Directors and Officers' Liability Insurance (Spain)

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An overview of directors and officers' (D&O) liability insurance in Spain. It explains its development in Spain, the features of typical D&O liability insurance policies and the trends in D&O coverage.

The role of directors and officers has become increasingly challenging, particularly in the light of the COVID-19 pandemic and stricter corporate governance regulations. These factors have also resulted in an increasing tendency for shareholders, creditors and the company itself to try to seek compensation from directors and officers personally.

Directors' and officers' liability insurance (D&O insurance) is now held by almost all medium and large Spanish enterprises. Businesses have found this product to be an effective tool to:

- Protect directors and officers' personal assets.
- Assure recovery in the event of a valid D&O claim.
- Cover the legal costs that could arise from a D&O claim which, in some cases, are significant.

This Note provides an overview of the background and characteristics of D&O insurance in Spain. It also describes the features of a typical D&O insurance policy.

Development of D&O insurance in Spain

Directors are liable to the company, its shareholders and third-party creditors for any damages caused by their acts or ommissions against the law, the articles of association or in breach of directors' fiduciary duties, provided there is wilful misconduct (*article 236, royal legislative decree 1/2010, of 2 July, approving the restated Companies Act* (*real decreto legislativo, 1/2010, de 2 de julio, por el que se aprueba el texto refundido de la ley de Sociedades de Capital*) (*Companies Act*). De facto directors (individuals that act as directors without being formally appointed) are also subject to this liability regime in the same manner as a duly appointed director (*article 236.2, Companies Act*).

Legislative changes in Spain have further expanded directors and officers' liability. For example, organic act 5/2010, of 22 of June, that amends organic act 10/1995, of 23 November, approving the criminal code (*ley orgánica 5/2010, de 22 de junio, por la que se modifica la Ley Orgánica 10/1995, de 23 de noviembre, del Código Penal*) brought significant changes to the Spanish legal system by recognising for the first time the criminal liability of companies through the provision of a new catalogue of corporate offences, increasing directors' criminal liability. This resulted in the expansion of D&O insurance as a means of limiting this growing liability.

The legal regime governing D&O insurance is the same as the legal regime that governs other professional liability insurance contracts, which is set out in articles 1 to 24 and 73 to 76 of act 50/1980, of 8 October, on insurance contracts (*ley 50/1980, de 8 de octubre, de Contrato de Seguro*) (*Insurance Contracts Act*).

D&O insurance is so widespread as to be almost considered compulsory for medium or large enterprises. It offers many advantages, including:

- Establishing a guaranteed protection from personal liability in favour of directors and officers.
- Reinforcing the company's creditworthiness in the market, as the D&O insurance policy is a sign that the board will be able to meet its liability should it arise in relation to the management of the company.

Key Provisions in a D&O Insurance Policy

The Insured and the Beneficiary

The insured is the individual or corporate entity, under the name of director, managing director, company officer or equivalent, who during the validity of the policy is a member of the company's senior management team or has decision-making or management powers in relation to the company or its subsidiaries. D&O insurance is of a nominative nature, so the specific directors and officers must be expressly identified in the policy by name.

Conversely, the beneficiaries of the insurance are, in principle, the company itself, the shareholders and the company's creditors. Creditors will include clients, suppliers or representatives, provided that they are not affected by the insurance contract's risk exclusion clause or exclusions of coverage.

The Injured Third Party

An injured third party is by definition not party to the D&O insurance contract. However the injured party or their successors may take direct action against the insurer to demand the fulfilment of the obligation to compensate, in the event that the damage or loss caused to a third party is due to the insured person's wilful misconduct (*article 76, Insurance Contracts Act*). Therefore, a person outside the insurance contract can in some cases, by exercising direct action, be entitled to the indemnity derived from the insurance contract held by the policyholder. This right arises either by operation of law or under the contract. It is most likely that the concept of who is to be considered an injured third party will be specified both in the definitions and in the exclusions in the D&O insurance policy.

Who is included and excluded must be adequately defined in the insurance policy itself, so that the direct action and the rights of the injured party are enforceable.

Risk, Loss and Coverage

D&O insurance policies cover the risk of civil liability arising from damages caused by the director or officer in the exercise of their functions (this is known as the liability debt).

The civil liability is triggered when the harmful event occurs (for instance, the director knowingly approving a corporate resolution in breach of the articles of association). However, it will only become an effective debt when a claim relating to the event of liability (covered by the insurance) is raised.

D&O insurance typically provides coverage for the following items:

- Losses arising out of a claim for improper, harmful or negligent actions carried out against directors or managers.
- Losses arising out of a claim for securities transactions due to improper actions.
- Legal defence costs arising out of a claim, including fees of the opposing party's legal counsel and court agent.
- Payment of expenses relating to the creation of monetary guarantees, imposed on the insured persons to cover civil liabilities and judicial guarantees (in the context of criminal proceedings) or an order for security for costs (in the context of a civil proceedings) (see *Payment of Defence Costs, Penalties and Fines*).
- Claims for improper actions in the field of employment.
- Reimbursing the company for any payment to insured persons that should have been assumed by the directors and officers.

The parties can cap or otherwise limit the insurer's obligation to compensate the insured for its losses (*article 73, Insurance Contracts Act*) (see *Limitations and Exclusions*).

Limitations and Exclusions

The most frequent coverage exclusions in D&O insurance policies are for:

- Claims based on the insured person obtaining any personal benefit, retribution or advantage to which they were not entitled.
- Fraudulent conduct deemed a crime, where a final judgment establishes that such conduct is relevant to the cause of the request or to the adjudicated claim.
- Environmental damage.
- Contractual penalties, fines, public law sanctions and taxes.
- Claims by the insured persons against each other.
- Claims for material or personal damage.
- Loss incurred while carrying out positions or functions in other companies different to that of the policyholder.
- Losses derived from the management of pension funds or profit-sharing programmes for employees.
- Claims involving the misuse of insider information.
- Claims by majority shareholders (usually with voting rights worth more than 30%).

In relation to the exclusion for fraud, note that the mere accusation of malice (that is, intentional wrongdoing) on the part of the director or officer will not necessarily trigger exclusions for defence costs. Fraud is not, as a general rule, insurable (*article 19, Insurance Contracts Act*). However the insurer may still, in the absence of specific wording to the contrary in the policy, be required to pay the insured's defence costs, including the payment of any civil or criminal guarantee (see *Defence Costs*).

Therefore, it is common for D&O insurance policies to set out in detail how the exclusion for fraud is to operate, including in relation to defence costs. This is particularly important in situations where the risk of fraud or collusion is high.

Insured Amount

The maximum guarantee limit that the insurer undertakes to pay under a D&O insurance policy is usually configured in one of the following ways:

- For each claim, and depending on the damage arising from each event during the period of cover or the additional period that has been agreed.
- On the so-called aggregate limit, which is the maximum economic amount of liability that the insurer will pay out of the same policy for the contracted insurance period, regardless of the number of claims and the value of each one.

In addition to a maximum limit, compensation excesses are usually established, which, as an incentive to diligence, means that the insured must pay the first compensation expenses from a certain amount onwards.

Large companies are generally inclined to set a large aggregate limit. This is because they expect to produce a certain number of claims, given the number of employees. On the other hand, SMEs are more inclined to set a limit per

claim, with the expectation that each claim is an exceptional event for the company. These are commercial decisions and there will be different profiles. The amount of the limit is usually negotiated with the insurance company, which will assess the risk beforehand. For this purpose, the insurer requires the policyholder to respond to a questionnaire (see *Declaration of Risk Questionnaire*), so that they fulfil their duty of truthful declaration of the risk involved (which is imposed by article 10 of the *Insurance Contracts Act*).

Premium

In D&O insurance the amount of the premium depends on the individual risk factors. These are established by the risk declaration questionnaire required by article 10 of the *Insurance Contracts Act* (see *Declaration of Risk Questionnaire*) and the disclosure of the company's last three audited balance sheets. This way, the premium would be different for a newly established company than for a company that has been established for a long time, or has a large number of subsidiaries or a higher volume of business.

External factors independent of the company's business, such as the specific market situation at a given time or the sum insured, may also be taken into account to set the premium.

Declaration of Risk Questionnaire

Insurance companies in Spain use the questionnaire provided for in article 10 of the *Insurance Contracts Act* as an instrument to evaluate the insured risk. Prior to the subscription of the policy, the policyholder is obliged to fill in the questionnaire truthfully. Any falsehood, ambiguity or omission in their answers could lead to the denial of coverage. The insurer is also obliged to provide a questionnaire that is not excessively generic, incomplete or ambiguous.

Common questions include:

- Financial situation of the company.
- Governing structure of the company and composition.
- Shareholder ownership and control.
- Entities where the company holds a controlling stake.
- Location.
- Existence of previous claims or criminal proceedings.

Questionnaires do not have to take a specific form in order to be legally effective.

Payment of Defence Costs, Penalties and Fines

Defence Costs

D&O insurance policies usually consider the coverage of fees, guarantees and other payments for the legal defence of the insured persons, in relation to the claims that can potentially lead to the activation of the payment of compensation.

D&O insurance policies also provide coverage for defence expenses or guarantees required by the courts as a consequence of a claim covered by the policy. Guarantee can be requested from the insured persons to guarantee their civil liability in any proceedings or claim. Guarantee can also be requested in criminal proceedings to guarantee their provisional freedom or in substitution of the precautionary measures adopted.

In terms of guarantees or orders for security for costs, coverage may take the following form:

- **Coverage of expenses relating to the granting of the guarantee.** The insured person, through their own means, is responsible for finding a financial entity that will provide the guarantee required by the court. The expenses associated with granting and maintaining the guarantee however is paid by the insurance company. The bank or financial institution will only provide the guarantee if the insured person's assets are sufficient for this purpose.
- **Coverage of the granting of the guarantee itself.** The insurance company directly grants the guarantee and the insured person is not involved in this operation. Here, the insurer is the direct guarantor or party responsible for drawing up the guarantee, and assumes its cost. This type of coverage is of course more advantageous for the insured person, although it is also less common and often more costly.

  These guarantees are provided by the insurer directly before the court, by means of a written document signed by a sufficiently authorised representative, in which they declare their irrevocable commitment in compliance with the corresponding insurance policy.

If the insured person is ultimately declared guilty by the court, the insurer will be entitled to request reimbursement of the guarantee coverage, regardless of its type.

Determination of the amount of a guarantee is regulated by the corresponding procedural act and depends on whether it is requested in the context of civil proceedings (*articles 746 and 747, Act 1/2000, of 7 January, on civil procedure (Ley 1/2000, de 7 de enero, de Enjuiciamiento Civil) (Civil Procedure Act)*) or criminal proceedings (*article 591, Royal decree of 14 September 1882 approving the criminal procedure act (real decreto de 14 de septiembre de 1882 por el que se aprueba la Ley de Enjuiciamiento Criminal) (Criminal Procedure Act*)).

Guarantees must be provided in cash or through a guarantee on first demand issued by a credit institution or mutual guarantee company.

Administrative Penalties and Fines

The liability of company directors and managers in the performance of their duties is not limited to the civil liability regulated in the Companies Act, but also extends to other laws and administrative obligations. Coverage of the D&O insurance policy can be extended to include these potential liabilities.

This insurance can therefore cover, for instance, the tax debts incurred by the directors of a company, since its ultimate aim is to protect their personal assets against claims arising from improper actions in their corporate management.

Among the most significant implications are fines related to tax liability. Two types of liabilities are established for directors and officers: subsidiary and joint and several liability (*articles 42.1.a and 43.1.b, Act 58/2003, of 17 December, on general taxation (Ley 58/2003, de 17 de diciembre, General Tributaria) (General Taxation Act)*). The former applies to cases where, for example, directors do not comply with their obligations in doing what is necessary for the payment of tax obligations or implement measures which lead to non-payment. Conversely, joint

and several liability is broadly established for any person who causes or collaborates in the execution of a tax offence, which could also apply to officers.

Although it is relatively common for directors and officers to be sanctioned for this type of offence, in many cases D&O insurance policies contain exclusions for any kind of tax liability. However, some policies cover this type of risk when there is good faith, or there is at least no fraud or gross negligence in the actions of the responsible director or officer; likewise, some policies insure civil liability arising from tax infringements.

Claims

Temporal and Territorial Coverage

The majority of D&O insurance policies cover cases in which the causal event has taken place prior to the entry into force of the policy, by means of a retroactive clause, as long as the insured person did not have any knowledge of the claim beforehand, for which a maximum period is established.

Likewise, a subsequent or additional extension period for the coverage is usually offered after the policy is contracted, in which the claims made after the expiry of the main period of coverage (which is usually one year) are included, for a period of time that usually ranges between 12 and 24 months, in relation to events that have taken place during the policy's validity.

Regarding the territorial scope, the policy conditions offer worldwide coverage, except for the USA and Canada. In some cases, other common law countries (such as the UK) are also excluded, as there is greater risk exposure for insurers in these countries.

Direct Action

Article 76 of the *Insurance Contracts Act* sets out a right for certain third parties (who are not party to the contract) who have suffered loss to file a direct action against an insurer. This means that they can request that the insurer fulfils the insured party's obligation to compensate them for damages that they have suffered.

The parties may exclude third-party rights from the policy coverage. Alternatively, the policy may limit coverage for third parties to situations where the obligation of the insured person to compensate the injured party has already arisen.

The right that the third party can exercise against the D&O insurer is limited to the consequences of the actions and omissions of the sole director that are enforceable against the insurer.

Trends in Spain

Progressive Shift Towards Criminal Liability Coverage

There has been a significant increase in corporate crimes in Spain, such as fraud, mismanagement or misappropriation, committed by directors and officers of listed companies or financial institutions, with enormous media coverage.

Committing these offences gives rise to the direct civil liability of D&O insurers within the framework of criminal proceedings. In recent years, the number of criminal investigations of offences committed by corporate entities has increased. This has resulted in directors and officers being subject to liability in both civil and criminal proceedings. This new context is resulting in D&O insurance shifting the focus towards providing coverage in the context of criminal proceedings. The main consequence of this situation is that an ancillary or accessory cover to this type of policy, which is the guarantee cover, is currently the most problematic and the one that raises the most queries for insurers operating in the Spanish D&O insurance market.

This coverage has caused many problems in scenarios where the insured has been accused of possibly committing an intentional unlawful act. D&O insurance policies usually state that they do not cover claims arising from intentional, unlawful or fraudulent actions committed by an insured, so when directors and managers are accused of criminal offences (for example, dishonest and fraudulent management, fraud and tax fraud and corruption) that can only be committed intentionally (as the Criminal Code does not foresee these crimes being committed through negligence) the exclusion would theoretically apply.

However, the exclusion of intentional or culpable actions cannot be opposed by the injured third party on the basis of Article 76 of the Insurance Contract Act (see *Direct Action*), so until now the insurer has usually been obliged to grant a civil guarantee even when the insured is accused of a crime that can only be committed intentionally or when the policyholder has been harmed by the actions of its accused director or officer.

One of the most significant and controversial cases related to D&O insurance in Spain took place on 11 January 2016, where the Central Court of Instruction no 3 passed a ruling in the so-called Abengoa case, which caused some uncertainty in the D&O insurance market. According to this ruling (Court order of 11 January 2016, issued in Preliminary Proceedings no. 125/2015), in the case of crimes that can only be committed intentionally, the D&O insurance policy could guarantee the indemnities to be paid to third parties, but it could never guarantee the damages suffered by the insured itself due to the actions of its directors. The Court of Instruction concluded that the policy taken out by the policyholder could not serve as a guarantee to cover the eventual civil liability of the insured (in this case the accused managers).

Although this decision was appealed, on 19 February 2016 the Third Section of the Criminal Division of the National High Court issued a judgment dismissing the appeal and upholding the first instance decision.

These decisions had a major impact on the market, although they have not been reproduced in subsequent rulings. If the courts continue to interpret D&O insurance policies in this way, this could mean that, although expressly provided for in the policy, guarantee cover could not be used in criminal proceedings to guarantee the civil liability of the accused insured parties of D&O insurance policies in cases in which the company itself could be considered an injured party due to the actions of its administrators and directors. Therefore, policyholders, brokers and insurers may have doubts about the guarantee coverage, which could ultimately be useless in some cases. This could have an important impact on the current trends in the Spanish D&O insurance market.

D&O insurance as an Alternative Solvency Instrument

D&O insurance is increasingly being used as an alternative solvency instrument for certain financial intermediaries, such as closed collective investment institution management companies (*sociedades gestoras de entidades de inversión colectiva de tipo cerrado*) (SGEIC) and investment companies (*sociedad gestionar de instituciones de inversion* colectiva) (SGIIC). These institutions need to meet very specific requirements laid down by Spanish financial laws.

SGEICs and SGIICs are required to either block certain of their own resources or take a professional liability insurance policy (like a D&O insurance policy), as a means to cover the possible risks derived from professional liability (*royal decree 83/2015, of 13 February, amending royal decree 1082/2012, of 13 July, approving the regulation developing act 35/2003, of 4 November, on collective investments institutions* (*Real Decreto 83/2015, de 13 de febrero, por el que se modifica el Real Decreto 1082/2012, de 13 de julio, por el que se aprueba el Reglamento de desarrollo de la Ley 35/2003, de 4 de noviembre, de instituciones de inversión colectiva*) *and act 22/2014, of 12 November, regulation venture capital entities, other closed collective investment entities and management companies of closed collective investment entities, and amending act 35/2003, of 4 November, on collective investment institutions* (*Ley 22/2014, de 12 de noviembre, por la que se regulan las entidades de capital-riesgo, otras entidades de inversión colectiva de tipo cerrado y las sociedades gestoras de entidades de inversión colectiva de tipo cerrado, y por la que se modifica la Ley 35/2003, de 4 de noviembre, de Instituciones de Inversión Colectiva*)).

D&O insurance therefore becomes an alternative to tying up these companies' own funds to guarantee their solvency. Between these two options, D&O insurance has become the more popular choice.

Note however that this insurance does not cover creditors in cases where there is no civil liability of the insured director or officer.

Increased Litigation

An increase in litigation is likely in the current environment. This will undoubtedly affect directors and officers.

The introduction of the *General Data Protection Regulation* (GDPR) has resulted in the public's greater awareness of the use of data and information of a personal or private nature and may also contribute to any increase in litigation.

In addition, in recent years the amount of litigation and cases filed in relation to the environment has grown, with cases related to climate change also increasing. It is expected that these will increase even further, especially in the most exposed sectors such as mining, oil, and aviation, but also those that are related in some way to facilitating the activity of those sectors, such as banking and insurance.

Litigation Funding

Litigation funding is emerging as a new type of investment that attracts capital from investors seeking high rates of return.

Litigation finance lowers the cost of litigation for claimants, further boosting already growing litigation. Although litigation funding has long been established in the US and the UK, many funders have started to offer their services in the rest of Europe.

Against this backdrop, D&O insurance is becoming particularly relevant and effective as a means of defending against the growing number of lawsuits.

Impact of the COVID-19 Pandemic on D&O Insurance

The COVID-19 pandemic has introduced risks and factors that will have an impact on companies and their D&O liability, such as dramatic revenue and profit losses, business interruption coverage (or lack of it), government measures and investigations, bankruptcy proceedings and increasingly challenging regulations and compliance burdens.

This environment will likely lead to an influx of claims against companies and their directors and officers as the economy and businesses reopen. This may in turn result in more D&O-related losses or claims. The most relevant example is the increase in premiums, as a means to avoid covering companies with solvency difficulties.

Any increase in claims would likely provoke a discussion on whether the unprecedented measures imposed by the government fall within policy exclusions. This uncertainty may affect renewals periods and potentially lead to clarifications on coverage and policy wordings. It could also limit temporary extensions granted by the insurer. In addition, some insurers will probably seek to incorporate COVID-19 exclusions into their policies and increase premiums, as was the case over the course of 2020 and the first quarter of 2021, possibly in response to regulatory and solvency pressure. In fact, insurance companies are already negotiating to exclude coverage for claims arising directly or indirectly from COVID-19 in upcoming renewals. The impact of COVID-19 can also result in longer underwriting processes.

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