Directors' and Officers' liability in Switzerland

The structure of corporations in Switzerland

A fundamental distinction has to be drawn between sole proprietorships and (general or limited) partnerships on the one hand and corporations – companies limited by shares and limited liability companies – on the other hand. While the principle of personal liability of the entrepreneur (or the partners) characterizes the former, the liability of the company itself is a fundamental element of the latter. Approximately 50% of all business enterprises in Switzerland are either companies limited by shares (stock corporations) or limited liability companies. While limited liability companies are quite popular for rather small businesses, the most important type of company is clearly the stock corporation which is used for small, medium, large and very large enterprises, either privately held or stock listed. The following comments therefore refer to the stock corporation. It should however be noted that similar rules on liability for administration, business management and liquidation apply for all types of companies.

Who are Directors and Officers?

Swiss company law recognizes three legal bodies governing a corporation: the general meeting of shareholders, the board of directors and the (external) auditor.

Standard board structure

The board of directors consists of one or more directors. It is competent to pass resolutions on all matters not reserved to the general meeting of shareholders by the law or the articles of association. It is responsible by law for the management of the business of the company. The more important managerial functions of the board – such as the overall management of the company and the issuing of all necessary directives, the determination of the company's organization and the overall supervision of the persons entrusted with managing the company, – are non-transferable and inalienable. Also the duty to notify the judge in case of over-indebtedness of the company belongs to the mandatory obligations of the board.

The officer structure

Other management functions can be delegated by the board to individual directors or to third persons who are not members of the board. These persons form 'the management' of the

corporation – in contrast to the board of directors. Their members are 'officers' – in contrast to the 'directors' who are the members of the board.

All these persons express the will of the company and bind the company by concluding transactions and by their other actions. It should be noted that not all persons entrusted with managerial functions qualify as 'officers'. This depends on their actual duties and responsibilities. The test is the extent of control which the person in question can exercise over the company's decision-making. As a general rule, it can however be said that at least members of the senior management usually qualify as 'officers' of the company.

In addition to the persons mentioned above, Swiss law recognizes that there may be individuals or even companies (e.g. a holding company) who exert a dominating influence on the company's decisions and are therefore treated as so-called de facto directors. They face the same liability as a formally elected or appointed director or officer.

Duties of the board

The board of directors is responsible for the management of the company, unless responsibility for such management has been validly delegated. As mentioned above, there are a number of non-transferable and inalienable duties, i.e.:

- the overall management of the company and the issuing of all necessary directives;
- the determination of the company's organization;
- the organization of the accounting, financial control and financial planning systems as required for management of the company;
- the appointment and dismissal of persons entrusted with managing and representing the company;
- the overall supervision of the persons entrusted with managing the company, in particular with regard to compliance with the law, the articles of association, operational regulations and directives;
- the compilation of the management report, the preparation of the general meeting and the implementation of its resolutions;
- the notification of the court in the event that the company is over-indebted.

With the exception of the duties listed above, the articles of association may authorize the board to delegate the management of all or part of the company's business to individual members or third parties. The members of the board remain responsible (and liable) for any losses caused by the delegate unless they can prove that they acted with all due diligence when selecting, instructing and supervising him/her.

Generally speaking, all directors and officers must possess sufficient knowledge and ability for their respective functions and must exercise due care in the performance of their legal, statutory or contractual obligations.

Liability of Directors and Officers

According to the law, the members of the board of directors and all persons engaged in the business management (or liquidation) of a company are liable to the company and to the individual shareholders and creditors for any losses or damage arising from any intentional or negligent breach of their duties. Accordingly, there are four different potential claimants against directors and officers: the company itself, the shareholders, the company's creditors and basically every third party which suffered a loss as a consequence of a director's or officer's wrongdoing. There are, however, certain pre-conditions and restrictions for some of these claims which will be addressed hereinafter.

All members of the board of directors and any third party who is engaged in managing the company must perform their duties with all due diligence and safeguard the company's interest in good faith. Furthermore, circumstances being equal, they have to give equal treatment to the shareholders of the company.

Company law rightly takes center stage in any discussion about directors' and officers' liability. The fundamental provision on D&O liability under company law is article 754 of the Swiss Code of Obligations (CO). According to this provision the members of the board of directors and all persons engaged in the management or liquidation of a company are not only liable to the company, but also to each shareholder and to the company's creditors for the damage caused by any intentional or negligent violation of their duties. However, in case of rightful delegation of the fulfillment of a specific duty to another corporate body or a third party, the directors and officers are not liable for the damage caused by the delegate if they can prove that they applied the necessary care in selection, instruction and supervision under the circumstances.

It should be noted that the possibility that a company becomes insolvent or over-indebted does not automatically trigger the liability of its directors and officers. As a matter of fact, in most D&O liability cases of the last few years the main allegation raised against the directors and officers were not the economic difficulties and the downturn of the company, but the lack of appropriate measures taken by the board and the management when such difficulties became apparent. Therefore, one of the most important duties of the board of directors in practice is to take the appropriate measures in case of loss of capital or over-indebtedness. If the last annual balance sheet shows that half of the share capital and the legal reserves are no longer covered, the board must call a general meeting of shareholders and suggest measures for a financial reorganization. In case of a substantiated concern of over-indebtedness, an interim balance sheet must be prepared and submitted to the auditors for examination. If the interim balance sheet shows that the claims of the company's creditors are neither covered if the assets are appraised at ongoing business values nor at liquidation values, then the board shall notify the judge unless creditors of the company subordinate their claims to those of all other company creditors to the extent of such insufficient coverage. If the board fails to comply with these duties and the company later goes into bankruptcy, the directors will be liable for the increase of loss between the time the company was technically insolvent and the date of the opening of bankruptcy proceedings.

In addition to the liability under company law, directors and officers also face other liabilities which can result from contract law, tort, public law and criminal law.

The relationship between the company and its directors and officers is not only governed by company law, there is also a contractual relation. As far as directors are concerned, this can be an agency contract. If the director is assigned with operational functions and stands in a subordinated relationship to the entire board, the relationship can also be employment based. As far as officers (members of the management) are concerned, they are usually employees of the company. As a consequence, directors and officers may incur contractual liability in case they violate their contractual obligations vis-à-vis the company.

In addition, there are several acts in Swiss private and public law which impose (unlimited or limited) liability on directors and officers. The most important of these are the following:

- liability for false, misleading or incomplete information in connection with the incorporation of a company or the issuance of shares, bonds or other securities that are accompanied by a prospectus;
- liability for the accuracy of the takeover report in a case of a merger or the acquisition of the company;
- liability for the contribution for the old age and survivors insurance of the company's employees;
- several federal and cantonal tax acts stipulate a joint and several liability of directors and officers together with the company for outstanding tax debts, e.g. for VAT and withholding taxes;
- the Swiss Banking Act explicitly refers to company law as far as the liability of directors and officers of banking institutions are concerned.

Furthermore, directors and officers can be liable for third-party damage caused by tortious acts committed within the scope of the company's business, including a violation of criminal law (in particular offences against property). As a practical matter, claimants usually sue the company which is responsible for the acts and omissions of the members of their governing bodies, and not (only) the directors or officers personally. Where it comes to D&O claims, it is common practice that they go along with criminal complaints (e.g. for disloyal management). Often the purpose of the latter is to obtain supporting evidence for the civil claim.

As a matter of principle, the pre-conditions for civil liability of directors and officers are the same for:

- a violation of the director's or officer's (statutory or contractual) duties;
- a financial loss suffered by the company, their shareholders or creditors;
- a causal connection between the breach of duty and such loss; and
- fault on the part of the director or officer (negligence or willful intent), except where the law does not require any fault but provides for a strict liability of the directors and officers (which is the case for the directors' and officers' liability for the contribution for the old age and survivors insurance of the company's employees and the joint and several liability of directors and officers together with the company for outstanding tax debts).

The burden of proof for these pre-conditions of liability lies with the claimant (except for the cases of contractual liability where negligence is presumed by the law and the defendant has to prove that no fault was attributable to him).

Liability triggers the obligation to indemnify the damaged party for the actual loss such party has suffered. The loss is calculated according to the so-called theory of balance (*Differenztheorie*): the difference between the damaged party's assets before and after the action (or omission) which caused the loss. The judge may take into account special circumstances (in particular circumstances which helped to give rise to or compound the loss and which are attributable to the damaged party) and the degree of culpability of the wrongdoer. This may lead to a reduction of the compensation due. On the other hand, the compensation must not exceed the actual loss suffered by the damaged party. Multiple or punitive damages are unknown to Swiss law.

Who can sue the Directors and Officers?

Directors and Officers can be sued by the company itself, by its shareholders, its creditors or by any third party which suffered a loss. Distinctions have to be made with regard to the question whether or not the company is over-indebted and in bankruptcy. For certain potential claimants, distinctions also have to be made with regard to the type of loss suffered (direct or indirect loss).

- Before bankruptcy, it is primarily the company itself which can be damaged by wrongdoings of its directors and officers and which will therefore raise respective claims against them. The company's shareholders can also sue the directors and officers. However, they have suffered only an indirect loss (a decrease of the value of their shareholdings) and, therefore, are only entitled to claim for performance *to the company.* As long as the company is not declared bankrupt, creditors of the company have not (yet) suffered a loss and are therefore not entitled to make a claim against the company's directors and officers. Only in the rare cases where they have suffered a direct loss, they can try to obtain direct indemnification from the directors and officers.

- The situation is different after the opening of bankruptcy proceedings against the company. Now, the creditors of the company are also entitled to sue the directors and officers, however, only in cases where the insolvency administrators have waived their right (i.e. the company's right) to assert such claims. Creditors (as shareholders) must request in their lawsuit that *the company* be compensated for the losses suffered. However, their proceeds of such an action will primarily be used to indemnify the litigant creditors. Any surplus is divided among the litigant shareholders in proportion to their equity participation in the company. The remainder is added to the company's estate. In very exceptional cases – where the legal provision violated by the director or officer is intended to only protect the rights of the creditor and not the company's and/or the shareholders' rights – can the creditor sue the director or officer on his own account.

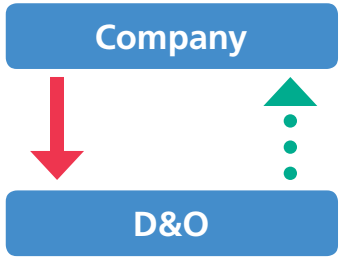
- Directors and officers are personally liable for their wrongful acts. Accordingly, any third party is entitled at any time to assert tort claims against the directors and officers of a company. As the company itself is jointly and severally liable, it is more likely in such a case that the third party will sue the company instead of the directors and officers. In this case, the company will be entitled to bring a claim of recourse against the responsible directors and officers.

The following scenarios can be distinguished:

= claim

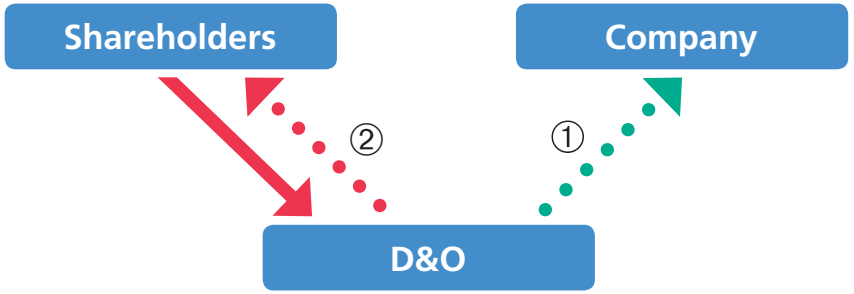
= payment

(1) Claims from the company:



Example: The company suffered a loss because the directors and officers did not properly supervise the company's accounting practices which resulted in a huge tax penalty.

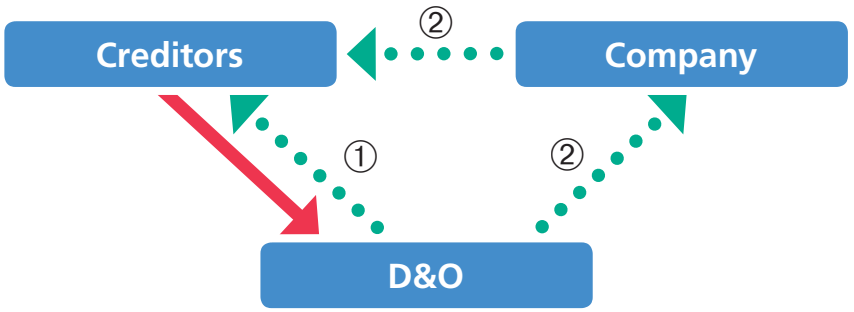
(2) Claims from shareholders:



① Indirect damages. Example: Value of shares depreciated because of losses suffered by the company.

② Direct damages. Example: The board of directors bars a shareholder from his statutory entitlement to a proportion of newly issued share captial.

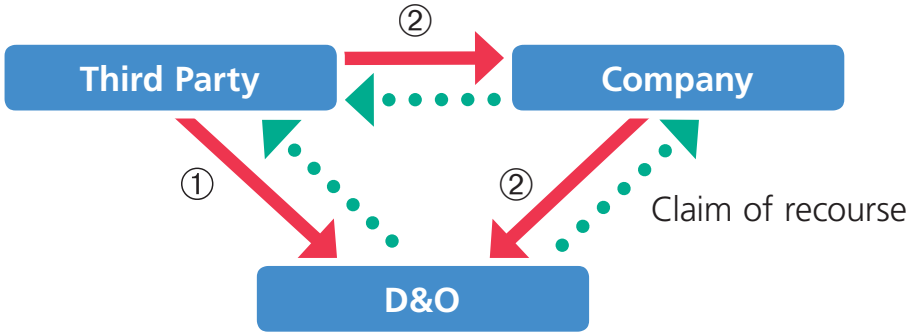
(3) Claims from creditors (in case of bankruptcy only):



① Direct loss. Example: A creditor suffered a loss because he granted a loan to the almost bankrupt company based on inadequate financial information provided by the directors and officers.

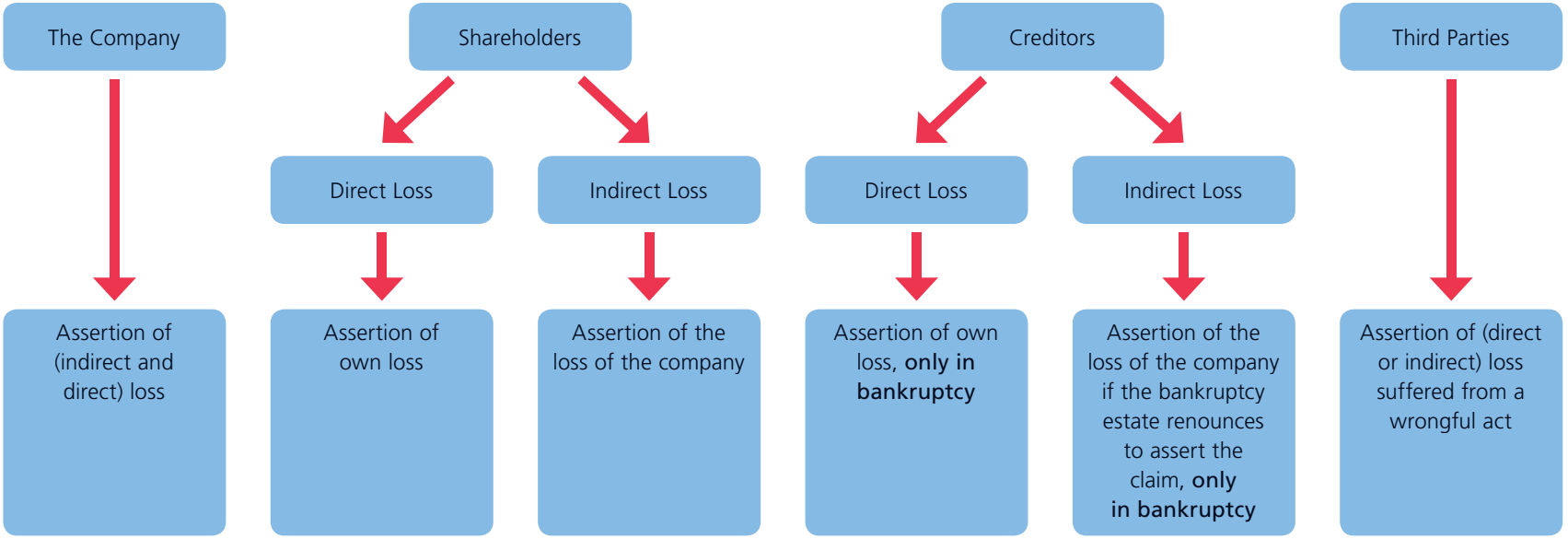
② Indirect loss. Example: A creditor suffered a loss as a consequence of the company's insolvency.

(4) (Extra contractual) claims from third parties:

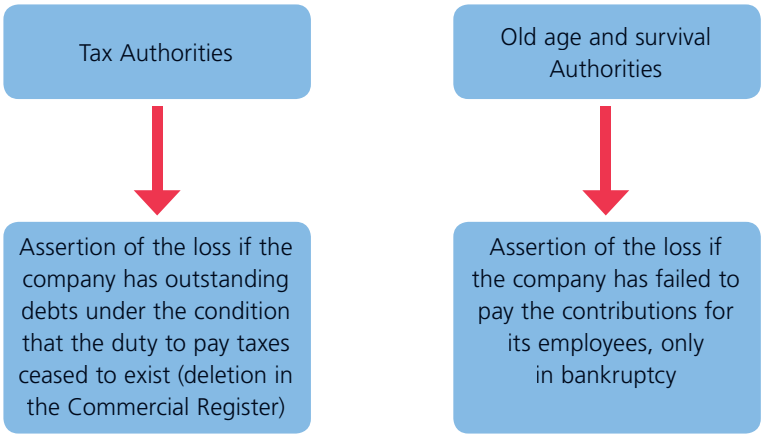


Example: The directors and officers made misleading statements regarding the quality of groceries produced by the company in order to get rid of a stock of contaminated products. The purchasers (= third party) suffered a severe food poisoning. They can sue ① the directors and officers or ② the company.

To sum up, the potential claimants against directors and officers are:



Under public law, there can be additional claimants. In practice, the most important ones are:



Are class actions permissible under local law?

While class actions, in the sense of US representative class actions, are unknown to Swiss law, multiple claimants may join together to bring an action if they have identical or closely related claims.

Scope of liability/indemnification

Are directors and officers personally liable?

If the pre-conditions of liability are fulfilled, the directors and officers are personally liable with all their personal assets for any claims made against them in their capacity as directors and officers. Except in specific cases (liability for tax debts of the company), their liability is unlimited.

Joint and several liability?

In cases where more than one director or officer is liable, each of them is jointly and severally liable with the others to the extent that the damage is personally attributable to him on account of his own fault and the circumstances. Thus, there is joint and several liability but only to the extent that the pre-conditions of liability – in particular a culpable breach of duty and a causal connection between such breach and the loss – are fulfilled for each director and officer. Alternatively, a claimant may bring action against several directors and officers and request that the court determines the liability of each individual defendant in the same proceedings.

Indemnification

As far as indemnification of the directors and officers by the company is concerned, there exists no statutory provision dealing with this issue. As a consequence, the admissibility of indemnification is strongly disputed amongst Swiss scholars. Most of the authors consider the indemnification by the company a violation of the mandatory provision of article 754 CO which states the liability for administration, business management and liquidation, and is regarded as part of the basic legal structure of each corporation. For the same reason, the general rule is that Swiss company law does not allow the directors and officers to contractually limit their liability towards the company. The situation is different with regard to third parties. The general approach is that the company may indemnify its directors and officers for the defense costs incurred in the successful defense of a third-party claim. Furthermore, as long as the court has not decided on the director's or officer's liability, the company may agree to a settlement and pay for the incurred defense costs as well as for the amount of settlement which has been reached with the claimant third-party.

What can be seen in practice is that parent companies indemnify the directors and officers of their subsidiary. As this amounts to an indemnification by a shareholder (instead of the company), this is generally regarded to be acceptable.

It should be noted that no Swiss case law on the issue of indemnification exists to date.

Procedural issues

The structure of the court system

While Switzerland, since 1 January 2011, has a unified Code on Civil Procedure, the organization of the court system still differs from canton to canton. Most of the cantons have established a system with two courts, namely a court of first instance and a court of appeal. However, four cantons (Zurich, Berne, St. Gallen and Aargau) have a specialized Commercial Court which is the only instance for commercial matters in the respective cantons. If the amount in dispute is at least CHF 30,000, the final cantonal judgment can be appealed before the Swiss Federal Supreme Court on issues of the correct application of federal and constitutional law. Besides, there is no reason why the parties to a D&O liability dispute should not be able to agree on arbitration instead of litigation.

Limitations

It should be noted that claims for damages against directors or officers become time-barred five years after the date on which the injured party learnt of the losses and the person liable, but in any event ten years after the date of the act or omission which caused the losses. Where the action derives from a criminal act for which criminal law provides for a longer time-limit, the latter also applies to the civil claim. The limitation period can be interrupted by the claimant by the initiation of debt enforcement proceedings, submission of a statement of claim to a court or arbitral tribunal, the petition for bankruptcy or the summons to attend an official conciliation attempt.

Enforceability of foreign judgments

A foreign judgment against a director or officer can be enforced in Switzerland. If the judgment has been rendered in a member state of the Lugano Convention, the competent Swiss court will not review the substance of the judgment except in cases of very severe defects like an obvious violation of due process or of Swiss public policy. If the judgment was rendered by a court of a state which is not a party to the Lugano Convention, the foreign judgment will normally be recognized if the judgment was rendered by a competent court, the decision is final and the recognition does not violate fundamental principles of Swiss law.

Insurance of Director's and Officer's liability

There is no provision in the Swiss Insurance Contract Act (ICA) or in any other Swiss law dealing with D&O insurance. However, the purchase of D&O insurance is common practice in Switzerland. D&O insurance can be bought by the company, its shareholders, by a group of companies or by the director or officer himself. Usually, the policy holder is the company (or one company for an entire group) which qualifies the D&O insurance as an insurance for account of a third party.

Is director's and officer's liability insurance permissible or legal under local law?

Yes. The validity of D&O insurance contracts under Swiss law is undisputed.

Are there limitations in law to what can and cannot be covered under a D&O insurance policy?

Fines or penalties are commonly excluded from coverage and it would indeed be prohibited by law to purchase such cover. Apart from that, there are no legal prohibitions with regard to the extent of coverage. In practice, punitive or exemplary damages and liability for dishonest or fraudulent acts or omissions are contractually excluded in most D&O policies.

Can an insurer write D&O insurance on a non-admitted basis?

No. Swiss or foreign insurance companies doing business in Switzerland are subject to the supervision by the Federal Insurance Market Supervision Authority (*Finanzmarktaufsicht* – FINMA) and need a respective license from FINMA for any kind of insurance business including D&O insurance.

Is a specific license required for the insurer to write D&O insurance?

There is no specific license for D&O insurance. The insurer must be authorized by FINMA to write liablility insurance which includes D&O insurance.

Are claims made and reported policies permissible under Swiss law, or does the law require occurrence?

The parties to a liability insurance contract are free to contractually agree upon the insured event which triggers coverage. Thus, they can agree on the occurrence or on the claims made principle (theoretically also on acts committed based coverage). As a matter of fact, Swiss D&O insurance policies are almost exclusively written on a claims made basis.

Can defense costs be covered inside the limit of liability?

Yes. The parties are free to determine whether defense costs shall be within the contractual limit of liability or in excess thereof.

Claims brought directly against the insurer

Claims cannot be brought directly against the insurer, except for certain areas of strict liability and tort where liability insurance is mandatory, the ensured activity requires a public license or concession and there is no direct third-party access to liability insurance under Swiss law. Thus, only an insured person or entity is entitled to bring a claim against the D&O liability insurer.

On what grounds can the insurance be avoided/rescinded?

There are a number of grounds under Swiss law on which the insurer can avoid a policy. In practice, the most important one is a violation by the applicant of his duty to correctly disclose material risk factors at the conclusion of the insurance contract. However, the insured only has to disclose information which the insurer specifically asks for in writing. There is no duty of the applicant to volunteer information for which the insurer has not asked, even if the applicant is aware that such facts are or could be relevant for the insurer's decision to conclude the contract on the basis of the terms agreed. In case of an incomplete or incorrect answer with regard to a significant risk factor about which the applicant was questioned in writing, the insurer is entitled to terminate the contract by written notice within four weeks after having obtained knowledge of the violation of the obligation to notify.

Other scenarios which can lead to avoidance of the policy are the aggravation of risk by acts of the policy holder, non-payment of the premium by the policy holder within two months after written notice by the insurer to the policy holder to pay the premium within 14 days, and the fraudulent justification of the insurance claim by the beneficiary or his representatives. The parties are further free to agree on conditions precedent to coverage as long as such conditions do not violate any mandatory provisions of the ICA.

Severability and exclusions

In addition to the regulation on misrepresentation/ non-disclosure, any kind of fraudulent justification of the insurance claim is prohibited under Swiss law. There is no difference if the fraudulent action is undertaken by the insured or his representative. An action is fraudulent if the insured person intentionally misrepresents significant risk factors or omits to correct false perceptions of the insurer. The insurance contract is a bona fide

contract. The legal consequences of a dishonest conduct of the insured in connection with the presentation of his claim to the insurer are severe: the insured loses all rights under the policy and the insurer is no longer bound by the contract.

In a collective insurance the disclosure of information and the knowledge of each insured has to be treated separately. For the question whether or not an insured person has insurance coverage, the misrepresentation of a significant risk factor or the fraudulent justification of the insurance claim by an insured person is not attributable to the other insured persons.

If a local company is a subsidiary of a foreign parent company and such foreign parent company has a worldwide D&O policy which covers the local subsidiary, is a separate local D&O policy also required to be issued for such subsidiary to comply with local law?

No. Directors and officers of a Swiss subsidiary can be covered by a D&O policy of a foreign parent company. An indemnification clause, however, may be illegal if the extent of coverage exceeds the admissible coverage under Swiss law. On the other hand, an additional Swiss policy may be advisable if the foreign policy does not provide sufficient coverage to directors and officers domiciled in Switzerland.

Claims history

In some respects, the collapse of Swissair some ten years ago and the subsequent lawsuits against the airline's former members of the board and of the top management can be seen as the starting point of a development which is hallmarked by an increasing number of D&O claims. While there are no official statistics on D&O claims in Switzerland, the growing number of companies making claims against their former directors and officers is quite obvious. Although most of these claims are settled at some stage and do no result in a judgment against the defendants, it is a natural consequence of this development that D&O insurance has become increasingly important in Switzerland in the last few years. According to numbers recently published by one of the leading Swiss brokers, privately held companies purchase limits of approximately CHF 14 million, public companies on average purchase limits of CHF 65 million with maximum limits of several hundreds of millions Swiss francs.

Influence of foreign law

Given the fact that there is no specific statutory law on D&O insurance and hardly any published case law, it cannot come as a surprise that foreign law indeed has a certain influence on how Swiss lawyers look at certain issues. This is

in particular the case where typical wordings are used in Swiss D&O policies, e.g. wordings from the London insurance market. But also German and French case law may have an influence on the interpretation of Swiss wordings, especially, of course, where no comparable Swiss case law exists.

Extended reporting periods/discovery in local law

The ICA states that the insured has to report the occurrence of the insured event to the insurer without delay, but the parties to the insurance contract are free to contractually derogate from this, e.g. by stipulating concrete notification deadlines which can also be drafted as conditions precedent to coverage. Also extended reporting periods/discovery may be contractually agreed between the parties.

Recent and expected developments

The Swiss Insurance Contract Act which is more than 100 years old, is currently under revision. The Swiss government issued its project which is now in the parliamentary debate. Like the existing ICA, the governmental project does not contain specific provisions on D&O insurance, but nevertheless contains significant modifications which would also have an impact on D&O insurance, such as the right of direct action of the damaged party against the tortfeasor's liability insurer. The most important of the suggested modifications, however, is that the new law would make a clear distinction between consumer contracts and insurance of commercial/industrial risks. While most of the provisions of the governmental draft would be mandatory for the former, this would not be the case for the latter where the parties would be free to amend or delete almost any provisions of the Act as long as they would not agree on anything impossible, unlawful or immoral.

The first chamber of the Swiss parliament rejected the total revision of the ICA and suggested a *partial* revision instead. It is likely that the second chamber will also reject the total revision. In this case, the government will

have to elaborate a new draft for a partial revision with the following main issues to be addressed: rescission and termination, confirmation of coverage, retroactive insurance, statute of limitations and e-commerce.

PRAGER DREIFUSS

Christoph K. Graber – christoph.graber@prager-dreifuss.com

Prager Dreifuss AG
Mühlebachstrasse 6, CH-8008, Zürich, Switzerland

www.prager-dreifuss.com/en/home