into play in practice in disputes concerning D&O policies and employment-practices-liability policies. Insurance contracts are formed based on ordinary rules of contract law and the arbitration clause is the only source of authority for which the law provides mechanisms of enforcement in an attempt to fill gaps left by the parties (Noussia 2013, 39). In this context, it is important to make sure, especially where several members of management may possibly participate in the same arbitration, that the arbitration agreements have been drafted properly (Berger 2015, 316).

Moreover, high profile D&O disputes often involve third parties, particularly in relation to liability insurance and indemnity matters, and raise commercial and/or technical aspects of the case. The decision to nominate certain person with commercial expertise and market knowledge for party-appointed arbitrator is extremely important and it lays the basis for a constitution of arbitral tribunal (Tomic 2017, 116).

The advantage of having members of the panel with commercial expertise and market knowledge can be disadvantage in the D&O cases. D&O cases raise the risk of conflicts of interest at the level of the selection of arbitrators higher than for state courts. This can be avoided if the selection of arbitrators is performed diligently on the grounds of their specialist knowledge of the insurance practice in question, and with due consideration of the each individual case. According to the Part 6, section 6.3 of the ARIAS Arbitration Rules (AAR), the ARIAS UK arbitration court prescribes as a requirement for the registration of an arbitrator on the list of arbitrators, qualification of with not less than ten years' experience of insurance or reinsurance within the industry or as lawyers or other professional advisors serving the industry. Part 6, Section 6.2 ARIAS U.S. Arbitration Rules allows for a current or former managing officer of an insurance company or a reinsurer, or an arbitrator certified by ARIAS U.S. to become an arbitrator or umpire. Explanatory note to Article 4.1.4 of AAR, the ARIAS UK and ARIAS Fast track arbitration rules (AFTAR), recommend that the qualification requirements for arbitrators may be set by the litigants themselves, which is taken into consideration by some permanent arbitration courts in their arbitration rules, where they require the parties to provide brief personal details of qualification for arbitrator expertise in the industry or legal specialty in which they will handle disputes.

Arbitration clauses in D&O and other liability insurance raise concerns if it is possible to conduct arbitrations in a multiparty context (for example, an D&O insurer or members of governing

bodies of the company may be interested in involving an intervening in a D&O dispute). In a multiparty context of insurance disputes, the insurance contract may be reinsured by one or number of re-insurers who may have a dispute resolution clause providing for arbitration with the insurer but may not have a provision that allows for multi-party dispute resolution of a claim relates to a single cause of action (Noussia 2013, 227).

From this point of view, the litigation in court has significant advantage over arbitration because it is considerably easier to involve third parties in state court proceedings. However, securing an effective multiparty proceeding of D&O cases depend on the careful harmonization of the arbitration clauses contained in different but interlinked contracts.

This list of advantages and disadvantages of arbitration proceedings in D&O insurance is not exhaustive and this paper only includes some specific examples. Moreover, each D&O case has its own peculiarities and it is necessary to distinguish characteristics such as severity of claims, expression of consent to arbitration for D&O dispute, coverage disputes or possibly even combined treatment of liability and coverage topics in the same proceedings and reaching mutual consent to arbitrate.

**Integrated arbitration proceedings of D&O cases**

As the increasing of number of D&O liability and insurance contracts necessary increase disputes, there is an interest in developing efficient resolution for D&O liability and policy cases. Generally, there is no real difference between litigation and arbitration, as both are proceedings where a neutral and impartial third party decides the dispute between the parties and renders a final and binding decision. However, more important, there are practical differences between litigation in arbitration versus in court (Noussia 2013, 322). Although litigation and arbitration both have advantages, litigation, however, might be a better option for D&O disputes because it provides greater power to obtain provisional relief, a far more extensive discovery and the ability to join related parties.

It is often suggested that arbitration is not convenient for D&O disputes because these cases can involve complex legal issues arising out of a liability and coverage issues, which should be dealt with in the same proceedings. Recently there has been much discussion on integrated arbitration proceedings of D&O cases in order to improve the efficiency of D&O dispute resolution.(Sieg 2015, 1). The integrated concept of arbitration of D&O cases aims that all details of the case such as loss event, liability and coverage aspects should be resolved exclusively by the company and the D&O insurer. The characteristics of proposed D&O arbitration includes that the direct action between the company and the D&O insurer, the matter of liability will be dealt with as an ancillary matter that is a requirement for the indemnification entitlement (Sieg 2015, 4).

Applications of integrated arbitration proceedings induces additional practical problems such as the question of admissibility of integrated arbitration proceedings of D&O cases and jurisdiction (Pauker 2015, 2). For many companies, arbitration provisions are initially attractive but the selection of arbitrators could be very difficult because insurance companies use the same arbitrators in all their cases and the current "party-selection" potentially leads to a systemic bias in favor of D&O insurer (Park 2015, 15). D&O liability and insurance disputes are separated at the state courts because they often require special judicial expertise. However, in integrated arbitration proceedings, the same arbitrators will have to decide both liability and coverage issues. The decision to nominate certain person with commercial expertise and market knowledge for party-appointed arbitrator is extremely important but integrated arbitration proceedings demand a broad knowledge which raises the question whether the same arbitrators are competent to decide on both these subjects.

We can conclude that integrated arbitration proceedings bring a variety of practical problems but it can certainly turn out to be the settlement of disputes in individual cases.

**Conclusion**

The insurance market in EU has become more dynamic and the number of complex insurance disputes, including D&O cases, are on the rise. As the economic and legal environment of the twenty-first

century is characterized by an increase in the number of regulations regarding corporate directors, and by the permanent rising of the standards of their liability, it is difficult to imagine contemporary business without having the institute, which decreases corporate risks. For many years, insurance sector has shown a marked lack of faith in arbitration and had no incentive or particular advantage to utilize private and quicker dispute resolution methods for insurance disputes. The arbitration offers advantages for all the parties involved in an insurance dispute (the insurer, insured and injured party) and the importance of arbitration is growing, especially for disputes involving directors' and officers' liability, coverage disputes and D&O insurance. There are numerous advantages to arbitration, but, also, some disadvantages which is why some D&O liability and coverage disputes are better to resolve in the courts. Integrated arbitration proceedings or settlement of liability and coverage claims during the same proceedings, has to be viewed critically, especially the fact that it can create the issue of an uneven level playing field between the claimant and the D&O insurer in same disputes.

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