Hedging liability risks for management in the context of corporate transactions through insurance solutions

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The management of the target company plays a key role in all phases of the transaction process for the successful completion of the transaction. Building on a brief overview of the role of the target company's management in the transaction process (I.), this article discusses typical liability risks for management (II.) and provides an overview of possible insurance solutions (III.).

I. The role of the target company's management in the transaction process

1. Overview of management involvement in the transaction process

The management of a company is typically involved to varying degrees at all stages of a transaction process.

(a) Preparation phase

In the preparatory phase of a transaction, management is usually intensively involved in the process of obtaining and preparing due diligence information due to its extensive knowledge of the target company's operational processes. In addition to the compilation of the data room materials, this includes in particular the participation in the preparation of an information memorandum and the performance of a seller-side due diligence.

(b) Implementation phase

The preparation phase is regularly followed by the actual transaction process. This is typically designed as a bilateral process with a single buyer or as an auction process with several bidders and includes, in particular, the performance of due diligence on the buyer's side and the negotiation of the transaction documentation.
(aa) Due diligence and contract negotiations

Depending on the details of the specific transaction, the management of the target company will be involved to varying degrees in the due diligence and contract negotiations. However, it is possible to identify topics in which the management is typically involved. These include in particular:

(i) Answering questions from the buyer as part of the due diligence Q&A process, further disclosure;

(ii) Participation in management interviews, expert sessions and site visits;

(iii) Participation in the contract negotiations with regard to topics with strong operational relevance and/or direct impact at the level of the target company[1].

(bb) Period between signing date and execution date

The positive conclusion of the due diligence and the signing of the negotiated transaction documentation is usually followed by a period during which the prerequisites for the completion of the transaction are brought about. This typically relates to the execution of measures and M&A transactions to structure the transaction parameter, obtaining antitrust clearance, obtaining necessary foreign trade approvals or obtaining declarations of consent from other third parties to the transaction (including contractual partners of the target company).

During this period, the management of the target company shall in particular be subject to the following duties to cooperate:

(i) Management of the business operations of the target company in compliance with the provisions of the sale and purchase agreement in the ordinary course of business;

(ii) Possible refinancing of the target company, in particular redemption of shareholder loans and securities of the seller;

(iii) Participation in bringing about the execution conditions, insofar as these require participation on the part of the target company;

1 This applies in particular to guarantee commitments for the operating business, the monitoring of ongoing business activities with regard to key negotiation parameters, the coordination of necessary transitional service arrangements, etc.

(iv) Assisting in the delivery of a bring-down declaration provided for in the company purchase agreement with regard to warranty and indemnity insurance;

(v) Participation in the takeover of the company by the buyer (as far as permissible under anti-trust law).

2. Special case: management guarantee declarations

The buyer's assurance with regard to the correctness of the material basic assumptions of the transaction typically takes the form of guarantee and indemnity declarations by the seller with regard to the legal, economic and tax circumstances of the target company.

More recently, the management of the target company has also increasingly been asked to provide guarantees or confirmations. These are usually declared outside the actual company purchase agreement in the form of management warranty deeds or management letters. The background to this is that the management usually has special knowledge of the target company and also of the target company's sector. On the one hand, this knowledge is of central importance for buyers, especially when acquiring from financial investors as sellers without participation in the operative management. On the other hand, financial investors as buyers secure their investment decision within the framework of the acquisition by means of guarantees of the management, which is regularly to continue to manage the target company operationally even after the completion of the company purchase agreement. In the context of the exit, these financial investors will then in turn rely on the management to carry out the disclosure and due diligence process.

At the same time, financial investors on the buyer side are not primarily interested in having recourse to their (then) own management. Rather, they want to ensure that their investment decision was based on complete and accurate information. Management guarantees are usually issued as independent guarantee promises within the meaning of § 311 para. 1 BGB (German Civil Code) with partial debtor liability and on the basis of individual positive knowledge of the respective individual member of the management.

However, a legal obligation of the management to issue management guarantees will have to be denied in view of the risk of personal liability, despite the existing corporate and contractual obligations of the management[2].

3. Interim result

In summary, the tasks of the target company's management in the transaction process can be summarized in the following central complexes:

(i) Fulfilment of the disclosure and disclosure obligations as part of the disclosure and due diligence process;

(ii) Participation in the contract negotiations and the closing of the transaction as a going concern in accordance with the transaction documentation;

(iii) If applicable, issuance of management guarantees.

II. Liability risks within the scope of duties and possible insurances

1. General standard of liability

With regard to the liability of the management, the standard of care of a prudent businessman will regularly have to be applied as a standard of care[3]. In principle, managing directors and board members are liable even for slight negligence[4]. A mitigation of liability according to the case law rules on business activities is generally not possible[5].

In this context, management is always bound by law (duty of legality), while the principles of the business judgement rule apply to entrepreneurial decisions. According to this rule, a breach of duty with regard to an entrepreneurial decision does not exist if the management could reasonably assume to act in the best interest of the company on an adequate basis of

2 Seibt/ Wunsch ZIP 2008, 1093, 1097 f.
3 Cf. e.g. § 43 para. 1 GmbHG, § 93 para. 1 AktG.
4 MüKoGmbHG/Fleischer, 3rd ed. 2019, GmbHG § 43 marginal no. 256 mwN; MüKoAktG/Spindler, 5th ed. 2019, AktG § 93 marginal no. 198 mwN.
5 BGH, NJW 2001, 3123, 3124; MüKoGmbHG/Fleischer, loc. cit.

information. Within this framework, the requirements for determining the facts - including an examination of the legal situation with the advice of professionally qualified professionals, with a plausibility check of the advice given by the management - are to be observed in particular. [6]

2. Disclosure and due diligence process

In the context of the disclosure and due diligence process, there is initially a contradiction between the management's obligation to maintain secrecy on the one hand and the acquirer's interest in the most comprehensive disclosure possible on the other. [7] Disclosure of secrets and confidential information of the company should always be oriented towards the progress of the transaction; misuse of information must also be counteracted by the management of the target company, insofar as it is involved in the disclosure process. In this respect, a transaction-related confidentiality agreement will usually have to be ensured. [8]

In addition, the management of the target company is exposed to the risk of breaching disclosure and information obligations vis-à-vis the acquirer. The management involved by the seller is obliged to inform the acquirer about such circumstances that may frustrate the purpose of the transaction and are therefore of material importance for the acquirer's decision, provided that the acquirer could expect the information according to the prevailing market opinion.[9] Unverified information must not be passed on in such a way that the addressee is given the impression that it has been verified; in particular, information "in the dark" must be avoided[10] in order to avoid liability for fraudulent intent. The corresponding disclosure and clarification obligations are of particular importance if the management is involved in the issuance of guarantees in the company purchase agreement (in particular as a person with knowledge on the seller's side) or issues management guarantees. This applies in particular in the case of warranties regarding the completeness and accuracy of the due diligence information, in the preparation of which the management will also typically have played a leading role.

However, if the management acts in implementation of a shareholder resolution when making the disclosure, the selling shareholder must accept the management's conduct and the management is generally not liable[11]. However, if the management deviates from a shareholder resolution or binding instructions of the shareholder or even relies on its own trust, the management's own liability may be considered[12].

3. Participation in the contract negotiations and the execution of the transaction

Within the scope of participation in the contract negotiations, there are in turn duties of clarification and disclosure, particularly in the area of operational guarantees and contractual disclosure. In addition, there is an obligation of neutrality, especially in bidding procedures. The management must act out of a duty of loyalty free of conflicts of interest and extraneous influences. [13] In particular, it may not influence the selection of the shareholder. In principle, gifts and other benefits from third parties in connection with the transaction may not be accepted[14].

In the course of the execution of the transaction, the management is subject to the general due diligence obligations, whereby again the principles of the business judgement rule apply. A particular aspect here is the implementation of measures under company law and preparatory M&A transactions for the final design of the transaction perimeter. These can lead to significant liability risks for the target company and – with regard to conceivable board liability claims – also for the management.

4. Special case: management guarantee declarations

With regard to management guarantees, liability of the management arises due to the general qualification of knowledge only in the case of intentional action, whereby statements "into the blue" are to be avoided by the management in particular.

III. Insurance solutions for management liability risks

With regard to the available insurance solutions, it emerges that various insurance solutions protect management against typical liability risks:

6 BGH NZG 2011, 271.
7 Cf. e.g. § 85 GmbH, § 93 para. 1 sentence 3 AktG.
8 For more details see Hensel/Dörstling, DStR 2021, 170, 171.
9 BGH, NJW 2001, 2613, 2164; OLG Munich NZG 2021, 423; OLG Düsseldorf, NZG 2017, 152, 155.
10 OLG Munich NZG 2021, 423; Schudlo/Kersten, BB 2021, 1154, 1157 each with corrigendum.
11 OLG Düsseldorf, NZG 2017, 152 para. 34 et seq. Weißhaupt, Haftung für Erfüllungsgehilfen bei M&A-Transaktionen in: Drygala/Wächter, Verschuldenshaftung, Aufklärungspflichten, Wissens- und Verhaltenszurechnung bei M&A-Transaktionen 1st edition 2020, Part II.
12 Koch-Schulte BB 2020, 1131, 1133.
13 BGH, NJW 1997, 1926 (ARAG/Garmenbeck); MüKoGmbHG/Fleischer, 3rd ed. 2019, GmbHG § 43 Rn. 86-86b; Herrmann/Olufs/Barth, BB 2012, 1935, 1940.
14 MüKoGmbHG/Fleischer, 3rd ed. 2019, GmbHG § 43 marginal no. 193.

- Compensation obligations of the management towards the company arising from a breach of the duty of care, including entrepreneurial action outside the discretion of the business judgement rule, are included in the typical scope of application of D&O insurance. In individual cases, however, an exclusion due to a knowing breach of duty may become relevant[15]. Furthermore, the issuance of management guarantees is not part of the management's duties towards the target company and is therefore not covered by the D&O insurance.

- If the management participates in the issuance of guarantee promises within the scope of the company purchase agreement, the conclusion of an S&I insurance policy will also provide protection for the management at the same time. It is true that the purchase agreement does not provide for a liability of the management for the correctness of the seller's warranties and that the management will at most appear as a person with knowledge on the part of the seller, whereas a liability of the seller for vicarious agents and other third parties is regularly explicitly excluded. However, it is conceivable that a seller may assert recourse claims against the management after performance to the buyer as a result of the breach of warranty if the management has acted negligently in this respect. W&I insurance policies insure the risk of such warranty claims and limit the insurance company's recourse against the management (subrogation) to cases of intent or malice, so that minor and grossly negligent breaches of duty by the management have no legal consequences for the management.

- With regard to management guarantees, it should be noted that liability risks can also be covered by W&I insurance. In this context, the general knowledge qualification according to the positive knowledge of the management is regularly declared inapplicable for the purposes of the insurance (knowledge scrape) and thus the management guarantees are objectively insured, provided that the guarantees and the buyer's due diligence allow this and make a specific reinsertion of a knowledge qualification dispensable. At the same time, the insurance company's recourse against the management (subrogation) remains limited to cases of intent or fraudulent intent. However, if the management as seller acquires a significant re-investment at the same time, a partial exclusion of liability in proportion to the re-investment may apply in individual cases of fraudulent or intentional acts of the management. In particular for financial investors, this results in the possibility that conflicts with the management due to minor and grossly negligent breaches of warranty are mitigated by an insurance solution, while the management is not personally held liable.

- In addition to the coverage by D&O insurances and W&I insurances, a coverage by taking out contingent risk insurances may be considered with regard to liability risks arising from a participation in the execution of the transaction by the seller or on the level of the target company. These insurances cover possible damages from identified legal risks, which indirectly also benefit the management, since the recourse of the insurance against the management (subrogation) is limited to cases of intent or fraudulent intent and thus possible claims for liability of the executive bodies due to non-intentional breaches of duty can otherwise be covered.

In the transaction context, it is not uncommon that several insurances with different scope exist for the same risk. This applies in particular to the coexistence of D&O insurance and W&I insurance on the one hand and existing insurance policies at the level of the target company (e.g. environmental liability or product liability insurance) on the other hand. This competition for claims must be resolved primarily in accordance with the provisions of the insurance policies, or alternatively in accordance with § 78 VVG.

15 Cf. no. A-7.1 p. 1 of the GDV's General Insurance Conditions for the D&O Insurance of Supervisory Boards, Management Boards and Managing Directors (AVB D&O) of May 2019; for further details, see de Lippe, VersR 2021, 69.

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