

Moral Hazards within Liability Insurance – A Problem Inventory¹

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1 Introduction

The insurance world is based on a belief in solidarity. Insurance entails that the individual is a part of a collective that bears losses as pulverized among several parties. Subscribing to an insurance policy in itself can be seen as a moral action – the intent to contribute to the collective and the assumption of a collective liability. Subscribing to an insurance policy is helping others, distributing assets more fairly and creating equality. Every insurance policyholder pays a premium for the appropriate risk and the right to compensation under the same conditions. Comparable cases are to be treated equally. Insurance is also based on a principle of loyalty. The party having knowledge as to the objects being insured is the insured party. It is also the insured who has knowledge as to the course of events constituting an insurance case. The insurance provider is forced to rely on the insured party and the insured party is to act loyally upon the subscription to the insurance and with any investigation as to insurance cases. Insurance is also built on the idea that it in itself cannot change the risk of harm incurring. Insurance can only distribute the costs for any harm that has arisen.

These fundamental principles as underlying the insurance system, however, do not always function in reality. Research, primarily conducted by economists, demonstrates that the existence of insurance can change the risk for harm arising. The insured can, in a disloyal manner, exploit the insurance system in order to gain personal benefit. An individual can act in a manner that is greedy, selfish and which entails personal profit at the cost of others. This behavior can be manifested on several levels. An individual acquires insurance protection at a lower premium than other insured parties and demands insurance compensation according to terms to which the party does not have the right. The truth is adjusted and the facts skewed so that the individual, personally, receives the greatest amount of possible compensation. The individual interest, the personal gain, goes before the collective interests, the solidarity.

The most recent financial crisis in 2008 has once again revived the phenomenon entailing that the financial risks of individual banks spillover to other banks and by way of extension to the financial system.² This same phenomenon occurs within the framework for insurance; the individual's risk-taking entails that losses are borne by the collective. In a certain aspect, such a distribution is the entire purpose with insurance, but in this article, the phenomenon that an insured adjusts behavior because there is insurance for the purpose of obtaining personal gain is examined. This phenomenon, by

2 See, for example, Lastra, Rosa Maria, *Lender of last Resort, An international perspective*, *International and Comparative Law Quarterly*, vol 48. 1999 p. 340; Sjöberg, Gustav, *Lagen om statligt stöd till kreditinstitut*, Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, Financial Stability Forum, April 2008, JT 2008-09 p. 579; Kristoffersson, Eleonor, *Statsstöd i ekonomisk kris, EU och den globala krisen* (2010) p. 171 ff. with references; and Ordeberg, Thomas, *Hantering av finanskrisen i EU – rättsliga och institutionella aspekter, EU och den globala krisen* (2010) p. 23 ff. with references.

economists termed a moral hazard, will be highlighted within a specific type of insurance –liability insurance. The object of this study is corporate insurance, even though certain consumer law questions will be touched upon. In this article different types of moral hazards with respect to liability insurance are examined, along with the different types of instruments existing in order to control these risks. This subject raises many difficult questions, for example, such as contractual interpretation as well as the boundary between contractual and tort liability. The intention here is not to give an exhaustive analysis of these issues. The intention with this article instead is to identify the behavior that can be seen to constitute moral hazards with respect to liability insurance and generally recount the tools existing in order to control these risks. The phenomenon of moral hazard in liability insurance is probably of a global nature. The focus in this article, however, is the Swedish approach to the problem.

1.1 *Moral Hazards*

What is a moral hazard? The concept is borrowed from the theory of Law and economics, in which the phenomenon moral hazard has been treated at the academic level.³ In Law and economics, moral hazards are sorted into three categories. First, the insurer has to take a stance as to a physical risk (physical hazard), in other words, a risk stemming from the nature of the object or circumstances. This can be the case, for example, with respect to a residence situated in a high-risk area.⁴ In addition, the insurer has to take a stance with respect to a legal risk (legal hazard), which entails that a contract, legal rule or other norm affects the risk for an insurance case. It is reasonable to assume that liability insurance is sensitive for legal risks even if there is research refining this assumption and demonstrate that there are other factors that to a high degree affect risks with liability insurance than simply changed tort rules.⁵ The moral risk (moral hazard) is a risk personally tied to the insured. A moral hazard consequently is an increase in the probability of an injury, or the risk that the amount of the harm is dependent upon the attitude or character of the insured or insurance policyholder's person. Physical and legal hazards at a certain point of time or to a certain degree are fixed, while the moral hazards contain an element of free choice: the insured knows that there is an insurance

3 See, for example,. Heimer, Carol A. *Reactive risk and rational action – Managing Moral hazard in Insurance Contracts*, University of California Press (1985); Parsons, Christopher, *Moral Hazard in Liability Insurance*, The Geneva Papers on Risk and Insurance, Vol. 28 No 3 (July 2003) pp. 448 – 471; Chandler, Seth, *The Interaction of the Tort System and Liability Insurance Regulation: Understanding Moral Hazard*, Conn. Ins. L.J. Vol. 2 (1996) pp. 91 – 178;. Stone, Deborah A. *Beyond Moral Hazard: Insurance as Moral Opportunity*, Conn. Ins. L.J. Vol. 6,(1999-2000) pp. 11 – 46; and Shavell, Steven, *On the Social Function and the Regulation of Liability Insurance*, The Geneva Papers on Risk and Insurance (2000), Vol. 25, No. 2 pp. 166 – 179.

4 Heimer *supra* p. 29.

5 Bengtsson, Bertil, *Försäkringsteknik och Civilrätt* (1998) p. 120 ff.

that eventually will cover the harm, and adjusts his or her behavior accordingly. In the context of personal insurance, at times inelastic and elastic hazards are discussed, where the latter are such that can be affected by personal considerations.⁶ The boundary between hazards that are affected by personal considerations and those by other risks is not clearly delineated. It has been maintained that the existence of insurance creates social mechanisms that tend to increase the scope of risks that are considered insurable and that deserve collective protection.⁷

The problem with moral risks is treated by the legal scholarship primarily in the context of when a party, based on the existence of insurance, becomes more prone to cause an injury, or more prone to omit trying to prevent an injury, or to creating an injury, for example by exaggerating the extent of the harm or quite simply fabricating the harm. This can be the case with respect to personal injuries of different types, such as sicknesses, industrial accidents or other types of accidents, harm to property that is intentionally caused, like arson or theft. It can also be other types of harm, for example, economic crimes or disruptions in business. The phenomenon that the insured is more prone to cause a harm when insurance is in place covering the losses has in Swedish law been taken up in discussions concerning the preventive effects of compensation.⁸

This article addresses moral hazards from a wider perspective. Moral hazards are examined not only in the recently-named context, but also from the perspective of the insured's actions for the purpose of tailoring an already occurring injury into the coverage area of the insurance. One example with respect to liability insurance can be that the insured, when reporting the injury, and during the insurance adjustment, incorrectly states that the harm was caused by negligence when in actuality it was a question of an intentionally caused harm that is excluded from the insurance coverage. One can also contemplate a situation in which the insured incorrectly states that an injury was caused by carelessness when in actuality it was a question of a pure accident that neither is covered by insurance.

Consequently, moral hazards, in contrast to other risks, have the common denominator that they are tied to the insured's person. Individuals who are protected from the consequences of risky behavior, for example by subscribing to insurance, can be prone to take risks. The cause of this can be questioned. Moral hazards are often described as being synonymous with character weakness, or "bad character."⁹ One method for combating these hazards is for

6 Carlsson, Mia, *Arbetskada – samspelet mellan skadestånd och andra ersättningsanordningar* (2008) p. 111 with references.

7 Stone, *supra* p. 13.

8 See, for example, Karlgren, Hjalmar, *Skadeståndsrätt* (1969) p. 13; Hellner, Jan, *Försäkringsrätt* (1965) p. 389; Bengtsson, Bertil, *Ansvarsförsäkring och skadestånd – är det dags för en omprövning?* in *Vänbok till Erland Strömbäck* (1996) p. 21 ff.; Bladini, *Preventionstanken i den skadeståndsrättsliga utvecklingen*, in *Vänbok till Erland Strömbäck* (1996) p. 55 ff.; Carlsson, *supra* p. 110 ff.; and Kruse, A. Vinding et al. in the debate series, *Preventionen i ersättningsrätten – finns den?*, SvJT 1987 p. 397 ff.

9 Heimer, *supra* p. 35.

the insurer to acquire better underwriting and, for example, investigate potential clients. The result then can be to refuse insurance protection for “hopeless” cases and demand higher premiums for dubious ones. Economic reality is also a factor that can constitute a moral hazard. By subscribing to insurance, economic risk is transferred from the insured to the insurer. By subscribing to insurance, the insured loses the incentive to investigate other possibilities for decreasing economic risks.¹⁰ In such cases, there have to be other incentives for reducing risks of injury, for example, deductibles, secondary obligations or exemptions in the terms and conditions of the insurance. One can also contemplate that the risk may arise through a combination of “immoral” risk-taking and economic rationalization. The many moments of uncertainty within liability insurance entail that insured parties can be prone to push the limits quite simply because it is possible to do so. Simply the possibility that through insurance to be able to cover losses can trigger a process of rationalization that can result in the insured adjusting his or her behavior after the existence of the insurance. If there is an incentive to push the limits with respect to the rules, terms and truth, there is also the risk that such will occur.

In this context, it should be mentioned that the insured party with respect to corporate insurance is often the actual corporation, the legal person, while the party who is taking an action or failing to act is a natural person identified with the corporation.¹¹ Even if one normally assumes that it is only natural persons who can have or lack morality, there ought to be examples of corporations acting in accordance to a corporate morality which corporate management has encouraged or allowed.

Something should also be said about the chronology of moral hazards. While the physical, and perhaps also legal, risks are in some way fixed at a certain point of time with respect to the execution of the insurance agreement, the risk for moral hazards exists throughout the entire period of insurance coverage. They can arise with respect to the execution of the insurance policy, when the premium is determined. The insured can also have the intent to hide or omit circumstances or give incorrect information. During the period of the insurance coverage, the insured can cause an insurance case to arise, or worsen its consequences. In cases of liability insurance, there is the risk that the insured admits to damage liability with respect to injuries arising or acts in collusion with the injured. One can also contemplate cases in which the insured fails to report an insurance case in time, with the consequence that it becomes more difficult to establish correct compensation. Finally, one can contemplate cases in which the insured fails to cooperate with the insurance investigation in an adequate manner, by refusing to submit, for example, relevant documentation. Moral hazards consequently can arise not only with the injury, but during the entire period of insurance coverage.

10 Heimer, *supra* p. 35.

11 With respect to identification within the context of company insurance, see Nydrén, Birger, *Identifikation samt förhållandet mellan biförpliktelser i företagsförsäkring, Uppsatser om försäkringsavtalslagen* (2009) p. 102 ff.

1.2 Specific Characteristics of Liability Insurance

Every form of insurance is the object of different types of moral hazards. With respect to personal insurance, there is the risk, for example, that the insured claims back problems difficult to verify. With respect to fire insurance, there is the risk that the insured sets fire to the insured property. Liability insurance is a form of injury insurance, however, the specific characteristics of this type of insurance entail that the moral hazards are also of a specific type of character.

First, there are always three parties involved with liability insurance cases: the insurer, the insured who is also the tortfeasor, and the injured party. Consequently, with respect to liability insurance, it is not the insured who has suffered the primary harm, but rather a third-party who has become a victim of the insured's recklessness. Such a three-party constellation is an excellent feeding ground for conflicts of interests of different types. The insurer and insured have a common interest which is in conflict with the interests of the party harmed, for example, when it comes to determining whether an insurance case exists or not. The injured party with a right to directly make a claim as to the insurance and the insurer can have interests opposing the insured's interests, for example when the insurer wishes to investigate the injury against the wishes of the insured. The insured/tortfeasor and the injured party can have a common interest in opposition to the insurer's interests, for example when the insured wishes to use the liability insurance to cover the losses of the injured party despite the fact that it is not certain whether it is liable.

This three-party constellation also constitutes excellent feeding grounds for different types of information asymmetry. The party injured has knowledge as to the actual injury that neither the tortfeasor nor the insurer possesses. The tortfeasor has knowledge as to the character of the actions that neither the injured party nor the insurance company possesses. The insurance company has knowledge as to the terms and conditions of the insurance policy and the process with respect to evaluating claims that the other parties have only a somewhat vague understanding about. When these different types of knowledge are communicated between the three parties, there is a risk that information asymmetry will arise. The risk for information asymmetry can be exploited in order to create collusions of different types. One can envision that the tortfeasor and the injured party take similar stances, for example, regarding the course of events that the insurer will later have difficulties refuting.

Another characteristic of liability insurance is that the interest insured is a liability for damages. The fact that it is the liability for damages that constitutes an insurance case, and not the actual damage, can complicate any insurance law issues that could arise in connection with the claim processing. Basic issues, for example, as to whether an insurance case exists, what is an insurance case, and when an injury is to be reported to the insurance company, can be difficult to answer from the context of liability insurance. The insurance law assessments in themselves are complicated. Were the actions negligent? Was there causality between the action and the harm? Was the injured party contributorily negligent?

Another characteristic is that the harm does not always exist at a fixed point in time, which can be the case, for example, when a building burns to the

ground. Instead, it is not unusual that the harm, and therewith the liability for damages, arises successively. A project in which the client is to upgrade an IT system can take several years. In such a project, with many parties involved both for the consultants and for the client, it can be difficult to establish who party caused the harm, and also when the harm arose. In addition, the risk with liability insurance can be a long-term risk, a “long-tail risk.” This means that the insurer can cover risks that were caused during the period of insurance despite the fact that they did not manifest themselves until long after the acts causing the damage, and even a long time after the actual insurance expired. This “cause” principle was the model for the 1927 Insurance Agreements Act, Lag (1927:77) om försäkringsavtal. If an event occurred during the insurance term, the insurance company in the event of liability insurance according to § 91 of the 1927 act was obligated to pay compensation under a liability insurance policy even if the harm was first claimed later. This statutory provision was a gap-filling provision, and in the insurance agreements other periods of coverage were prescribed. Another method is to cover events that occur or are reported during the insurance term, or cover events that were detected during the insurance term.¹²

2 Moral Hazards with Respect to the Insured

2.1 *The Insured Causes the Damage*

That the insured, who is also the tortfeasor, is less careful than he or she would have been in the absence of insurance, with the consequence that the insured creates the risk which would not have been created if the insurance did not exist, is a classic moral hazard. This can be the case, for example, in the event that the insured, for the purpose of saving time and money with respect to work, fails to perform a quality check in the belief that the insurance will cover any future losses. This can also be the case if an insured, who discovers that a commission is going to be unsuccessful, fails to inform the client and the insurance company as to this course of events, and therewith causes a greater injury than was necessary.

Such behavior, from the perspective of insurance, can be deemed as causing an insurance case. According to § 8:11 of the current Insurance Agreements Act, Försäkringsavtalslagen (2005:104) the insurance company is released from liability as against an insured who has intentionally or through gross negligence caused an insurance case. The same is true in the event that the insured otherwise must be assumed to have acted or to have failed to act in the knowledge that a considerable risk for harm would arise. This statutory provision entails a higher threshold in relationship to the former 1927 act with respect to the fact that the current act includes certain conscious carelessness as well as an act or failure to act in the knowledge that it would entail a

¹² See further Bengtsson, Bertil, Ullman Harald and Unger, Sven, *Allehanda om skadestånd i avtalsförhållanden* (2009) p. 143 ff.

considerable risk.¹³ It can be seen from the second paragraph of this provision that the insurance company is released from liability as against the insured to the extent the circumstance has affected the harm if the insured has worsened the consequences of the injury.

Such an action can also be seen to be in conflict with the insured's duty to prevent damage. From § 4:7 of the current Insurance Agreements Act (which according to its § 8:12 is to be applied even with corporate insurance), it can be seen that the insured in the event of an insurance case is to take any measures necessary in order to prevent or mitigate the harm according to the insured's ability. In order for a reduction of damages to come into question, the insured must have intentionally or with gross negligence neglected his or her duties. For there to be a violation of the duty to prevent damage, the insurance case must also have arisen or be immediately at hand. With respect to liability insurance, where liability arises successively, it can be difficult to establish such a point of time. The question is whether the insured understood that an injury had occurred or was on the way to occurring and whether he understood that he could limit the harm. In such a case, one can generally speak of intent.¹⁴

With the application of these provisions, the insurer is faced with a series of evidentiary difficulties. The insurer is to prove that the insured realized or ought to have realized at a certain point of time, and also that the circumstances affected the injury. Liability insurance agreements are therefore often provided with a "moral clause" that exempts harms that the insured ought to have realized, which is easier to prove. Such a clause can have approximately the following text: "The insurance does not cover injuries arising under such circumstances that the insured's corporate management or supervisors ought to have clearly realized that the risk for harm occurring was significant and which they reasonably could have prevented." This clause gives insurers the possibility to exempt injuries where the insured ought to have realized the risk for damage, and not only if the insured de facto realized the risk for damage.¹⁵ There is also rather extensive case law, certainly older, from the National Council on Insurance Terms (Skadeförsäkringens villkorsnämnd) assessing issues as to the application of insurance clauses within damage insurance.¹⁶ The formulation in § 8:11 of the Insurance Agreements Act has entailed that the moral clause is now more consistent with the gap-filling rules, even if the formulation "ought to clearly realized", which is common in the clause, entails

13 Legislative Bill 2003/04:150 p. 466; Bengtsson, Bertil, *Försäkringsavtalsrätt* (2006) p. 340 f.; and Strömbäck, Erland, *Något om den renoverade försäkringsavtalslagen*, JT 2004-05 p. 369.

14 Bengtsson, *supra* (2006) p. 270.

15 In the legal scholarship, this clause has been addressed, for example, by Bengtsson, Bertil, *Försäkringsrätt – Några huvudlinjer* (2005) p. 39; Peter Lagerström, *Företagsförsäkring* (2007) p. 243 ff.; Strömbäck, Erland, *Något om den renoverade försäkringsavtalslagen*, JT 2004-05 p. 369; and Ullman, Harald, *Försäkring och ansvarsfördelning* (2006) pp. 92 f. och 217 ff.

16 See, for example, SkVN 109/1983, SkVN 131/1981, SkVN 27/1974, SkVN 4/1987, SkVN 85/1995 and SkVN 37/1992.

that the clause still includes a higher threshold in relationship to the act where the insured “must be assumed to have acted” with knowledge as to the risk.¹⁷

In order to address at an earlier stage in the insurance relationship moral hazards consisting of the insured causing a harm, the insurer can attempt to choose suitable clients, which is easier said than done. Underwriters ought to have witnessed as to the fact that the insurance companies during the 1960’s made it easy for themselves by quite simply choosing away potential clients within certain types of occupations,¹⁸ for example, furriers, junk dealers, pub owners, journalists or other persons “vaguely connected with showbiz”.¹⁹ The duty to inform the insurer in the Insurance Agreements Act has the objective that the insurer is to be able to make an assessment in part whether the insurance is to be granted generally, and in part what premium is to be determined. With liability insurance, the terms are priced after established tariffs that take into consideration statistical calculations as to the risks for injuries for the operations in question. For the majority of operations, the individual operation’s risks is considered when the premium is determined. That several injuries previously have arisen in the operation entails as a rule a higher premium, while good results with respect to an absence of injuries can entail that the premium is lowered.²⁰

Insurance protection is almost always united with some type of deductible. The objective of the deductible is for the insurance company to be able to avoid costs with respect to adjusting minor claims, however, the deductible also serves a preventive purpose. The deductible with respect to liability insurance typically has the form of a basic amount with an additional amount reflecting a certain percentage of any excess amount.

17 Bengtsson, *supra* (2005) p. 39, who deems that the formulation “ought to have realized” entails a far-reaching limitation of liability.

18 A question in this context is whether an insurance company can refuse to provide insurance. For consumers, there is a duty to contract according to § 3:1 Insurance Agreements Act, which is not the case with respect to corporate insurance (compare Chapter 8 of Insurance Agreements Act). As a starting point, consequently, an insurance company can freely refuse to provide insurance to certain persons. Certain types of work however have a duty to have insurance. Consequently, there is an insurance duty for real estate brokers under § 6 of the Real Estate Brokers Act (2011:666), insurance brokers have a duty to have insurance according to §§ 2:5(1) and 2:6(1) of the Insurance Brokers Act (2005:405), pawnshops according to § 15 of the Pawn Shop Act (1995:1000) and accountants according to § 27 of the Accountants Act (2001:883). That there is insurance then becomes a step towards receiving the necessary license in order to be active in the field. It is the Financial Inspection Agency that enforces these acts, and therewith that there is appropriate insurance in accordance to the legislation. That certain work assumes current liability insurance can be problematic. What happens if a potential tortfeasor with a duty to have insurance is refused insurance, perhaps because of previous neglect against the insurance company? The situation could arise in which it is the insurance company that determines who can be active in certain types of work, a task that an insurance company perhaps does not want to assume.

19 Parsons, *supra* p. 452 at footnote 6.

20 Bengtsson, Ullman och Unger, *supra* (2009) p. 139 f.

One method that has been applied with premium setting is experience rating, which means that the insurer calculates the premium based on the history of the insured. Experience rating is an effective method for insurers to be able to calculate premiums, and an effective way to control moral hazards. Liability insurance, however, often is a long-term risk, which means that a long time passes between the actual acts causing the injury and the claim for insurance compensation. This can entail that the history of claims does not give adequate information as to the insurer's risk. The fact that the insured has not been the object of any insurance case during recent years does not necessarily mean that it has been particularly careful. This method however does not appear to generally be used in Swedish law.²¹

An insurer can also choose to insure the actual risk and combine the protection with a separate insurance amount, a sublimit. The insurer can then offer expanded protection, for example with respect to pure economic losses, if the protection in relation to the insured's operations in general represents a small amount of the total insured risk. The sublimit consequently can be paid out by the insurer without interfering to any considerable extent with the insurer's premium calculation.²²

Many liability insurance policies directed at chief executive officers and boards of directors, Director and Officers insurance (D&O), contains conditions according to which compensation is not to be paid for claims based on, or that are a consequence of, that the insured received unlawful compensation, advantages or another profit. This clause has been directed towards immoral behaviour comprising that a board director becomes liable for damages for a measure taken in conflict with his or her obligations as a board member, where that measure has led to an economic profit for him or her. The absence of such an exemption would entail that the insured board director could gain economically with respect to an insurance case, which could be an incentive to commit such an action causing such damages – and therewith constitute a basis for moral hazard.

Liability insurance subscribed to in accordance with the “occurrence” principle entails that the insurance covers events that are caused or occur during the period of insurance despite the fact that the injury first arises at a much later date. Insurance subscribed to according to this principle can be combined with moral hazards, as the possibility that the insurance is subscribed to and therewith the insured files bankruptcy when the injury later arises. This has been exploited by less scrupulous insurance takers. In the United States, there are examples of companies that have had only the objective of disposing of environmentally dangerous waste. The company's only asset is the grounds upon which the waste has been dumped. When the injury is discovered, the company for a long time has either been bankrupt or ceased to exist. The majority of legal systems in such cases give the right to the injured party to directly make a claim against the insurer, which entails that the insurer has

21 SOU 2002:1 p. 50.

22 Ullman, *supra* (1999) p. 108.

liability for such injuries. This phenomenon has come to be termed “hit-and-run” or “looting”.²³

One method to eliminate such long-term risks is to provide insurance based on the “claims-made” principle. With the claims-made principle, or claim principle,²⁴ the insurance covers events that are reported during the period of insurance coverage regardless of when they were caused. For an insurance company to escape being liable for injuries caused long ago, claims-made insurance is combined with a retroactive time limitation, which means that injuries caused prior to the time limitation fall outside of the insurance. A claim according to typical terms and conditions can be considered to be made, for example, at the appointed time when the insured or the insurance company for the first time received a written claim of damages from the injured party, or when the insurance company for the first time from the insured received written notification as to the circumstances that can be expected to lead to a claim for damages being presented against the insured.²⁵

Problems with claims-made insurance can occur with a change of insurers and unanticipated damage liability. The situation can then arise that the previous insurance agreement covers events that are altogether too insignificant to be considered an insurance case and fall within the framework for the former insurance, but altogether too concrete so that the new insurance company wishes to exclude them from the insurance agreement. The problem then becomes that the insured does not have insurance coverage for such cases in any of the insurances.

Claims-made insurance therefore is often combined with a notification clause or notice clause. This clause gives the insured, through notification to the insurance company as to circumstances that can affect or can come to affect the insurance company in the event of an injury, the right to have the injury covered by the applicable insurance agreement. The disadvantage that has arisen with notice clauses is that certain insurers attempt to so to speak “empty the drawers” and notify the insurance company as to all types of circumstances, even those that lack substance. It is perhaps dubious whether this behaviour can be seen to constitute immoral behaviour by the insured. This behaviour certainly occurs for the purpose of ensuring that a potential future injury will be covered by the current insurance, and the insured must have the right to do this, but notification without any exercise of judgment however creates problems with respect to management at the insurance company. There is no Swedish case law further illuminating notice clauses, however in English law such have been objects for judicial assessment.²⁶

23 Parsons, *supra* p. 460.

24 Bengtsson, Ullman and Unger, *supra* (2009) p. 145.

25 See further Wilhelmssen, Trine-Lise, *Skjulte handlingsklausuler – forholdt mellom beskrivelse ansvarsforsikring forsikringstilfellet og reglene om opplysningsplikt, meldeplikt, meldefrist og foreldelse*, NFT 3/1999 p. 259.

26 See, for example, *H L B Kidsons v. Lloyd's Underwriters and Others*, Court of Appeal, Case No: A3/2007/2450, 5 November 2008.

2.2 *The Insured Admits Liability*

The party who can best contribute with relevant information for the purpose of contesting damage liability is the insured party itself. The insured has the best knowledge as to the actual actions occurring, and also perhaps as to the causality between the actions and the harm. One risk is that the insured in one way or another admits damage liability. Here collusion between the insured and the party harmed could occur when the insured to the party harmed agrees to pay damages and admits that the insured caused the harm in a careless matter. The insured could have an interest in admitting to damage liability, perhaps in order to retain a valuable commercial relationship, or for that he or she for some reason fears the consequences of not admitting damage liability. Such an admission can take several guises. It can be a question of settlements of different types. In the Swedish Supreme Court case, NJA 2009 p. 355, the tortfeasor had entered into a settlement with the injured party consisting of several components: That a certain amount would be paid and that certain shares would be transferred to the injured party. Such behaviour can be seen as a moral hazard in the sense that the insured, based on the fact that there was insurance, also was more prone to admit liability.

The insurer in such a situation can refer to § 4:7 of the Insurance Agreements Act (which according to its § 8:13 is also applicable to company insurance). It can be seen from this provision that the insured, in the event of an insurance case and taking into consideration its ability, is to take any measures in order to prevent or reduce any harm and, if another party is liable for damages, preserve the right the insurance company would have against that party. This provision, which sets out the insurance duty to prevent damage, focuses in part on the obligation to minimize and mitigate the injury, but also on securing evidence and preserving the insurer's right of recourse. This provision ought to also encompass the insured's obligation to avoid damage liability with respect to liability insurance. In addition, the insurer can cite § 7:2(1)(1) of the Insurance Agreements Act (which according to its § 8:19 is also applicable to company insurance), prescribing that in the event the insured neglects to follow the terms and conditions of the insurance with respect to the obligation to cooperate with an investigation of an insurance case or of the insurance company's liability, and this neglect entails harm to the insurance company, the compensation that otherwise would have been paid to the insured can be reduced by a reasonable and fair amount. In the event the insured fails to do this, according to § 7:2(1)(2) of the Insurance Agreements Act, this in fact does not affect the injured party's rights to compensation. Instead the insurance company has a right to make a claim of recourse against the insured for a fair part of that which was paid out as compensation to the injured party.

In order for a reduction of the compensation to come into question, the insurance company is required to show that it suffered some type of harm due to the neglect.²⁷ It is very difficult for an insurance company in reality to prove that the investigation, due to the insured's behavior, was of a lesser quality in

27 Hellner, *supra* (1965) p. 208, Bengtsson, *supra* (2006) p. 345 f.

such a manner that it entailed damage to the insurance company. In reality, therefore, these rules are not a viable way to reduce the risk for the insured admitting liability.

It is very common, in any case with respect to company insurance, that terms can be found in the insurance agreement that have the objective of preventing the insured from admitting damage liability. Such a term also has the effect that it constitutes an incentive for the insured to prioritize its relationship to the insurer instead of the relationship to the injured party. Such a term can prohibit the insured from admitting damage liability unless it is "obviously based in law". Such a term has a direct correspondence in § 94 of the 1927 Insurance Agreements Act. However, the current Insurance Agreements Act lacks such an equivalent provision. The absence of such a provision has been criticized by the Council on Legislation, and in the legislative bill this criticism was addressed by maintaining that the term was unusual and that if such a term were to be cited in any event, it was possible to "without much effort to come to the correct result" based on the support of § 36 of the Swedish Contracts Act.²⁸ The stance of the legislator appears to be that as a term of this type is unusual, no specific regulation is necessary. The legislator's understanding as to the frequency of such terms is based however on an incorrect assumption. The liability insurance conditions of ten insurance companies were reviewed, with this term being found to be very common. It was found in all of the studied insurance agreements.²⁹

The above-referenced case, NJA 2009 p. 355, entails that it is not necessary to adjust the terms, as suggested in the legislative preparatory works. Instead, the Swedish Supreme Court has stated how the term is to be interpreted. In that case, a fund company, Aragon, had acted recklessly with respect to a securities transaction, with the consequence that the injured party (whose claim was assigned to Carnegie) lost large amounts. The parties later settled as to the issue of compensation. Carnegie reduced its claim and Aragon assigned any future right to compensation from the liability insurance provider to the injured party as a step in the final settlement. The liability insurance provider contested the injured party's claim with reference to that the settlement made occurred in violation of such a term. The Swedish Supreme Court found that the acquisition of the insured's right as against the insurance provider as complete payment of the compensation was in violation of the objective underlying the term and § 94 of the former Insurance Agreements Act, which is that the insured is to have an economic interest as to contesting liability. The insurance company was released from the obligation to pay compensation.³⁰ In the event an insured has admitted an obligation to pay, this typically means that it has a weaker economic interest as to contesting liability and the processing of a

28 Legislative Bill 2003/04:150 p. 231.

29 See, for example, the general terms and conditions in the liability insurance of Zürich, Länsförsäkringar, Folksam, Salus Ansvar, Gjensidige Försäkring, Trygg Hansa, Dina försäkringar, S:t Erik Försäkring, and Försäkrings AB Göta Lejon.

30 As to this judgment, see van der Sluijs, Jessika, *Carnegiedomen*, Stockholm Centre for Commercial Law, Årsskrift 2010 p. 419 ff.

claim. On the other hand, a recognition falling outside of the framework for the insurance, or a recognition that is "obviously based in law", can be in accordance with the term.

2.3 *The Insured is Passive*

One hazard closely related to that stated above is when the insured, without directly admitting liability, refuses to cooperate actively with the processing of an insurance claim. When an injury is reported to the insured and then later to the insurance company, there is a risk that the insured remains passive. The insured neither admits nor contests responsibility, but rather takes the position that it is entirely the problem of the insurance company and the injured party to resolve the claim. Neither does the insured party submit documentation or cooperate at meetings, etc. The insurance company cannot possibly know which relevant materials exist in the form of correspondence, agreements and other documentation. Neither can the insurance company act totally independently of the insured's cooperation when it comes to the investigation of an insurance case. If these actions are for the purpose that only the injured party's information is to constitute the basis for the assessment with the processing of the claim, which can increase the probability that the event is considered an insurance case, such behaviour can be defined as a moral hazard. This type of behaviour is not covered by a term such as that described above. In the Swedish Supreme Court case, NJA 2001 p. 255, concerning broker insurance, the insured was entirely passive and allowed the issue of damages to be determined in a default judgment. The liability insurance provider later contested liability with reference to such a term as discussed above according to which the insurance company was released from liability in the event the insured admitted liability for damages in a case. The question tried was whether the fact that the insured allowed the damage issue to be determined through a default judgment constituted such a recognition within the terms of the condition. The Swedish Supreme Court found that the wording of the term could not be seen as including judgments issue through default and found that the insurance company was responsible as the term was not clearly formulated.

According to the Insurance Agreements Act, the insured is obligated to cooperate with the processing of a claim. Included in this obligation is submitting information and documentation. In order for the insurance to cover liability for damages, the insured is to also observe the above-referenced duty to prevent damage as stated in § 4:7 of the Insurance Agreements Act and the duty to cooperate with an investigation of an insurance case as found in § 7:2 of the same act. In order for a reduction according to these provisions to come into question, the insurance company is required to have suffered a loss based on a violation of these duties, which in reality is very difficult for the insurance company to prove with respect to liability insurance. In order to create an incentive for the insured to cooperate with the investigations of insurance cases, the insurance agreement therefore can contain conditions stating approximately the following: "construction drawings, manufacturing plants, receipts, instructions, agreements, user guides, guarantees and like

documentation which can be of significance in the processing of a claim are to be preserved to a reasonable extent. In the event the insured does not honour its obligation according to these provisions and this can be assumed to be of a material detriment for the insurance company, the insurance company is entitled to a reasonable reduction in the compensation which ought to have been paid.” One can envision situations in which the insured refuses to submit documentation based on alleged confidentiality. Such a refusal ought to constitute a basis for refusing compensation with reference to this term.

The system created in the Norwegian Insurance Agreement Act can be named in this context. In Norway, the injured party has a general right to a direct claim, which means that the processing of claims mainly occurs directly against the tortfeasor. Such a system increases the risk that the insured is passive in the processing of the claim. According to § 7:6(3) of the Norwegian Insurance Agreements Act, the insurance company can therefore in the event of a directly presented claim, require that the injured party direct a comparable claim against the tortfeasor. This provision has the objective to protect the insurance companies from the risk that the insured delays the processing of claims.³¹

The assignment of the right to insurance compensation to another party, for example the injured party, cannot in itself be seen to constitute behaviour in violation of a term prohibiting the admission of liability. In the Swedish Supreme Court case, NJA 1993 p. 222, the tortfeasor assigned the right to the insurance compensation to the injured party, and the liability insurance provider contested liability with reference to that the assignment was unlawful based on that the insurance provider was in a worse position. The Swedish Supreme Court found that the basic rule in Swedish law is that a claim can be assigned and that it is only in specific cases of exception that such is not permitted. Therewith there is nothing prohibiting that the insured assigned the right to eventual payment. The assignment on the other hand did not entail that the insured was released from its obligations according to the insurance agreement. It was simply the right to the insurance compensation that was assigned, not the obligation, for example, to cooperate with the processing of the claim.

2.4 Collusion

Another moral hazard facing liability insurance providers can be found when the insured and the injured party agree as to the course of events and/or definitions for the purpose of the liability insurance covering events that have occurred. This can be defined as collusions of different types. This can be the case when a claim is to be presented against a liability insurance provider and the insured and injured party together change the course of events. For example, for the purpose of allowing liability insurance to cover the damage, the parties fail to inform the insurance company that a situation of contributory

31 NOU 1987:24 p. 149.

negligence existed, or they fabricate a negligence action or fail to report that the damage was caused intentionally.

To misrepresent or hide the actual circumstances for the purpose of tailoring a course of events to fit within the area of coverage of liability insurance must be considered as deceit, insurance fraud. Section 7:3 of the Insurance Agreement Act regulates such a situation (which according to its § 8:18 is also applicable to Company insurance), prescribing that in the event the insured or another party requesting compensation from the insurance company due in an insurance case, intentionally or through gross negligence incorrectly states or omits anything of significance for the assessment of the right to insurance compensation, the compensation that otherwise would have been paid to the party can be decreased according to that which can be seen as fair taking the circumstances into consideration. This can be a question of a serious violation of the insured's duty of loyalty, and that the acts were intended to entail either compensation that was not lawful or higher compensation than that which was to be paid. It can also be a question of a repression of evidence or an unauthorized influence as to witnesses. The reduction in the compensation is to occur after an assessment of fairness and it need not be proven that the insurance company has suffered a harm. A party invoking these types of planned actions can lose the entire compensation.³² It can be seen from the legislative preparatory works that a reduction can affect a party other than the insured if that party is in bad faith. This can be the case, for example, when an insured attempts to create advantages for the injured party. If that party consequently receives compensation with an insight into such circumstances, the compensation can also be reduced.³³

Another form of collusion can arise when the insured and the injured party agree to define a cost as damage and not, for example, as a price reduction. The tortfeasor and the injured party can together define the alleged amount as damage for the purpose of having the course of events included under the coverage of the insurance. This can be the case, for example, when a client has received less than satisfactory service or advice, with the consequence that the client is forced to obtain supplemental services or advice from another source. This can be compared to the purchase of cover goods and the question is whether the costs for such are covered by the liability insurance.

According to the legal scholarship within contract law, there is no clear boundary between the different contractual consequences of a price reduction, the purchase of cover goods or damages. Jan Hellner states that "the loss that the damages cover often includes costs which, even if the right to damages is not present, can be covered in another manner, for example through a price reduction, cure by the seller or by compensation so that a buyer can cure the goods himself. Even if a certain part of the damages are covered by compensation, damages are compensation for the remainder. The great

32 Bengtsson, *supra* (2006) p. 307 f.

33 Legislative Bill 2003/04:150 p. 448 f.

significance of the damages is the fact that it is complete compensation.”³⁴ How a loss is to be defined consequently must be assessed in each individual case.

The assessment must also occur against the background of the cited grounds upon which the claims are being made. The injured party and the insured's common definition of the claims cannot have any independent significance with respect to whether a claim can be considered an injury or another consequence, which is to be assessed from the actual circumstances. In older consultant liability insurance agreements, there were terms included according to which the consultant fees would be deducted within the calculation of the damages. These terms are no longer included in the current insurance agreement, primarily because of their application difficulties.

The next question is to what extent liability insurance is to cover a contractual obligation. Liability insurance originally was intended to cover injuries that were caused in tort. This issue is problematic as it is difficult to define a boundary between contractual and tort liability. Bertil Bengtsson states in his doctoral dissertation of 1960 that it is not possible, on the basis of the formation of the terms of the agreement or through interpretation, to determine any general principle that liability of a certain type should fall within or outside of liability insurance.³⁵ This statement remains true even today. Harald Ullman described in his doctoral dissertation of 1999 that ”the principles for which an insurer gives expression to in the insurance agreement are typically reflective of a custom and usage existing at the time of the issuing of the liability insurance and all-risk insurance and most closely in the form of unwritten rules that have been developed and established in a rather relatively uniform manner. The principles for the insurance of commercial risks were attributed different meanings in different markets, depending on the structure of the individual market. In a soft market, which is characterized by a high degree of competition and therewith a lower premium level, the possibilities for a company if it so wishes to insure its business and production risks increases. This possibility exists for larger companies which subscribed to insurance based on individual premium rates.”³⁶ A general tendency can be seen however to give an increased protection to contractual liability.³⁷ With consultant liability insurance, liability based on the insured's failure to perform commissions can be covered.³⁸ The terms and conditions of the insurance can contain different limitations as to coverage for the purpose of reducing uncertainty with respect to different moments of liability. A natural limitation is that liability insurance commonly does not cover harm as to delivered products and property in possession. An additional limitation is that the

34 Hellner, Jan, Hager, Richard and Persson, Annina, *Speciell avtalsrätt II, Kontraktetsrätt* (2006) p. 147.

35 Bengtsson, *supra* (1960) p. 564.

36 Ullman, *supra* (1999) p. 107.

37 Ullman, *supra* (1999) p. 108; and Lagerström, *supra* (2007) p. 166.

38 Bengtsson, Ullman and Unger, *supra* (2009) p. 150.

insurance does not cover guarantees and warranties.³⁹ Another natural limitation can be found in the fact that liability insurance normally covers liability only for person or property damage, which means that liability for pure economic losses is not covered by liability insurance.⁴⁰ With respect to professional liability insurance, on the other hand, liability for pure economic losses is covered. These limitations entail that it is not always easy to determine where the boundaries for liability insurance lie. The extent to which a contractual liability is covered by liability insurance becomes an issue of interpretation, in part of the contract between the insured and the party injured, in part of the liability insurance agreement.

The problem of the extent to which damages in a contract relation should be covered by liability insurance or fall outside of it could possibly be assessed from general insurance law principles. These principles, which cannot be seen as etched in stone, and which in addition in reality can be combined with exceptions, perhaps have their primary application with respect to property insurance. But even with liability insurance, the principles ought to be able to be guiding for whether liability should fall within the framework of a liability insurance or outside of it.

One such principle is that contractual consequences other than damages are not to be covered. According to Jan Hellner, liability insurance cannot be seen as suitably covering damages that consist of the fact that the other contracting party has failed to perform under a contract. If the seller delivers 90% of the contracted delivery, the insurance cannot protect against any claim that arises based on this, regardless of whether this takes the guise of a claim of damages. The insurer's compensation cannot constitute an alternative to the other contractual party fulfilling its obligations.⁴¹ The boundary between the responsibility to perform contractually and damage liability is of decisive significance and ought to be highlighted even with claim processing.⁴²

Support for this can also be found in the concept of insured interest. A presumption as to the insurer's interest can be found in § 36 of the former Insurance Agreements Act. This provision was applied with "the insuring of goods." The concept insured interests with respect to property insurance is also addressed in the legal scholarship for the purpose of determining that the object of the property insurance is not the insured's property as such but rather the interests consist of the fact that the property is preserved. In the event of a destroyed real estate parcel, the owner, a lessee or a secured creditor consequently can be carriers of an interest in the property. The insured interest with respect to liability insurance is the liability for damages and not liability for the contract.

A second insurance law principle is that insurance compensation can only be paid if the insured has suffered an injury. In the event of a breach of

39 Bengtsson, Ullman and Unger, *supra* (2009) p. 150.

40 Ullman, *supra* (1999) p. 102 ff.

41 Hellner, *supra* (1965) p. 408 f.; and Bengtsson, Ullman and Unger, *supra* (2009) p. 149 f.

42 Ullman, *supra* (1999) p. 410 ff.

contract, the insured, in other words, the tortfeasor, cannot be seen as having suffered any damage, as he or she has performed a promise for which he or she has received a counter performance.⁴³ The effect of that a price reduction would be covered would be that insured can perform in a less than satisfactory manner and supplement any fees through the insurance.⁴⁴

In addition, the harm has to be a question of an uncertain and to some degree suddenly occurring event. Damages based on a breach of contract are something that an insured has to calculate dealing with and from the circumstances it can be seen that such are not sudden.⁴⁵ Examples of damages that ought to be covered by liability insurance can be when the seller delivers poisoned goods that poison the purchaser, or where a painter has dropped a paint bucket and destroyed the client's property.⁴⁶ In addition, it must be a question of a damage that is a consequence of an unpredicted event. The event must have occurred in an unpredicted or improbable manner. To the extent that there is in a breach of contract an element of free will by the insured, such an event consequently can be deemed to be an event that could be predicted, and therewith not covered by the liability insurance.⁴⁷

Another insurance law principle is that a risk must be able to be calculated. Consequently this can be a limitation for which liability is to be insured. From the insurance company's point of view, it is difficult to assess the risk for contractual damages, as the insurance company does not have insight into the contracts that have been executed. The insurance company cannot predict the content of the agreements and therewith the risks for liability.

3 Moral Hazards for the Injured Party

3.1 *The Deepest Pockets*

An injured party has several different possibilities for covering an injury in an insurance case. Property insurance can cover the injury, but there can also be other reasons as to why the injured party chooses to direct a claim against the tortfeasor. One such reason can be, for example, that an injury to a person can be calculated on a tort basis, which means that other compensation can also be paid, which can be a different amount than the pre-determined amount available with the party's own accident insurance. If the possibility exists, the injured party can choose to present a claim with respect to the tortfeasor that

43 Bengtsson, *supra* (1960) p. 317.

44 Bengtsson, *supra* (1960) p. 319 f.

45 Bengtsson, *supra* (1960) p. 317.

46 Hellner, *Försäkringsrätt* (1965) p. 408 f.

47 See NJA 2007 p. 17 in which the question arose whether a break in a line constituted an unanticipated harm. See also SkVN 40/1995 and SkVN 24/1992. The term "unanticipated harm" has been addressed in the legal scholarship by Ullman, Harald, *Plötslig och oförutsedd skada*, NFT 1/1980.

has the best possibility to pay, which often is a party having liability insurance. This phenomena, that an injured party seeks the best compensation possible for injuries received, is a right of the injured party. From the insurance provider's perspective, these types of choices can rarely be considered as a problem involving moral hazards.

On the other hand, there are risks that an injured party has either fabricated injuries or in an extreme case, actually caused the injury, for the purpose of receiving compensation from a liability insurance. This problem can be the same with respect to property, sickness, or accident insurance. Conflicts of this character arise with less well-defined personal injuries such as back trouble or whiplash injuries, and these problems can be seen to permeate all types of liability insurance forms with respect to the reporting of false injuries for the purpose of receiving compensation from liability insurance.⁴⁸

That an injured party does not have a right to compensation with respect to injuries they caused themselves can be seen from the regulations in tort law with respect to contributory negligence. False claims or damages can be reached by demanding that the injured party prove the injury. The regulations placing upon the insured party a duty with respect to the adjusting of claims are also applicable to an injured party. According to § 7:2 of the Insurance Agreements Act, a party entitled to compensation is obligated to cooperate with the investigation of an insurance case, and the failure to do this can entail that the compensation can be reduced. According to § 7:3, compensation can be reduced if the insured or any other party who has demanded compensation intentionally or due to gross recklessness states incorrectly or fails to state something of significance for the assessment of the rights to compensation.

3.2 *Confidentiality*

In certain sectors, the customer, in other words the potentially injured party, when contemplating signing a contract, wishes to ensure that the other party has liability insurance. This is for the purpose of ensuring that the other party has the ability to pay in the event an injury should arise. This author has received information from representatives in the IT branch, that insurance companies can require that the insured be bound by a duty of confidentiality consisting of the insured not revealing to new customers the insurance amount that has been subscribed to that could potential cover arising customer injuries. It seems probable to assume that the objective of such a confidentiality clause is to be able to prevent the injured party from exaggerating injuries or failing to cooperate with preventing injuries, which can be characterized as different types of moral hazards.

48 See, for example, Carlsson, *supra* (2008) p. 112.

3.3 *Insured Versus Insured*

In directors and officers insurance (D & O), which covers damage liability for a corporate directors and chief executive officers, there is often an “insured versus insured” exception. This exception can be formulated so that the insurance does not pay for claims for compensation presented by the insured against another insured. The objective of this consequently can be to head off collusions of different types. The background is that D & O insurance led to behaviour that was seen to be immoral. In the United States in the 1980s, due to deficit credit assessments, banks suffered credit losses and attempted to limit these losses by first firing and then demanding that the person who granted the loan pay damages.⁴⁹ The terms of this exception, also referred to as an assured v. assured exclusion, entail that the liability insurance does not cover claims presented internally within the company.⁵⁰ For example, it is not possible for a shareholder who can be identified with an insured to present a claim against his or her own chief executive officer or board or directors. This clause has its own application problems. In the United States, litigation has arisen as to the issue of which parties belong to the circle of the insured, and therewith are exempted from the right to present a compensation claim.⁵¹

Despite this, it is common in Sweden to have cross-liability conditions, which entail that the insurance covers demands for damages between insured parties.⁵² From the perspective of the insured, there is the wish to be able to subscribe to separate insurances for two different companies belonging to the same corporate group. Even if this in actuality entails that there is a cross-liability situation, such solutions are provided by insurance companies. Cross-liability conditions can cause problems, as they can open up situations in which a subsidiary performing construction for a parent corporation, and the corporate group is provided with a protection against damages with respect to poorly constructed or poorly functioning products. The insurance consequently takes on the character of a type of product guarantee protection which is not the true purpose of liability insurance.

4 **Moral Hazards with Respect to the Insurance Company**

Are there moral hazards with respect to liability insurance for the actual insurer? Can the character of liability insurance lead, for example, to an employee of the insurance company taking greater risks than necessary?

It can be difficult to calculate risks with respect to liability insurance. This uncertainty, together with a tendency towards an increased insurance protection

49 Parsons, *supra* p. 462.

50 As to these clauses, see further Palmore, Melanie K. “*Insured vs. Insured*” exclusions in *director and Officer Liability Insurance Policies*, 9 *Bankr. Dev. J.* 1992 p. 101 ff.

51 Palmore, *supra* p. 110 ff.

52 Bengtsson, Ullman and Unger, *supra* (2009) p. 143.

for contractual liability, entails that it can be tempting for an insurance provider in its eagerness to enter into a contract with a new customer and not observe the requirements as to calculating liability and perhaps be satisfied by limiting the insurance obligation. In addition, the long-tail character can entail that it is tempting to provide insurance as the risks are only realized long into the future.

A moral hazard for the insurance company that is directed at the collective of the insured, rather than against the actual company, can be seen in the exploitation of excess information. This has been shown to be an actual problem with respect to personal injury insurance. Presently there is a memorandum drafted by the Swedish Justice Department with a draft proposal to the Council on Legislation in which measures for strengthening and protecting privacy in the area of insurance are proposed, focusing primarily on the forms of obtaining health information. In different contexts, criticism has been directed as to the ways insurance companies request broad consent to access health information. This criticism has included the manner by which insurance companies receive access to irrelevant, excess information which then is over interpreted or wrongly interpreted by the companies with the consequence that the insured without reason receives less favourable terms or is entirely denied insurance.⁵³ The problem with excess information has been particularly eliminated through other forms of insurance and liability insurance, even if it could be contemplated, in any event theoretically, that a company providing liability insurance through the claim regulation process, for example, can receive access to information that is then later used in an unanticipated manner.

5 Moral Hazards in the Development of the Law

One can envision a certain moral hazard consisting of that the courts and governmental authorities make decisions based on the fact that liability insurance exists that will cover the loss.⁵⁴ This can be the case consequently where judges or public servants make different decisions depending upon whether there is or is not liability insurance.⁵⁵ Whether this type of behaviour constitutes a moral hazard can be debated, but the effect becomes that the event is assessed differently depending on whether there is liability insurance. In certain cases, the existence of liability insurance affects the assessment as to damages. For example, with an adjustment of damages according to §§ 2:3, 2:4 and 6:2 of the Swedish Tort Damages Act, the availability of liability insurance is significant. Even with the application of that act's provision regarding the

53 Department Report Ds 2005:13 – *Försäkringsbolags tillgång till patientjournaler samt promemorian med utkast till lagrådsremiss - Ett förstärkt integritetsskydd i försäkringssammanhang.*

54 With respect to “jurisprudential hazards” see Parsons, *supra* p. 463.

55 Hellner maintains that it cannot be ruled out that the courts in individual cases consider whether there is liability insurance, both with respect to imposing liability and with the determination of the amount of damages, see Hellner, *supra* (1965) p. 391.

right of regress in § 3:6, the existence of liability insurance as well as its extent has significance.⁵⁶ The general principle is that the existence of insurance is not to affect the substantive outcome of the damage issue.

There are a number of decisions in the case law where it cannot be clearly seen from the court's reasoning whether the existence of liability insurance was considered, but where one could still question whether the existence of the liability insurance (perhaps unconsciously) affected the Swedish Supreme Court's assessment. Section 2:2 of the Swedish Tort Damages Act states that a party causing pure economic loss as a result of a crime is to compensate for the harm. An e contrario interpretation of the provision would appear to be that an economic loss not caused by a crime is not to be compensated in accordance to the act. In a pair of decisions, the Swedish Supreme Court has, when liability has been encompassed by a liability insurance, qualified such a harm as a consequential damage to a property injury, consequently removing the limitation with respect to a pure economic loss. In the Swedish Supreme Court case, NJA 1990 p. 80, a female dog pregnant with mixed breed puppies, was deemed to have undergone such a physical change that an injury to property was found to exist. In that case it was clear that the liable dog owner had liability insurance. In the Supreme Court case, NJA 1996 p. 68, concerning the interpretation of a term in a liability insurance, a defective object had been welded to a defect-free object which was deemed to entail that the final product's function was lost or reduced. Damage to property had consequently occurred and was encompassed therefore by the insurance. In the Supreme Court case, NJA 2004 p. 566, the Swedish Transport Administration was found to have had suffered damage to property when gasoline was spilled over the highway, despite the fact that the highway in itself was not harmed. The conflict concerned compensation from motor insurance.

There are in addition a number of cases in which the Court has, in favour of the injured party, made rather generous culpa assessments which have led to damage liability as well as to the fact that the liability insurance covered the harm. In the Swedish Supreme Court case, NJA 1992 p. 782, an insurance broker had failed to follow up with respect to an insurance brokered, which led to the circumstance that the premium was paid late with the consequence that the insured no longer had insurance protection when the insured real property, the hotel was totally destroyed in a fire. The issue was whether the broker had acted negligently in this respect. A damage liability was imposed on the broker. This case was much discussed in the industry as many argued that the decision by the Swedish Supreme Court went considerably further than that which at that point of time was understood to lie within the responsibilities of an insurance broker.⁵⁷ The fact that damage liability was imposed upon the broker could possibly be explained by the circumstance of the existence of the obligatory liability insurance that all insurance brokers have.

The phenomena that liability insurance is limited to culpa has entailed a risk for the courts characterizing in reality an intentional act as an unintentional act,

56 NJA 1996 p. 118.

57 Korling, Fredric, *Rådgivaransvar* (2010) p. 215.

and has been identified in the legal scholarship. This can occur, for example, when a board of directors, in a manner giving a basis for liability, promotes the interests of others over that of their own corporation.⁵⁸ The boundary between gross recklessness and intent can be difficult to draw in the rather mild assessments by the court as against the tortfeasor, entailing that damages that otherwise would fall outside of the liability insurance area of coverage are compensated.⁵⁹

In this context, the Swedish Supreme Court case, NJA 1982 p. 421, can be mentioned in which the Court was confronted with the issue of whether a pharmaceutical manufacturer should be seen as having strict liability for injuries caused by a radiocontrast agent. Strict liability was not imposed. The Supreme Court stated that "the first report on products liability contained a proposal for an act on compensation with respect to injuries arising from the use of pharmaceuticals. However, this did not lead to any legislation but gave rise to a specific, voluntary form of insurance, pharmaceutical insurance, whereby – the companies and importers – which otherwise normally would bear the responsibility for the products liability of pharmaceuticals, assume the obligation to compensate injuries arising from the use of pharmaceuticals and to insure this obligation due the specific consortium, named the consortium for pharmaceutical insurance. This pharmaceutical insurance, which enters into force on 1 July 1978, consequently replaces legislation in this area." The Court further stated that in the case of injuries arising from the use of pharmaceuticals starting on 1 July 1978, the compensation regulations were those to be found in the terms and conditions of the pharmaceutical insurance. The insurance was not applicable however for injuries arising prior to 1 July 1978. The State, according to the Swedish Supreme Court, based on this can be seen as having taken a stance in the issue with respect to liability for injuries arising from the use of pharmaceuticals. To impose a strict products liability for such injuries arising in the period of time prior to that date by judicial decision ought not to occur. This judgment can be interpreted as that in itself there may be reasons to impose greater liability with respect to injuries arising from the use of pharmaceuticals, but based on the fact that the pharmaceutical insurance was to come into effect, it was not necessary to establish such a rule through case law. The consequence in the case was that the injured party did not receive any compensation. This case perhaps is not an example of a moral hazard within the development of the law (even if the injured party perhaps experiences it to be such) but the case does illustrate that at times there can be unexpected consequences derived from the existence of a system of liability insurance (which as in this case had not even yet come into effect).

58 Normann Aarum, Kristin, *Styremedlemmers erstatningsansvar i aksjeselskaper* (1994) p. 110.

59 Normann Aarum, *supra* (1994) p. 111.

6 The Boundary Towards Careless Behaviour

One problem with examining moral hazards is that it is very difficult to prove that an insured party has adjusted conduct because of the existence of liability insurance. To a certain degree, neglecting any of the insured's obligations (for example, the duty to prevent damage, the obligation to cooperate with a claim adjustment or the duty to report) can be considered morally dubious, as such neglect assumes some form of negligence or careless behaviour. On the other hand, all forms of negligence, carelessness or nonchalant behaviour cannot be categorized as moral hazards in the sense intended within the framework of this article. For it to be a question concerning a moral hazard, something more is required. It can be a question of an element of disloyalty, or of a deviation from an ethical requirement which entails that the insured party has adjusted their actions because of the existence of liability insurance.

It could be posited that all of the risks discussed above have a "light" variety in which situations arise based on ignorance or general sloppiness. For a liability insurance case to arise in general, negligence by the insured party has to be assumed. Pure accidents are not compensated by insurance. A situation could arise in which the liability for damages successively arises without the insured party noticing it to such a degree that an on-going project should probably be called off or contact should be made with the liability insurance provider. One can also envision a case in which the insured party enters into a settlement with the injured party in the good faith that such would not affect the liability insurance agreement. Situations in which the insured party lacks knowledge as to that which is required after the injury has arisen in order for it to fulfil its obligations with respect to the duty to cooperate with the processing of a claim can also be envisioned. Of course, there can be legitimate reasons for such an omission, for example, that the insured party did not understand the relevance of the information.

The provisions in the Insurance Agreement Act referred to in sections 2 and 3 above also capture behaviour that is not necessarily categorized as moral hazards. Section 8:11 of the Insurance Agreements Act entails that the insurance company is released from liability as against the insured party if the insured party has caused the insurance case either intentionally or through gross negligence, regardless of whether the action has occurred against the background of the fact that there is liability insurance or for another reason. The same is true with respect to the regulations governing the duty to prevent damage in § 4:7 and the duty to cooperate with the processing of a claim as found in § 7:2, and also in § 94 of the former Insurance Agreements Act.

These provisions distinguish between lesser forms of neglect, such as general sloppiness, or more grave neglect such as disloyal behaviour, as different legal consequences arise in the different situations. According to § 8:9 of the Insurance Agreements Act that regulates the duty to inform, the insurance company is released from liability if the insured party has acted deceptively or in conflict with faith or honour, in other words immorally, while compensation can be reduced with other types of violations of the duty to inform. With respect to a violation of the duty to prevent damage in accordance

to § 4:7 of the Insurance Agreements Act, such a breach entails a reduction in compensation when some form of a defined negligence exists, which entails that in lesser cases complete compensation is still paid. Sections 7:2 and 7:3 of the Insurance Agreements Act, which govern the insured's obligation to report damages and to contribute to the processing of an insurance claim, set out a requisite for the insurance company with respect to harm so that different compensations can be paid depending upon the degree of neglect by the insured. Even if these provisions govern actions of different types, they can be seen as having a focus on exactly the type of behaviour that can be defined as a moral hazard. In order for the insurance company to have the right to reduce damages in according to these regulations, as stated above, the insurance company must have suffered some type of loss based on the careless behaviour, which with respect to liability insurance is very difficult to prove. The regulations governing the insured's obligations in the Insurance Agreements Act are therefore of limited benefit in order to reach careless behaviour by the insured with respect to liability insurance.

On the other hand, there are conditions and terms that give the insurer the possibility to limit its liability without needing to prove that the behaviour by the insured has created losses for the insurance company. Several other regulations that have had the objective of limiting moral hazards also capture general carelessness and nonchalant behaviour. The majority of terms that are referenced above also encompass careless behaviour, for example, the terms with respect to deductibles, experience rating, sub-limits, insured versus insured and claims-made, the duty to provide documentation and the notification clause. Moral clauses can also reach careless behaviour as they are applied in the event the insured ought to have seen that the damage would arise. Terms prohibiting the insured from assuming damage liability can also encompass careless behaviour by the insured. That such clauses also govern careless behaviour is an advantage from an evidentiary perspective. It is the insurer that has the burden of proof with respect to an immoral behaviour with the consequence that the insurance compensation is to be reduced.⁶⁰ Some clauses are formed so that it is not necessary to prove an inappropriate objective or disloyalty by the insured. It is sufficient to show certain of the circumstances, or that the insured ought to have understood the existence of certain circumstances.⁶¹ In certain cases, the placement of the burden of proof can be changed in the terms. A moral clause can prescribe that it is the insured party that is to demonstrate that it was not conscious of nor ought to have been conscious of the risk for injury.⁶² Certain of the behaviours described above are such in their character that they are difficult to prove. This is the case, for example, with respect to collusion between the insured and injured party, but also the hit-and-run phenomena that has been shown. According to this author,

60 This is a question of a reversed burden of proof, see Lindell, Bengt, *Bevisbördan i försäkringsmål*, NFT 2/1992, p. 216 f.

61 Ullman, *supra* (1999) p. 295.

62 Bengtsson, *supra* (2006) p. 342.

there is no case in Swedish law in which insurance coverage has been denied an insured party based on collusion between the insured and the party injured.

7 Is the Form of Liability Insurance in Itself Immoral?

Since its inception, the actual form of this insurance has raised issues as to whether it is immoral in itself as it protects tortfeasors against the consequences of negligent actions. It has been argued that tortfeasors become less cautious as they know that any potential harm will be covered by insurance. Liability insurance first appeared within the maritime area. It has been posited that there are notes from the 17th century evidencing insurance fraud. Liability insurance was also seen to weaken shipping companies' incentives to build strong ships or navigate more carefully.⁶³ Tunc wrote that "[a]t the beginning of the nineteenth century, liability insurance would have been unthinkable. It would have been considered as immoral to take out an insurance against the consequences of civil liability as to take out one against the consequences of criminal liability".⁶⁴ In many countries, insurance was not allowed to cover liability for damages until the mid-19th century. In fact, damage liability caused by negligence was first allowed to be covered by liability insurance in 1876, and the obligation to pay damages caused by gross recklessness in 1930. In the United States, it was maintained up to 1925 that a liability insurance agreement was void as it encouraged carelessness by the insured.⁶⁵ In Sweden, liability insurance was introduced around 1915. Even here there were suspicions against this form of insurance. Hjalmar Karlgren writes that liability insurance significantly entails that a tortfeasor, to a high degree, avoids the consequences of its own wrongful actions and it can scarcely be denied that this development entailed certain dangers.⁶⁶ As late as the 1980s, the form of liability insurance was totally prohibited in the then Soviet Union.⁶⁷

Nowadays, this form of insurance no longer faces these types of impediments but instead is a commonly occurring form of insurance. For Swedish, or Nordic, law, discussions as to whether this type of liability insurance should exist are not particularly relevant. The Swedish stance as to the law of damages for long-time has been that it has primarily a reparative function, and then this can easily be seen to lead to that the damages are channelled through insurance. In the legislative bill to the Tort Damages Act, the role of liability insurance was maintained to be as a financier of damages,

63 Parsons. *supra* p. 454 f. with references.

64 Tunc, André, *Introduction*, in *International Encyclopedia of Comparative Law*, Vol 11 p. 50.

65 Tunc, *supra* p. 51.

66 Karlgren, Hjalmar, *Skadeståndsrätt*, 4th edition (1969) p. 13.

67 Tunc, *supra* p. 51 f.

for example, when the question concerns respondeat superior.⁶⁸ Instead, as described above, obligatory liability insurance has been put into place in many different fields.⁶⁹

One tendency is that the deterrent aspect is being strengthened within Swedish damage law. If the damages have an explicit deterrent objective, which is the case for example with compensation for certain types of individual violations, it is not equally self-evident that the liability would be covered by liability insurance. Upon occasion, the issue of how liability with respect to damages in certain cases should not be possible to insure has been raised in discussions. For example, the Swedish National Council for Crime Prevention in a report from 1990 has discussed whether an increased liability for persons having custodial care of children should be supplemented with an instruction to the insurance companies that liability up to a certain amount should not be insurable. This would occur through a central agreement with the insurance companies, that the insurance would not be able to cover a part of the legally limited amount.⁷⁰ In a ministerial department report, in which a higher damage liability for custodians was investigated, no such proposal was made. Instead, it was stated that it becomes a question for the insurance companies whether they are willing to offer an insurance product that covers this risk. As this was a question concerning a new ground for liability, it was not known whether such insurance products would be offered on the market. In addition, reference is made to the principle of freedom of commerce, which briefly entails that insurance companies ought to be able to freely state those risks they cover and those exceptions from insurance protection that are made. The legislator's role therefore ought to be to set up the framework for the insurance agreement. This principle is motivated, among other things, with reference to the fact that it does not prevent product development in the area of insurance and also the increased national competition between insurance companies.⁷¹

When it comes to liability for corporate boards of directors, discussions have arisen in the legal scholarship and in the legislative process as to whether this liability also ought to be insurable in general. Politician Lars Leijonborg has in a motion 1986/87 L 208 as to corporate boards of directors' liability, argued that it should not be possible to insure such liability. As reason was stated that it is enormously important that directors in corporations are prepared to assume complete responsibility for their assignments. If there is no personal monetary liability, the risk exists that the feelings of responsibility by the corporate directors would be less. This expresses therefore the belief that many corporations nowadays take out insurance for the damage liability that a director could be judged to have based on his or her actions in the company and it ought therefore be assessed whether the possibility to insure away responsibility of corporate directors ought to be limited, for example, to a

68 Legislative Bill 1972:5 p. 214 ff.

69 *See supra* footnote 20.

70 BRÅ-PM 1990-1, *Barnens brott och föräldrarnas ansvar*, p. 113.

71 Department Report Ds 2009:42 p. 62.

prohibition against the use of corporate funds for such a purpose or through specific regulations on deductibles. The parliamentary standing committee did not share the proponent of the motion's understanding that the existence of liability insurance would entail that directors generally would be less prone to take responsibility for their assignments.⁷² Dotevall has raised such a discussion but finds with reference to the fact that damages have a reparative function, that there ought not to be anything wrong with insuring this responsibility.⁷³

Damages have received a clearly deterring objective with respect to discrimination. The legislative preparatory works to the Discrimination Act state that "in order to give the prohibition against discrimination in every field of community life an effective force, effective sanctions against discrimination are required. With the assessments concerning how the remedies with respect to discrimination ought to be formed in the new discrimination act, these aspects must specifically be considered". It goes on to state that "the government finds that it is of great importance that the consequence that is chosen clearly indicates that a double function is to be maintained, in other words that the consequence in addition to compensating the violation that the breach of law has entailed is also to deter from discrimination."⁷⁴ The heading to this section in the legislative preparatory works states "Discriminating should cost."

The discrimination legislation does not raise the issue of insurance at all. Neither does liability insurance cover discrimination compensation as it is not a question of a personal harm in the typical sense. Historically, the opposition to such a form of liability insurance as such has tended to follow the views as to damages. In the beginning of the 20th century, when damages had a more explicit deterring function, liability insurance was viewed as somewhat dubious, and immoral in a certain sense. Since the second half of the 20th century, the view which focuses on damages' reparative function has dominated and nowadays liability insurance is not questioned as an immoral insurance form. It will be interesting to follow what any future shift in the view as to the function of damages will have with respect to the view as to this form of liability insurance.

8 Concluding Remarks

Moral hazards, in other words, the increase of the probability of a harm, or the risk that the size of a harm depends upon the attitude or character of the insured or the insurance policyholder's person, are raised within all forms of insurance. The specific characteristics of liability insurance, however, entail that the moral hazards reviewed here also have a specific character. The hazards consist not

72 Parliamentary Motion 1986/87 L 208.

73 Dotevall, Rolf, *Bolagsledningens skadeståndsansvar* (1999) p. 149.

74 Legislative Bill 2007/08:95 p. 390.

only of the probability of a harm arising. The form of liability insurance also entails specific risks for the insurer and the injured party having an interest of “finding” an insurance case with respect to a harm that has arisen.

The Insurance Agreement Act contains several provisions as to secondary obligations that can be cited by the insurance company in order for the insurer to receive a reduced insurance compensation in such situations. These provisions constitute, however, simply blunt instruments for the insurer as it immediately finds itself in a difficult evidentiary situation. It is the insurer that has to prove the circumstances that are the basis for the reduction of the compensation, for example such as that the insured intentionally neglected a duty to save, or that it neglected its duty to save with the knowledge that this would mean a significant risk for an injury occurring. The insured is in addition obligated to cooperate with the processing of an insurance claim, and if this is neglected, the compensation can be reduced. In such cases, it can be difficult for the insurance company to prove that neglect existed in general as the insurance company does not know which investigative materials were in existence which the insured in such a case failed to provide with respect to the processing of a claim. In order for a reduction of the insurance compensation to be at hand with the support of the provisions in the Insurance Agreements Act, the insurance company in addition is required to prove that this neglect has caused harm to the insurance company, which can be very difficult to establish in many cases.

A more effective approach in order to stem moral hazards therefore would be to limit liability in terms of making exceptions for damages in certain concrete situations, which would entail that the insurance company need not prove the circumstances such as intent, negligence or a worsened situation with respect to the processing of an insurance claim. With liability limiting terms such as deductibles, experience ratings, sub limits, insured versus insured and claims-made, duties to provide documentation and duties to notify, a more objective assessment of the situation can be made which in turn simplifies the evidentiary situation for the insurer. A “moral clause” contains a more objective assessment as the insurance company must demonstrate that the insured ought to have seen that the damage would occur, which is simpler to prove than that the insured actually realized that the damage would incur. Terms which prohibit the insured from assuming liability for damages when such obviously is not lawfully grounded would also give rise to that the situation can be approached in a more objective manner. Another way by which to treat these issues would be to include in the terms a reverse burden of proof with the consequence that the insured is to prove, for example, that the damage has arisen without any contributory negligence, but as stated above it is doubtful whether such a condition can be cited by the insurance company. The insurer cannot go too far in limiting liability. The insurance market is a competitive market which means that companies are forced to cover troublesome risks. The tendency that liability insurance also covers contractual risks, as well as cross-liability conditions, are examples of terms that could create incentives to behaviour that could be seen to constitute moral hazards. For the same reasons, the insurer in the actual situation of processing claims can be seen to need to take a more generous attitude towards the insured.

The terms existing in order to capture moral hazards constitute blunt instruments in that sense that they also capture disloyal behaviour and also careless behaviour. That an insured has adjusted his or her actions in accordance with the existence of liability insurance consequently has no decisive significance for the sanctions that are available. Does this mean that identifying moral hazards is totally meaningless? I don't believe so. It is plausible that moral hazards have an effect with respect to the development of the law. Financial crises often give rise to reviews of regulations. It can be assumed that a comparable mechanism exists in the area of liability insurance. Societal development creates new behaviours that by the insurer are perceived to be disloyal. The insured finds new ways to utilize liability insurance in order to cover risks that the insurer did not have the intent to cover. The insurer will then most probably, for the purpose of avoiding comparable claims in the future, adjust its terms by enacting new exceptions. In this manner, the development of the product is driven forward. Several of the terms described above, for example insured versus insured exception and also the moral clauses, ought to have arisen in this manner.⁷⁵ By this, moral hazards contribute to the development of the terms of liability insurance.

One effect of a financial crisis is typically that a review of existing regulations occurs. One learns from the phenomena that led to the financial crisis, reviews regulations in order to prevent the comparable from happening in the future.⁷⁶ One proposal for such a solution is to increase the review of the operations of banks and financial institutions.⁷⁷ A condition necessary for the state to intervene during hard times is that the review of the operations is improved during better times. One could contemplate, in any event at least theoretically, a comparable tactic within the area of liability insurance with increased insight as to the insured companies. However, this could hardly be implemented in practice.

Practitioners active in the insurance industry have expressed fears that a rather large part of the liability damages that are processed are results of actions which to some degree could be characterized as a moral hazard. Evidentiary difficulties make it impossible to present any relevant statistics in this issue. Moral hazards are phenomena that the insurance companies are forced to live with and respond to. Simply the ability to be able to through insurance cover losses triggers a process of rationalization that can result in the insured taking risks that are not seen as moral. If there is an incentive for bending the rules, concepts and the truth, one can rely on the fact that such will also occur, but a creative process of drafting terms can prevent at least the most common hazards.

75 Lagerström, *supra* (2007) p. 244, Parsons, *supra* p. 463.

76 See, for example, Stattin, Daniel, *Skandaldriven och problemdriven reglering, Regelrågor på en förändrad kapitalmarknad* (2009) p. 157 ff.

77 See the Swedish National Bank's report, Riksbankens rapport 2009:2- *Finansiell stabilitet* p. 107 ff.

