ALTA SIGNA

A view on the German market:

Excess layer issues

Bulletin from Alta Signa and DWF

dwf

www.dwfgroup.com

www.altasigna.com

A view on the German market:
Excess layer issues

Although widespread in business for a long time, but perhaps rather exotic in legal case handling: excess insurance raises a multitude of legal issues in Germany. By skilfully drafting and coordinating contracts, all parties involved can avoid conflicts and minimise risks in the settlement of claims. If this does not succeed, legal interpretation will be required in the event of a dispute. This is because German insurance law does not explicitly regulate excess insurance. **Maximilian Moll** from **Alta Signa** and **DWF Germany**'s dispute experts **Jan-Ulf Suchomel**, **Michael Zierhut** and **Lea Christ** on the potential and possibilities of excess insurance in German legal transactions

Spotlight Germany:
Legal Challenges for Excess Insurance

In current market events, large companies see themselves challenged with claims in the billions in liability cases. One of the best-known example in the recent past is certainly the VW diesel scandal. In practice, a single insurer does not bear such large risks alone. It requires many shoulders to provide a sum in the hundreds of millions as insurance cover. In view of their enormous economic significance, the coverage of major risks - especially in D&O insurance - is practically impossible without the concept of excess insurance.

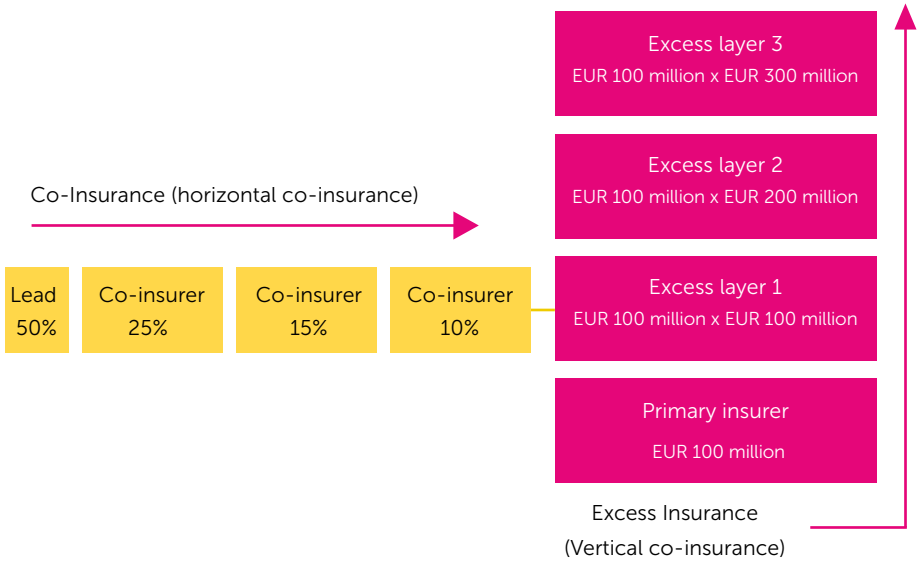
What is excess insurance?

Excess insurance is a layered supplementary insurance that covers sums in cases of damage that exceed a certain primary insurance sum. Benefits from excess insurance are only paid if a claim exceeds the primary insurance sum. Due to the different distribution of risk for the layers involved, the premiums are usually lower the further down the chain the excess is from the primary insurance.

Large losses are thus covered by insurance policies that build on each other. This leads to a double matrix of horizontal and vertical co-insurance:

- The first level is the primary insurer, who is liable in the event of an insured event up to the amount of his individual liability sum (primary insurance sum). For losses exceeding the primary insurance sum, a number of excess layers are available after the primary insurer as fall-back insurers. The first excess after the primary insurer is thus liable in the event of a claim with its individual liability sum for claims that exceed the primary insurance sum. If both the primary insurance and the first excess layer are not sufficient to meet the loss, the second excess in turn absorbs the next tranche of loss. Depending on how many excesses are involved in the relationship, this scheme is repeated until the last excess in the chain. In practice, any number of excesses can be involved in an insurance relationship. This results in vertical co-insurance.
- Sometimes several insurers participate in a particular excess layer, which results in horizontal co-insurance.
- In this way, any number of insurers successively share a risk.

The so-called excess or insurance tower is as follows:



Legal classification

Excess insurance is not yet regulated in German law, co-insurance only cursorily. For both types of insurance, individual insurance contracts are therefore concluded between the policyholder on the one hand and each excess and co-insurer on the other. The rights, duties and obligations between the policyholder and the respective insurer must consequently be assessed separately for each individual contract, as these are legally independent legal relationships.

In practice, such insurance towers are therefore difficult to handle, especially for the policyholder, and carry the risk of confusion and impracticability. In the event of an insurable event, the policyholder for example would have to inform each individual insurer involved in the insurance relationship about the loss event, each within the scope of his specific legal and contractual notification obligation for that insurer, in order to avoid adverse legal consequences such as a reduction of the claim.

How does excess insurance work in practice?

A large tower of cover as described can easily involve a double-digit number of participating insurers. For the policyholder, it would be a great challenge to have to correspond with each and every one of the insurers in the event of a claim. It is possible to design towers in a way to alleviate these problems, but inevitably that means that some participants in the tower forfeit some power or freedom of choice.

Settlement at horizontal level: lead clauses

Almost all co-insurance contracts on the German market contain so-called lead clauses. According to these, one insurer, the leading insurer or also called lead, is entrusted with the entire contract handling. The lead insurer has rights vis-à-vis the policyholder, but is also responsible for the obligations of the co-insurers vis-à-vis the policyholder. As a rule, the lead also acts as the sole contact person for the policyholder and is authorised to receive notifications and declarations of intent from the policyholder on behalf of all co-insurers.

The internal relationship between the lead and the co-insurers involved, however, is not always the same and depends on the individual agreements in each case. The question of to whom risk-relevant circumstances must be reported or to whom an insured event must be reported cannot therefore be answered in a general way. For example, a leadership clause may authorise the lead to bind all co-insurers in all decisions (strong-lead clause). In other cases, the lead has a pure duty to inform and the co-insurers make the final decision on the insured event themselves (soft lead clause). Legally, a lead clause establishes an agency agreement or mandate which obliges the lead to act in the interest of the co-insurers it represents. Resulting breaches of duty can lead to the lead's liability to pay damages to the co-insurers.

Settlement at the vertical level: A challenge for the policyholder

However, within the vertical matrix, i.e. between primary and excess, lead clauses are hardly common. Each excess initially retains its settlement sovereignty and is not bound by the assessment of the claim, cover notes or similar decisions of the primary or the excesses before it. This can lead to a fragmentation of claims settlement: In the event of an insured event, the primary and the excesses examine independently of each other the "whether" and the "how" of the defence or settlement of the potential claim within the framework of the sum insured assumed by them.

This gives rise to a number of questions, both in terms of substantive law and procedural law, if individual contractual provisions between the primary and excess layers are missing, incomplete or diverge in terms of content. In the worst case, the policyholder must expect that his claim will not be fully settled. Publicly available case law on this topic is scarce.

Disputes are usually settled in non-public arbitration hearings.

Support from the insurance broker

If the policyholder purchases excess insurance from an insurance broker, care should be taken to ensure that appropriate so-called notification clauses are agreed. This means that the insurance broker acts as the main contact person for the policyholder. In this way, the policyholder can - ideally - submit notifications and declarations only to the insurance broker but with effect vis-à-vis all insurers involved.

Rules on alternative dispute resolution

Also to be considered is the issue of alternative dispute resolution in the case of excess insurance. In practice, settlements are often desired and achieved to avoid expensive coverage disputes. However, in the absence of any contractual provisions on this issue at the excess layer level, disputes are to be expected as to whether settlements at the lower levels should be binding on the excess insurers involved. This can be particularly difficult if individual excess insurers block settlements out of self-interest. Sometimes there is a desire, less for legal reasons than for reasons of perceived justice, to distribute settlements among certain excesses, even if the settlement sum does not strictly reach those excess layers, but there is a risk of this if the case proceeds to trial and an adverse conclusion. It might be helpful for there to be some guidance or regulation across layers that leads to clarity in the event of such a case.

In summary, in view of the (still) uncertain legal situation in the settlement of claims due to large insurance exposures, particular care should be taken to ensure a clear and structured contractual arrangement of the individual insurance relationships involved in a tower of insurance. Only in this way can it be ensured in the event of an insurance claim or dispute that the parties involved have clearly defined rights and obligations vis-à-vis each other and both time, money and resources can be minimised in the settlement of claims.

Absence of contractual regulations: What now?

If no suitable structure has been agreed in advance to link and coordinate the primary insurance and the excess insurance relationships, disputes are inevitable. Commentators in German legal commentaries have divergent views on what is the material basis of the layer structure. Some say the different layers are each individual legal relationships with protective effect in favour of third parties (“zugunsten Dritter”). That legal construction results in duties of cooperation and consideration. Others see it as a partnership without written codification simply by reason of the parties joining the excess tower.

Either way, one will have to rely on the argument that a fiduciary duty relationship exists between the insurers involved, which requires mutual consideration and which is enforceable in court. Finally, it is clear that the insurance relationships insure one and the same risk of the policyholder and are thus factually connected. The sense and purpose of excess insurance therefore require that a legal connection be affirmed as well and that mutual responsibility be imposed on the parties involved.

At this point in time, it remains to be seen whether the topic of settlements by excess towers of insurance and, in particular, the highly relevant questions surrounding the conclusion of a settlement in practice will find their way into case law and whether clear specifications and guidelines for legal transactions will be developed in this regard. In any case, it is better to formulate clear rules with help of your broker or lawyer in advance. Otherwise, in the event of a dispute, it will be necessary to convince the other parties involved to accept one’s own interpretation of the contractual position.

Maximilian Moll

Branch Manager DACH, Alta Signa

Michael Zierhut

Associate, DWF Germany

Dr. Jan-Ulf Suchomel

Partner, Head of Insurance (Germany)

Lea Christ

Associate, DWF Germany

ALTA SIGNA www.altasigna.com

www.dwfgroup.com