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The Swedish Corporate Governance Board

DISCHARGE FROM LIABILITY
in the Swedish listed company

by Carl Svernlöv

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Foreword

This brochure examines a special feature of Swedish corporate governance: The annual discharge from liability for the members of the board and the managing director. Under Ch. 7 § 11 of the Swedish Companies Act 2005 (referred to below as the SCA), the shareholders are to resolve whether to grant discharge from liability to the board members and managing director at the annual general meeting. Discharge is granted unless a majority of the votes at the shareholders' meeting are cast against the proposal or shareholders representing at least 10 percent of the issued and outstanding capital vote against it. The discharge resolution usually follows the recommendation of the auditors, who are required to state in their audit report whether or not they recommend that discharge be granted. Almost without fail, such a recommendation is given each year in listed Swedish companies, and from a Swedish corporate governance perspective, the decision is usually uncontroversial.

However, in view of the increased activism and use of proxy voting by foreign shareholders in recent years, and the need for such shareholders to understand how the discharge resolution works and what it means, the Swedish Corporate Governance Board is of the opinion that it would be helpful to international investors to explain in more detail this uniquely Scandinavian feature of corporate governance.

Accordingly, the purpose of this brochure is to facilitate a better understanding among international investors of the purpose and effects of the annual discharge resolution in Swedish listed companies.

This brochure has been written by Carl Svernlöv, LL.D., a leading academic and practicing attorney within Swedish company law and corporate governance, who alone is responsible for its content. It is published by the Swedish Corporate Governance Board as a service to international investors.

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Hans Dalborg

Chairman
Swedish Corporate Governance Board

I. The Liability Rules under the Swedish SCA

Before the discharge rules are discussed in detail, it is useful to provide a general introduction to, and description of, the rules of Ch. 29 of the SCA which relate to the liability of board members and the managing director for damages. The purpose of this section is not to analyse these rules, merely to provide the backdrop for the subsequent presentation of the discharge rules, which are inextricably connected to them.

The persons subject to liability under Ch. 29 of the SCA are not only the founders, board members, managing director and liquidators, but also auditors, lay auditors, special auditors and shareholders. Considering that the resolution to grant discharge from liability concerns only board members and the managing director, the following discussion focuses on the liability of these two categories.

Liability for damages under the SCA is usually divided into "internal" liability towards the company and "external" liability toward shareholders, creditors and other third parties. The common elements of these categories are that they both require that damage has actually occurred (and is not just contingent), that the member of the board or officer causing the damage has committed an act or an omission that is at least negligent, and that the damage arising from the act or omission is a reasonable and proximate result thereof. The starting point of the assessment of negligence is the standard of care required of a fiduciary, and the terms of reference used to assess culpability are primarily the rules of the SCA, the Annual Accounts Act and the articles of association. However, other laws and legal regulations that impose duties on the members of the board or the managing director may affect the assessment.

The imposition of "external" liability to shareholders, creditors and other third parties requires, in addition to the requirements set forth above, that the damage has arisen through a violation of the SCA, the Annual Accounts Act or the articles of association, or of the prospectus rules contained in the Swedish Financial Instruments Trading Act or Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements.

An action for liability may be brought by the company, by the board, or on the company's behalf (i.e. a derivative lawsuit) by owners of at least one tenth of all shares. A settlement with the liable party must not be made without a formal decision or ratification by the shareholders' meeting and, if a shareholder has brought a derivative action, not without his or her approval.

Moreover, actions by the company against members of the board or the managing director may, as a main rule, not be brought unless the issue of bringing such action or (not) to grant discharge from liability has been considered by the general meeting of shareholders. If the action is brought under the rules of exception set forth in Ch. 29 §§ 11, 12 or 14 of the SCA (see below), the issue of discharge from liability or bringing action does not need to be brought up again at the shareholders' meeting. There are no corresponding rules relating to actions by a third party.

The rules regarding limitation of actions (statute of limitations) in the SCA that are of relevance here comprise a one-year and a five-year period. The main rule is that an action for damages on behalf of the company against a board member, a managing director or their deputies that refers to a decision or action taken during the course of a financial year must be initiated not later than one year after the annual accounts and the audit report were presented at the shareholders' meeting. The five-year limitation period applies from the end of the financial year in which the decisions or the actions that the proceeding is based on were taken. This period applies regardless of whether discharge from liability was granted or not and even if no annual accounts for that financial year have been presented or no shareholders' meeting is held. The limitation period is subject to exceptions related to actions based on criminal conduct and, under certain circumstances, to actions initiated by the bankruptcy estate in case the company enters into bankruptcy (insolvent liquidation).

II. A Brief Overview of the History and Purpose of the Discharge Resolution

Originating from German law, the discharge resolution has a long history in Scandinavian and particularly Swedish law. This section discusses the background to and purposes underlying the annual discharge resolution. In light of this connection, comparisons are drawn to the laws of the other Scandinavian countries and Germany, which all have similar legislation in this regard.

The issue of discharge from liability has been a mandatory agenda item at the annual meeting since the Swedish Companies Act 1895, and the relevant provision has remained largely unchanged to the present day. However, the exceptions to the discharge rules have gone through a successive evolution so that the protection granted by a discharge resolution is at present significantly restricted (see VII below). As indicated above, the discharge rules were originally based on German law, which still has similar rules and – as to discharge from liability in the GmbH – also similar effects of such a resolution. However, the rules applicable to German listed companies, i.e. the AG, specifically provide that granted discharge does not preclude the company from bringing an action in liability against a board member.

There is substantial similarity between the rules regarding personal liability and discharge for board members and managing directors in the company legislation of Denmark, Finland and Norway. However it is only Finland that has a mandatory annual discharge resolution. In the other two Nordic countries, the resolution is optional.

The rules on discharge from liability in the SCA have several purposes. Ultimately, the provisions regarding discharge from liability may be subsumed under the main purpose of the SCA, i.e. to promote business. The primary purpose of the rules regarding discharge from liability has been stated by the legislator to be the interest of bringing the issue of liability of the members of the board and the managing director to a speedy and clear resolution, in order not to interfere with the company's operations. In addition, the discharge rules promote openness and the provision of information to the shareholders about circumstances of importance for the assessment of how well the board and management are have handled their assignment. An economic argument related to the cost of litigation can also be made for the discharge rules, as these promote a quicker and more efficient handling of issues of liability, since any actions for liability need to be brought within a limited period of time.

III. Persons Subject to Discharge

The persons normally covered by a discharge resolution are board members and the managing director. This means that each person who has served in the capacity of board member or managing director during the financial year to which the annual accounts presented at the annual general meeting refer has a right to have the issue of his or her discharge from liability considered at the general meeting. Consequently, unless otherwise set forth in the discharge resolution, it also covers board members and managing directors who have been appointed or dismissed or have resigned during the course of the financial year.

The only board deputies (alternates) of a Swedish listed company are normally the deputies, if any, of the employee representatives. To the extent there are such deputies, a generally formulated resolution to grant discharge from liability that covers the board members and the managing director is normally deemed also to cover such deputy board members and deputy managing directors, to the extent the resolution itself does not otherwise provide. These deputies should consequently also have a right to have the issue of their discharge from liability considered by the annual general meeting of shareholders.

IV. The Auditors’ Recommendation

As stated in the foreword, the auditors of a Swedish company have an obligation to state in their audit report whether the members of the board of directors and the managing director should be granted discharge from liability vis-à-vis the company. Where an auditor, in the course of the audit, becomes aware of any acts or omissions by any member of the board of directors or the managing director which may give rise to liability, this must be noted in the auditor’s report. This requirement also applies where the auditor, in the course of the audit, finds that a member of the board of directors or the managing director has acted in contravention of the SCA, the applicable annual reports legislation or the articles of association.

Normally the auditor will make a clear recommendation to the shareholders to grant discharge from liability. This is almost without fail the situation in Swedish listed companies. On rare occasions, the auditors may – in view of a potentially damaging action or omission by a member of the board or the managing director – recommend against discharge being granted. It is also possible, albeit also very rare in the context of a listed company, that the auditors are unable to recommend for or against a discharge resolution, e.g. for reasons of insufficient information. Under such circumstances they will state that this is the case.

V. The Discharge Resolution

The discharge resolution is considered at the annual meeting on the basis of the adopted annual accounts for the latest financial year. This section describes the decision in some detail, including the rules on requisite voting majority for the resolution, conflicts of interest in the voting and the role of proxies.

As an initial comment, it would be very rare for the shareholders' meeting not to grant discharge if the auditors have so recommended. However, a shareholder may freely vote against discharge with or without reason.

Because of the rules on conflict of interests in the SCA, a shareholder who has also served as a board member or managing director during the relevant period (normally the relevant financial year) may not, directly or through a proxy, vote on the issue of his or her own discharge from liability at the shareholders' meeting.

The conflict rule applies also to proxies, with the result that a shareholder may neither vote for another person's shares under a proxy nor empower anyone else to vote his or her shares in issues where he or she has a conflict of interests. Against this background, if the question of discharge from liability for all board members is considered as a single matter (and thus not individually for each member), no shareholder who has served as a board member or managing director during the relevant financial year may vote. Furthermore, such a shareholder is prevented by conflict of interest from voting on his or her own discharge from liability if the issue is considered individually for each board member and the managing director. The conflict rule does not however extend to prevention of the shareholder in such case from voting on the discharge from liability of the other board members, even if the vote is cast with the understanding that board members who are also shareholders return the favour.

The SCA does not contain any specific provisions regarding the majority requirement in order for a resolution to grant discharge from liability to pass. Consequently, as a result of the general rule on voting in Ch. 7 § 40 of the SCA, compared with Ch. 29 § 7 of the SCA, a decision to grant discharge from liability is passed by simple majority. In the interest of protecting the minority shareholders, however, this principle is subject to an important exception, under which discharge from liability is refused if owners of at least one tenth of the shares vote against the resolution at the shareholders' meeting. Such a minority may thus prevent discharge from liability from being granted. Consequently, a discharge from liability is granted if shareholders representing a majority of the shares support the resolution at the shareholders' meeting, unless a minority representing at least one tenth of the shares in the company votes against the resolution.

The failure to hold an annual shareholders' meeting at all or the failure by the company to include the discharge issue in the summons to the meeting raises the issues of whether the shareholders, individual board members and the managing director can demand that the discharge issue be resolved and what other effects the failure to pass a resolution in this regard would have. Not only shareholders, but also individual board members and the managing director have a right under Ch. 7 § 17 of the SCA to have the county administrative board with jurisdiction over the company call a shareholders' meeting to be held according to the SCA, the articles or a resolution by the shareholders' meeting. This rule is most frequently sufficient to bring about a shareholders' meeting. However, if no shareholder attends the meeting, no meeting can be held. In such a case, the board members and the managing director cannot be granted discharge from liability. If the problem is merely that the issue of discharge from liability was not included in the summons, the shareholders' meeting may still resolve this issue under Ch. 7 § 26 of the SCA, since it is a mandatory issue at the annual shareholders' meeting.

However, if the shareholders' meeting omits – intentionally or inadvertently – to resolve the issue of discharge from liability, the situation is more problematic. Under the applicable statute of limitations, if the annual accounts have been presented to the shareholders' meeting, the possibility to bring claims against the board members and the managing director will expire one year thereafter. While the board members and the managing director would clearly prefer to be granted discharge from liability with immediate effect, the result for them of a failure to consider this resolution at all is not as problematic as for the (minority) shareholders.

Such a failure is clearly detrimental to the minority shareholders, since a failure to resolve the issue will effectively prevent a derivative action from being brought by the minority shareholders under Ch. 29 § 9 of the SCA. As stated above, the reason for this is that it is a condition sine qua non under Ch. 29 § 7 of the SCA that, in order for any action to be brought, the shareholders' meeting must have passed a resolution to bring action or to deny discharge from liability (or that shareholders representing one-tenth of the shares voted for such action to be brought or for discharge to be denied). Even though the SCA does not provide for this contingency, the mandatory requirement for the annual shareholders' meeting to consider the issue of discharge from liability and the right to have the issue of action to be brought by the company against a board member or the managing director considered by the shareholders' meeting would be of little value if the shareholders' meeting could simply refuse to consider these issues.

On the basis of this assumption and on the basis of a Swedish Supreme Court case in a similar issue, NJA 1960 p. 698, an aggrieved shareholder would have recourse to the courts in case of such an omission. The reason for this is that failure by the shareholders' meeting to consider the issue would constitute an express or implied resolution of the issue that may be attacked under the general provisions regarding invalidity of decisions under Ch. 7 §§ 50-51 of the SCA. A court may – if it is possible to determine how the vote would have resulted – in this connection declare that the shareholders' meeting has passed a certain resolution on the issue of discharge from liability. If the court cannot determine how the vote would have gone, it is still possible that the ability to bring derivative action may be thwarted.

VI. Effects of the Discharge Resolution

A resolution to grant discharge from liability means – unless an exception is applicable – that the company waives the right to bring an action for liability against the board members and managing director covered by the resolution for the relevant period. A decision to grant discharge from liability thus generally means that the shareholders approve of the administration and its results. This section discusses in more detail the legal effects of the discharge resolution.

Under Swedish law, it is the shareholders' meeting that decides on whether an action in damages should be brought against a board member or the managing director. Following such a decision, it is generally the board that handles the actual lawsuit against the defendant. However, as suggested above, a shareholder minority comprising at least one tenth of the aggregate number of outstanding shares (not votes) has the right to bring a derivative action against a board member or managing director in its own name but on behalf of the company. Furthermore, the board of directors has the right, without a prior resolution by the shareholders' meeting, to bring an action in damages based on the criminal action of the defendant. Another limitation on the discharge is the right of a person who has been adjudged liable under Ch 29 § 1 of the SCA to bring a recourse action against another director or managing director who has contributed to the damage, even though the latter has been granted discharge from liability.

With respect to the substantive scope of the discharge decision, the starting point for its determination is the contents of the resolution of the shareholders' meeting. Since the discharge resolution most often takes a fairly generic form, it is rare that the resolution as such provides much guidance. Against that background, other methods are needed in order to determine the scope of the discharge. To this end, there is a presumption that a discharge resolution covers all assignments that a person has in the company, primarily the combined role as board member and managing director. Conversely, discharge does not cover liability for consulting assignments for the company outside the framework of the assignment as board member or managing director. Acts and omissions on the borderline between these two areas are covered by a general discharge resolution, at least to the extent that the relevant act or omission could lead to liability by extensive application of the liability rules of the SCA.

The liability rules in the SCA outside Ch. 29 are not affected by a discharge resolution. Such rules include inter alia liability under Ch. 17 § 6 of the SCA for deficient coverage liability in the event of unlawful value transfers and under the rules on personal liability in Ch. 25 § 18 of the SCA for failure to take appropriate actions in case the company's share capital has been depleted.

VII. Temporal Aspects of the Discharge Resolution

The provisions regarding discharge from liability include a number of time periods. A discharge resolution under Ch. 7 § 11 of the SCA is granted with respect to a financial year in accordance with the annual accounts and audit report presented at the annual shareholders' meeting. This means that the discharge resolution normally refers to the administration of the board members and the general manager during the 12-month period that the financial year comprises. It may, however, also comprise other periods, primarily in the rare event that a company changes its financial year.

VIII. Exceptions from Granted Discharge

This section considers in greater detail the special issues that arise in relation to the exceptions to granted discharge from liability, which constitute a significant limitation to the effect of discharge.

The main exception in Ch. 29 § 11 of the SCA signifies that discharge granted according to Ch. 7 § 11 of the SCA or due to the statute of limitations in Ch. 29 § 10 of the SCA shields a person from liability for a certain decision or action only where materially correct and complete information was provided in the annual report, the auditor's report or otherwise to the general meeting regarding the resolution or the measure on which the proceedings are based. With respect to how information may be provided to the shareholders' meeting, the terms "in the annual accounts" and "in the audit report" are to be interpreted narrowly and, in principle, no other documentation is included. Information provided "in another manner" may in principle comprise all oral or written information that is presented or available at the shareholders' meeting. However, without the consent of all shareholders, (not just the ones present at the meeting), information submitted to the shareholders outside the shareholders' meeting is not included.

The materiality standard in Ch. 29 § 11 of the SCA refers to the correctness and completeness of the information to be supplied, not the materiality of any withheld information. A central issue in the interpretation of the exception rule in Ch. 29 § 11 of the SCA, is whether the discharge is to be considered an overall assessment of the management and administration of the board members and the managing director during the relevant financial year or whether each individual decision or action is subject to consideration. While there may be both teleological and systematic arguments for the first alternative, there is no basis in the provision, as presently worded, for such interpretation. On the contrary, the information threshold is fairly high, and an action for liability under Ch. 29 § 1 of the SCA may in principle be brought on the basis of any decision or action with respect to which the shareholders' meeting was not correctly and completely informed.

Another exception is found under Ch. 29 § 12 of the SCA, which permits the board of directors to bring an action for liability based on criminal actions. Initially, it is noted that it is sufficient for the application of this exception that the elements of a criminal action are present, i.e. commitment of a criminal act with scienter (or in some cases gross negligence or even negligence). It is not necessary that the person to be held liable has been prosecuted for or convicted of the crime.

Another exception from the discharge rules applies in the case of bankruptcy of the company. According to Ch. 29 § 14 of the SCA, the bankruptcy estate may thereafter bring a liability action, even though such action was precluded prior to the bankruptcy by Ch. 29 §§ 7, 8 or 10 of the SCA. However, after the five-year statute of limitations, such an action may not be brought later than six months from the date of the hearing in respect of administration of oaths. No decision by the shareholders meeting is required in order for such action to be brought.

If any substantive or formal errors have occurred in connection with the discharge resolution at the shareholders' meeting, the resolution may be challenged in a court of law under Ch. 7 §§ 50-52 of the SCA, just like any other resolution. Such a challenge may be brought by a shareholder, the board of directors, a single member of the board or the managing director. However, neither the board, its members nor the managing director may challenge a resolution to deny discharge on substantive grounds, as this would be contrary to the interests of the company and accordingly in violation of their fiduciary duties.

If such a challenge is successful, the discharge resolution will be invalidated ab initio, which has the same effect as if no discharge resolution had been made at all. However, because of the time involved in obtaining a judgment in the public courts and the one-year statute of limitations in Ch. 29 § 10 of the SCA, an action that is founded on the invalidation of a discharge resolution should always be combined with a petition for an interim judgment that the precondition to an action in Ch. 29 § 8 of the SCA has been fulfilled.

Finally, if a share issuance is invalidated following an action to challenge the issuance, any resolution on discharge made on the basis of the invalid shares is not void, and will therefore become valid when the three-month time limit to challenge resolutions by the shareholders' meeting has expired.

IX. Conclusion

As shown in this brochure, the time-honoured discharge resolution in the Swedish listed company is normally an unconventional decision to be taken by the shareholders' meeting. Even though its effects may appear far-reaching to an investor unfamiliar with the system, the scope of the exceptions from granted discharge is sufficiently wide for one well-known Swedish legal scholar, Knut Rodhe, to remark that "A decision to grant discharge from liability [is] generally only... a gesture without any legal significance whatsoever."

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