A Mandatory Liability Insurance Scheme for CEO:s and Board Members – Problems and Possibilities

Jessika van der Sluijs[1]

1 This paper is based on an earlier version published in Festskrift to Lars Pehrson (Jure) 2016.

From time to time, in Sweden there is a debate whether to introduce a mandatory liability insurance scheme for CEO:s and board members, similar to the existing mandatory insurance schemes for other professionals, i.e. auditors, attorneys, real estate agents and insurance intermediaries. The issue is often raised in the light of the large damage claims raised against auditors. In practice, the auditors often bears the liability for damage caused by (or also by) CEO:s and board members. In this paper, I will discuss the problems and the possibilities associated with the introduction of a mandatory liability insurance scheme for CEO:s and board members.

1 The Context – the Non-Functioning Shared Liability between Company Bodies

According to the Swedish Companies Act (2005:551) (SCA), the board members, the CEO and the auditors have a shared liability for damages. However, in practice, the claims are often allocated only to the auditor. There is also a tendency that the size of claims is increasing, which has highlighted the problem with the imbalance of the liability. Lately, in Sweden, there has been several cases where the claims raised against auditors have been very large. Several explanations for this mechanism are pointed out. One explanation is that the auditor is an external party to the parties suffering the damage, while the CEO and the board members are internal parties. The different relationships between the parties make it easier for the victim to claim damages from the auditor, and not from its "own" CEO or board members. Another explanation is that the parties suffering damages nowadays are less concerned whether the auditor "survives" a duty to pay large damages, than they used to be. Previously, the parties to a larger extent depended on the continuity of their relationship, and that the relationship would be long-lasting. Thus, it was not in the victims' interests to overthrow the auditors with large compensation claims. Lately, there is a tendency that the suffering parties are more interested in a "one shot-game" with the focus on maximal compensation, instead of the survival of the auditor firm.[2] A third explanation is that it is easier to prove negligence on the auditor than on the CEO or board members, which makes compensation from the auditor more accessible. A fourth explanation of the imbalance is that since liability insurance by law is mandatory for auditors, everyone knows that the auditors always are insured. Board members and CEO:s on the other hand, might be uninsured.

The problem with the non-functioning shared liability has been addressed by the Swedish Government, by the auditor industry and by the EU commission. In 2008, the Commission reviewed the liability claims against auditors,[3] and in Sweden the review led to a legislation proposal suggesting that the auditors'

2 Study on the Economic Impact of Auditors' Liability Regimes (MARKT/2005/24/F) London Economics (2006) s. 81.

3 Kommissionens rekommendation 2008/473/EG av den 5 juni 2008 om begränsning av det civilrättsliga ansvaret för lagstadgande revisorer och revisionsföretag.

liability should be limited to a "cap".[4] The proposal also suggested that the auditors' liability would be subsidiary to the CEO:s and the board members' liability. However, the proposal did not lead to legislation. Just recently, the Swedish Government investigated the possibility to construct a mandatory insurance scheme for CEO:s and board members as an attempt to balance the claims raised against auditors and other company bodies (SOU 2016:34).[5] Due to, among other things, the practical difficulties no such insurance scheme was proposed. Below, I will make an attempt to provide an in-depth comment on those "practical difficulties".

2 Mandatory Liability Insurance for CEO and Board Members

Mandatory liability insurance for board members of public limited companies was considered already in 1995 by the Company Law Reform Committee (Aktiebolagskommittén). The reason was that a mandatory liability insurance only for the auditor disturbed the intended balance of liability between the company bodies. The committee did not propose a mandatory liability insurance on board members.

The advantages with liability insurance are obvious. The insurance increases the possibilities for the damaged parties to reach compensation. From the potential damaged parties' perspective, a mandatory liability insurance scheme would be to prefer over capping the liability. Liability insurance offers security also for the insured parties. Mandatory liability insurance might facilitate recruitment of competent CEO:s and board members. According to chapter 9 article 7 of the Swedish Insurance Contracts Act (2005:104), the victim has a right of direct action towards the liability insurer in case of mandatory insurance. A mandatory liability insurance scheme for CEO:s and board members would thus strengthen the damaged parties' access to compensation. Liability insurance also has a function of an insurance that covers legal expenses. Typically, liability insurance not only covers the damage itself, but also the costs for disputing the claim.

So, why is the Swedish legislator reluctant about introducing a mandatory liability insurance scheme on CEO:s and board members? In the latest legislation proposal from 2016, the investigator mentions two reasons. The first reason is that the industry itself recently considered the possibility of adopting a mandatory liability insurance scheme through soft law, but decided not to. The other reason is that adopting a mandatory liability insurance scheme is associated with "practical difficulties".

In my view, the first reason is not a very strong one. A mandatory liability insurance scheme is adopted in the interest of the parties potentially suffering damages; customers, consumers, shareholders or others. To my knowledge, throughout history, a mandatory liability insurance scheme has never been initiated by the potential tort-feasors. The initiative has always been the legislator's, based on a desire to strengthen the potential victims' access to

4 SOU 2008:79 pp. 11, 16.

5 SOU 2016:34.

compensation. However, the second explanation for the Swedish legislator's hesitancy of adopting a mandatory liability insurance scheme; the "practical difficulties", is stronger.

2.1 Infra Structures

In order to adopt an efficient scheme of mandatory liability insurance for professionals, there is a need for a certain infra structure. A common feature for attorneys, auditors, real estate agents and insurance intermediaries is that they are subject to *public regulations,* which impose a duty to seek *authorization* from supervisory bodies in order to conduct business. I order to obtain such authorization, the regulations stipulate several requirements, including that the applicants are (or will be) covered by liability insurance. The supervisory bodies *monitor* the businesses and ensure that liability insurance is retained. If the authorized professional for some reason forfeits insurance coverage, the authorization is withdrawn.

Board members and CEO:s don't belong to a "guild" in the same way. Thus, a fundamental problem with implementing a mandatory liability insurance scheme for CEO:s and board members is of a *legislative nature*. The Swedish Companies Act contains private law rules about the formation of a limited liability company, but does not contain rules about the quality of the company or competence of the individuals involved in the company. Before the formation of a company, there is no legal entity that is able to enter a liability insurance contract in favour of its future board members or CEO. Thus, the Swedish Companies Act does not have the normative structure that naturally would include regulations on mandatory liability insurance.

Regarding the other professionals encompassed by this paper, the liability insurance is *assessed* by the supervisory body as a part of the authorization process. In order to form a limited liability company, it must be registered at the Swedish Companies Registration Office. The question is whether the liability insurance could be assessed during this process. According to the Swedish Companies Ordinance (2005:559), the registration at the Swedish Companies Registration Office does not have the character of a formal authorization or evaluation. In order to register a company, the applicant has to *inform* the Office about certain aspects, such as names and addresses of the parties involved. The applicant needs to provide information about the shares. Also, the applicant needs to ensure certain conditions, such as the auditors' competence. However, the registration process does not include any elements of evaluation or assessment. Consequently, today, the registration process is not suited for assessing liability insurance.

Another important part of a mandatory liability insurance scheme is the *supervision* of it. Attorneys are monitored by the Swedish Bar Association (Advokatsamfundet). Auditors are monitored by the Swedish Inspectorate of Auditors. Real estate agents are monitored by the Swedish Estate Agents Inspectorate and insurance intermediaries by the Swedish Financial Supervisory Authority. The supervisory authorities shall not only ensure that there is liability insurance in place at the time of the authorization. The supervisory authorities

shall also ensure that liability insurance is maintained during the entire time of the authorization. For instance, according to the Insurance Intermediation Ordinance (2005:411), the mandatory liability insurance contract must include a section according to which the liability insurance is valid one month after the Swedish Financial Supervisory Authority has been informed about the expiration of the insurance contract. The Real Estate Agents Ordinance (2011:668) contains a similar provision. This mechanism ensures that the liability insurers have an interest in communicating the expiration of liability insurance contracts to the supervisory authorities. In practice, the communication is conducted by the professional associations, that insures their members through collective insurance arrangements (see below). Today there is in Sweden no such supervisory body that monitors board members and CEO:s.

In order to create an efficient mandatory liability insurance scheme, there has to be some kind of *sanctions* available in the event of the failure to comply with the duty to obtain liability insurance. If an attorney, real estate agent, auditor or an insurance intermediary fails to maintain liability insurance, the authorization is withdrawn. What would the sanction for board members and CEO:s be? De-registration of the company? Penalties?

Finally, a common feature of the mandatory liability insurance schemes for attorneys, real estate agents, insurance intermediaries and auditors is that there are strong *industry organizations* arranging for the liability insurances. The organizations have double functions; they are at the same time "service-providers" watching the interests of its members, and "supervisors" of their members. Every Swedish attorney is a member of the Swedish Bar Association. The industry organization for auditors is FAR, and for insurance intermediaries Svenska Försäkringsförmedlares förening (Sfm). Real estate agents have two industry associations, Fastighetsmäklarförbundet (FMF) and Mäklarsamfundet (Association of Swedish Real Estate Agents). The organizations cover most of the respective industries. These industry organizations play an essential part in the all of the Swedish mandatory liability insurance schemes for professionals. All of these organizations provide collective liability insurance in favour of their members. Thus, in practice, there is one party that keeps track of the legal requirements of the liability insurance; namely the industry organization. It also means that in practice, the respective supervisory authority or body has to monitor mainly one (or two) collective liability insurances. The system also means that as long an attorney, auditor, real estate agent or insurance intermediary lives up to the industry organizations requirements, and thus becomes a member, he or she will be automatically covered by the organization's collective liability insurance. Today, in Sweden, there is no such professional association that encompasses all of the CEO:s and board members.

To sum up, the infra structures that bears the mandatory liability insurance schemes for attorneys, auditors, real estate agents and insurance intermediaries, i.e. authorization, supervision, sanctions in the event of failing to be insured, and industry organizations providing collective liability insurance in favour of their members, are today missing for CEO:s and board members.

2.2 Identification of the Relevant Companies

In order to impose a mandatory liability insurance scheme, it is necessary to be able to identify the subjects that shall be included in it. Regarding the other professionals encompassed by this paper, the identification is very easy, since all of them need authorization in order to conduct their respective business.

Companies don't need authorization, so the question is what kind of companies should be covered by an eventual mandatory liability insurance scheme. To my knowledge, every time the issue of mandatory liability insurance for board members and CEO:s has been raised, the context has been the imbalance between the auditors' liability and the other company bodies' liability. Consequently, one can assume that an eventual mandatory liability insurance scheme at least should encompass companies with a duty to have an auditor. It would be practically possible to identify those companies, since information about the auditors shall be provided to the Swedish Companies Registration Office at the time of the registration of the company. Maybe the categories of companies should be targeted according to other criteria, for instance depending on the character of the potential victims. If the aim of the mandatory liability insurance scheme is to protect both companies and shareholders, i.e. also parties that typically have insight in a company's whereabouts, the mandatory liability insurance scheme should be adopted for all limited liability companies. On the other hand, if the aim of the mandatory liability insurance scheme is to protect parties that typically have no insight in the company's whereabouts, the mandatory liability insurance scheme should be adopted only for public limited liability companies.

2.3 Models of Regulating the Scope of Insurance

Experiences regarding the mandatory liability insurance schemes for the other professionals encompassed in this paper reveal that it can be problematic to determine general rules about the insurance sum, geographical scope, self-deductibles, allowed exceptions of coverage, triggers and so forth. Furthermore, the question on *how to regulate* the minimum scope of insurance is problematic. A duty to obtain and maintain liability insurance must be realized on the commercial insurance market. Thus, a precondition for a well-functioning mandatory liability insurance scheme is that there is an insurance market willing to meet the demands from the ones seeking insurance. The regulations for attorneys, auditors, real estate agents and insurance intermediaries are targeting the professionals and the supervisory authorities. The insurers providing the insurance products are not targeted by the rules. Thus, it is the professionals that have a duty to acquire adequate insurance, and not the insurance companies that have a duty to offer adequate insurance products. This means that a possible scenario is that there is a mandatory liability insurance scheme adopted by law, but at the time being no adequate insurance products available on the market. The effect is that there might be situations, where professionals have no practical possibilities to fulfil all of the requirements for the authorization. This scenario has actually incurred in Sweden. For instance, in the early 1990'ies, the regulations for insurance intermediaries stated that the mandatory liability insurance had to

cover damages that were *caused* during the insurance contract period. At that time, no insurance company on the Swedish market was willing to underwrite insurance contracts in accordance with those requirements. Instead, the insurance companies offered liability insurance covering damages that were *reported* during the insurance contract period. The solution to the problem was that the regulations were adjusted (and not that the insurance companies had to change their minds).

Regarding the other professions mentioned in this paper, the scope of the mandatory liability insurance is regulated according to different models. The requirements on the mandatory liability insurance for real estate agents and insurance intermediaries are determined by legislation (by ordinances, issued by the Government). To determine the requirements on a mandatory liability insurance by legislation might cause problems, similar to the situation with the insurance intermediaries in the 1990'ies mentioned above. An ordinance is not a very flexible normative measure. The insurance industry's desire to insure different risks may change rapidly, while changing an ordinance is a slow process. Thus, to regulate the scope of the insurance by legislation is associated with the risk of "gaps" arising when the commercial insurance market occasionally does not meet the legal requirements on the insurance. Other systems are more flexible. The required insurance sum for auditors is determined by regulations issued by the Swedish Inspectorate of Auditors (RNFS 2001:2). The Inspectorate's regulation can, if necessary, be easily adapted to changes in the insurance market. Regarding other criteria than the insurance sum, the auditors must obtain liability insurance "approved by the Swedish Inspectorate of Auditors". Thus, in the authorization process, the Inspectorate is able to take the current insurance market into account when approving the adequate liability insurance coverage. Attorneys have the most flexible system. In order to function as an attorney in Sweden, one has to be a member of the Swedish Bar Association. Members are automatically covered by a collective liability insurance, negotiated by the Association.

Since there is no system of authorizing CEO:s and board members, the issue of how to regulate liability insurance would be problematic.

2.4 Determining the Scope of Insurance

To impose a legal duty to maintain liability insurance without at the same time determine a minimal level of the scope of the insurance is rather pointless. The mere fact that there *is* liability insurance doesn't say anything about the expected level of insurance protection.

The requirements of the liability insurance for attorneys is not determined by any regulation, but by the Association that insures their members. The requirements for the mandatory liability insurance for auditors are determined by regulations issued by the Swedish Inspectorate of Auditors. There are rules about the insurance sum and rules in the event of a series of liability insurances. Furthermore, the terms of the liability insurance must be approved by the Inspectorate, which gives the Inspectorate the mandate to ensure that satisfying insurance coverage is in place. The requirements for the mandatory liability insurance for insurance intermediaries are determined by the Insurance intermediary ordinance (2005:411) and regulations issued by the Swedish

Financial Supervisory Authority (FFFS 2005:11). There are rules about insurance sum, and for insurance intermediation including insurance based investments products, rules about insurance sum, time frame of insurance coverage, direct action of the party suffering damage and self-deductibles. The requirements for the mandatory liability insurance for real estate agents are determined by the real estate agents ordinance. The ordinance contains rules on required insurance sum, time frame of the coverage and self-deductibles.

Only the ordinances for insurance intermediaries and real estate agents contain provisions about the required time frames of the insurance. Typically, a liability insurance contract is entered for a period of one year. Tort liability, on the other hand, may develop over a long period of time. Many years may pass from the time of the causation of the damage to the time when the damage becomes evident. Thus, for actuarial reasons, there is a need to in the contract somehow define the time frame of the liability insurance coverage. According to common Swedish liability insurance practice, the time frame of liability insurance is defined according to four principles, or "triggers"; the causation principle (the insurance covers damage caused during the insurance period), the occurrence principle (the insurance covers damage occurred during the insurance period), the discovery principle (the insurance covers damage discovered during the insurance period) and, finally, the claims made principle (the insurance covers damage reported to the insurer during the insurance period). The most common trigger for professional liability insurance is the claims made trigger. For a party suffering damage, the trigger of the liability insurance in question is essential, and therefore the trigger should be determined by the legislator, and not by the insured.

If a mandatory liability insurance scheme were to be imposed on companies in favour of their CEO:s and board members, perhaps the most difficult issue would be to determine the scope of the insurance duty. Naturally, regarding attorneys, auditors, real estate agents and insurance intermediaries, there is a great variation of the businesses within one and the same profession. Yet it is possible to make a (very) rough estimation of these professionals' businesses and the risks involved. This would be a very difficult to do regarding limited liability companies in general.

3 The Code

An important factor in Swedish company law is the Swedish Corporate Governance Code (the Code). The Code is adopted by the Swedish Corporate Governance Board, and thus private regulation. Through contract the Code is binding for all companies whose shares or depositary receipts are admitted to trading on Nasdaq Stockholm and NGM Equity.

To impose a liability insurance scheme on companies targeted by the Code would technically be rather uncomplicated. The aim of the Code is to improve corporate governance of companies listed on the Swedish securities market, and to specify norms for what is generally regarded as good corporate governance. Rules about mandatory liability insurance would technically fit in to the Code.

If a liability insurance duty were to be introduced in the Code, the duty would be imposed only on companies admitted to the Nasdaq Stockholm and NGM

Equity. Companies admitted to, for example, First North or Aktietorget, would be excluded from the mandatory insurance scheme. Thus, the liability insurance duty would not be imposed to all of the companies with a duty to have an auditor. To impose a liability insurance duty through soft law also means that direct action rules followed by the Insurance Contracts Act are not applicable, since such a right follows only liability insurance mandatory by law.

The Swedish Corporate Governance Board would, if they wanted to, be able to have a function as a "supervisory body", and it would also be possible for the Board to arrange a collective liability insurance for all of its members.

Apparently, the Board has recently considered to introduce such a mandatory liability insurance scheme, but refrained. It is not difficult to understand why. To adopt, and to maintain a collective liability insurance scheme is hardly a part of the core business of the Board. Furthermore, according to the Boards estimations, approximately 90% of the member companies already has (voluntary) liability insurance for their CEOs and board members.

4 Information Duties as a Possibility?

In the governmental investigation mentioned above, SOU 2016:34, it is proposed that a company shall have a duty to in the annual corporate report provide information about existing liability insurance. The motive for the proposal is that the mere fact that there is liability insurance for CEO and board members likely will cause a better balance of the liability claims raised against the CEO/board members and the auditors.[6]

It is possible that such a rule might improve the balance of claims. It is said that one reason for the victims to target the auditors with the claims instead of the CEO and board members, is the assumption that the former are capable of paying the damages, while the latter are not. However, the auditors' assumed financial capacity is not only due to the mandatory liability insurance; The minimum mandatory insurance sum for auditors for the largest firms is around 90 000 Euro per damage and around 2.7 million Euro per year. Thus, the parties suffering damage can only assume that there is (voluntary) liability insurance exceeding those sums. In spite of that, it is not uncommon with much larger claims raised against auditors. This means that the mandatory liability insurance for auditors is not decisive for the victims when choosing the potential liable party. Instead, the auditor may have a position in a global group of auditor firms with a good financial capacity, while the CEO and the board members are individuals without such financial capacity. Thus, financial capacity is probably relevant for the choice of potential liable party, but existing liability insurance may just be a part of the decision.

The way the government proposed the information duty is problematic also in another way. The proposed rule states that the company report shall contain information that *there is* insurance. Such information is quite useless. For the information to be useful to anyone, it must be more substantial. Naturally, there

6 SOU 2016:34 p. 121.

must be information about, among other things, the insurance sums, but also information about exceptions, trigger, geographical scope and self-deductibles.

5 Concluding Comments

To sum up, the Swedish legislator is right about the practical problems connected with the introduction of a mandatory liability insurance scheme for CEO and board members. The other mandatory liability insurance schemes for professionals, i.e. attorneys, auditors, real estate agents and insurance intermediators, have infra structures that carries those systems, which are lacking for board members and CEO. Furthermore, there are practical problems when it comes to *how* such insurance should be regulated, and how to identify the companies that should be targeted with the mandatory scheme. Finally, to determine the minimum scope of the insurance would be difficult.

A feasible way to create an adequate mandatory insurance system would be through the Swedish Corporate Governance Board. The duty for the companies to provide insurance in favour of the CEO and board members could be stated in the Code, and the Board could arrange a collective liability insurance, similar to the insurance system for attorneys or auditors. However, the Board just recently rejected the possibility.

A mandatory liability insurance scheme is a very good measure to strengthen the potential victims' access to compensation in the event of a damage. In Sweden, there is such insurance schemes not only for the professionals mentioned in this paper, but also for traffic injuries, patient injuries, pharmaceutical injuries and labour related injuries. In this paper, I have attempted to show that introducing and maintaining an efficient mandatory liability insurance scheme is rather complicated. It requires a certain legal infra structure with regulation and monitoring, but also an insurance market willing to meet the demands. All of the existing, mandatory liability insurance schemes are maintained by strong private organizations.

The prognosis for a Swedish mandatory liability insurance scheme is thus (still) weak. The auditors will also in the future have to hope for other solutions that will better balance their shared liability the way it was intended in the Swedish Companies Act.