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Commercial Insurance

Limits to the insurer's freedom of contract regarding major risks

1. INTRODUCTION

In German insurance contract law, the principle of freedom of contract (*„freedom of disposition"*) applies. The Insurance Contract Act (Versicherungsvertragsgesetz = "VVG") contains regulations which limit the parties' freedom of disposition. The limitation implies that the parties to the insurance contract may not deviate from the legal provisions of the VVG at all ("mandatory provision") or not unilaterally to the detriment of the policy holder ("semi-mandatory provision").

Limitations to the freedom of disposition under the VVG do not apply to major risks (also called "jumbo risks") according to sec. 210 para. 1 VVG. Numerous commercial insurance contracts cover major risks. However, although limitations to the freedom of contract under the VVG do not apply to major risks, this does not mean that clauses included in general terms on insurance for major risk insurance contracts are not subject to control. This article examines limitations to the insurer's freedom of disposition for policies covering major risks on the basis of individual examples.

2. MAJOR RISKS

2.1 Term and function of major risk

By limitations to the freedom of contract, the legislator intends to protect mainly the policy holder's interests. The policy holder is usually less experienced in business and the "weaker" contracting party. The legislator and courts assume that policy holders seeking coverage in specific lines of insurance do not need legal protection but usually

are able to assert their own contractual interests vis-à-vis their insurers. In such cases, limitations to the freedom of contract therefore would not be required.[1]

A major risk is the opposite of a "normal" mass risk.[2]

2.2 Types of major risks

Sec. 210 para. 2 VVG distinguishes between two different kinds of major risks.

2.2.1 Major risks determined by line of insurance

According to sec. 210 para. 2 s. 1 No. 1 VVG major risks are *transport and liability insurances* expressly named therein. According to sec. 210 para. 2 No. 2 VVG, major risks are *credit and suretyship insurance* expressly named therein.

The list of abovementioned major risks by lines is exhaustive.

2.2.2 Major risks by reference to economic performance

Irrespective of the line of insurance, insured risks may be qualified as major risks according to sec. 210 para. 2 s. 1 No. 3 VVG. Such risks at least have to exceed two of the following characteristics:

- EUR 6.2 million balance sheet total;
- EUR 12.8 million net turnover;
- on average 250 employees per fiscal year.

Policy holders in the industrial sectors often belong to a corporate group. If the group has to provide financial statements according to specific regulations, the classification of the insured risk as major risk depends on the overall financial statements of the corporate group, sec. 210 para. 2 s. 2 VVG.

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[1] Cf. regarding VVG previous version : judgment of the Federal Court of Justice of 3 June 1992, NJW 1992 2631, 2632; judgment of 1 December 2004, NJW-RR 2005, 394, 396.

[2] The term "major risk" originates from the so-called second directive on non-life insurance of the Council of the European Communities from 1988. In sec. 187 VVG a.F., the previous version of the VVG contained a regulation corresponding to sec. 210 para. 1 VVG. Please note: The terminology of this article deviates from the official English translation of the VVG which uses the term "jumbo risks" for major risks.

Insurance contracts may cover major risks and mass risks as combined insurance (e.g. coverage of personal liability of directors and officers in the company's general liability insurance). In this case, limitations to the freedom of contract of the VVG apply for the entire contract. [3]

2.3 Legal consequence according to sec. 210 para. 1 VVG: limitations to the freedom of disposition are waived

Sec. 210 para. 1 VVG allows the parties to the contract to deviate from the regulations of the VVG in case of major risks. The permission to deviate applies both for semi-mandatory provisions protecting the policy holder as well as for mandatory provisions.[4] The permission to deviate only applies to limitations to the freedom of contract resulting from the VVG ("*under this Act*"). For mandatory provisions resulting from other acts, the permission to deviate pursuant to sec. 210 para. 1 VVG does not apply. The permission does also not apply for regulations which have the intention to protect third parties other than the policy holder (e.g. secs. 142-149 VVG, creditors such as banks as mortgagees).

The permission to deviate pursuant to sec. 210 para. 1 VVG thus implies that a clause in a policy covering major risks is not ineffective solely because the clause deviates from semi-mandatory or mandatory provisions of the VVG to the detriment of the policy holder. The clause may still be invalid due to other legal provisions.

3. LIMITATIONS TO THE FREEDOM OF DISPOSITION FOR MAJOR RISKS PURSUANT TO THE LAW ON GENERAL TERMS AND CONDITIONS

If parties negotiate an insurance contract on major risk in detail, they are free to agree what they want as long as the agreements do not violate a statutory prohibition or are contrary to public policy (secs. 134, 138 German Civil Code "BGB").

Insurers usually use general terms on insurance also for policies covering major risks. If an insurer in his terms deviates from legal provisions, the deviating clauses have to comply with the legal provisions on general terms and conditions pursuant to secs. 305 et seqs. BGB. If such clause does not comply with the legal provisions, it will not become

[3] In this meaning BGH, judgment of 24 November 1971, VersR 1972, 85, 86; differentiating: Prölls/Martin, VVG, 28. edition., sec. 210 No. 4.

[4] Cf. official reasons for sec. 210 VVG, government draft, BT-Drucks. 16/3945, p. 115.

a part of the contract. The content of the contract will then be determined by statutory provisions, sec. 306 para. 2 BGB. The requirements resulting from secs. 305 et seqs. BGB apply to policies covering major risks as well as for other contracts.

The legal review of the individual terms pursuant to sec. 307 BGB is crucial. According to sec. 307 para. 2 No. 1 BGB, a clause will be ineffective if it is not compatible with essential principles of the statutory provisions from which it deviates. In cases of doubt, an unreasonable disadvantage of the policy holder will be assumed (cf. sec. 307 para. 2 BGB). The provisions of the VVG contain respective examples which the insurer might waive according to sec. 210 VVG for major risks. The permission to deviate does not eliminate the character of the waived statutory provision as a guiding principle. The permission to deviate from provisions does not mean that a deviation is actually effective.

Moreover, irrespective of a possible ineffectiveness of clauses pursuant to provisions of the BGB, the principle of good faith (sec. 242 BGB) may prohibit the insurer to rely on individual clauses of the insurance contract.

4. EXAMPLES OF RELEVANT GUIDING PRINCIPLES

The following examples demonstrate the limits to the freedom of disposition for the insurance of major risks.

4.1 The proof of non-causation

Insurers may not effectively stipulate contractually that they are entirely released from their duty to perform in case the policy holder has culpably breached an obligation – although this breach did not cause the insured event. The insurer has to allow the policy holder to prove that the breach did not cause the insured event (so-called *proof of non-causation*, cf. *Becker* in: Versicherungspraxis 2013, 48, 49).

Already before the reform of the VVG, the policy holder's possibility to prove non-causation was regarded as a guiding principle.[5] Based on the so-called relevancy ruling of the Federal Court of Justice, the legislator established the requirement of causation as a principle in the new version of the VVG, sec. 28 para. 3 VVG – allowing for the possibility to prove non-causation.

[5] Cf. BGH, judgment of 2 December 1992, NJW 1993, 590, 591; judgment of 3 June 1992, NJW 1992, 2631, 2632.

4.2 Quota principle in case of gross negligence

A guiding principle of insurance law is the commensurate reduction in cases of gross negligence (quota principle).

The quota principle provides for the insurer's entire release from liability only in case the policy holder intentionally breached an obligation. In case of grossly negligent breach of an obligation, the insurer shall be entitled to reduce any benefits payable commensurate with the severity of the policyholder's fault (cf. sec. 28 para. 2 VVG).

An opinion in literature questions the guiding character of the quota principle. [6] According to such opinion, the legislator disestablished the former All-or-Nothing-Principle with the reform of the insurance contract law in 2008. But even after the reform, the All-or-Nothing-Principle was still part of some regulations[7] concerning open policies and transport insurance. Transport insurance and open policies typically cover major risks. Therefore, the regulations on transport insurance and open policies would be applicable to all major risks. The legislators argued that the All-or-Nothing-Principle was maintained for the named lines of insurance due to established structures of the insurance market and due to the internationality of those lines. According to *Freitag's* view, the entire market for major risk is characterized by internationality[8]. Therefore, the All-or-Nothing-Principle as a guiding principle applied for all major risks instead of the quota principle.

This is questionable. The fact that the legislator maintained the All-or-Nothing-Principle for transport insurance and open policy does not necessarily contradict a guiding character of the quota principle for major risks. There are arguments for applying the quota principle as a guiding principle (with the exception of transport insurance/open policy): by reforming the insurance law, the legislator created "*a general system which is comprehensible for all participants and considers their interests appropriately*". The "principles" of this system also include the reduction in case of gross negligence.[9] If it is assumed that major risks in fact mainly have an international character, it would have

[6] Cf. Prölss/Martin, VVG, 28th edition, sec. 210 No. 17.

[7] Cf. seqs. 57 para. 2 s. 2 No. 2, 58, 132 para. 2 s. 2 No. 2, 134 para. 2, 137 para. 1 VVG.

[8] Cf. Freitag, R+S 2008, 96,98

[9] Cf.Government draft, Bundestagsdrucks. 16/3945, page 49.

been consequential for the legislator to establish an All-or-Nothing-Principle for all major risks. But the legislator maintained the All-or-Nothing-Principle only and exceptionally for transport insurance/open policy. The quota principle remains to be the general rule. Apart from that, many practical characteristics of transport insurance (regarding underwriting, claim settlement, etc.) are not comparable with other lines of insurance (e.g. property insurance covering industrial risks). Thus, any special treatment of transport insurance cannot be generalized to all major risks just because they are also "predominantly international".

Furthermore, the regulations on transport insurance and open policy which comprise the All-or-Nothing-Principle, solely relate to the policy holder's conduct before occurrence of the insured event (aggravation of risk or causation of insured event). Whereas sec. 28 para. 2 VVG does not differentiate between conduct before or after the occurrence of the insured event. The VVG "provides for a mostly consistent regime of legal consequences for all breaches of contractual duties and obligations of the policy holder (notification about risks, prohibition of aggravation of risk)"[10] The consistent regime of legal consequences includes the quota principle. The quota principle is therefore a guiding principle. A deviating clause in any general terms on insurance of a policy covering major risks would thus be ineffective pursuant to sec. 307 BGB.

4.3 No release from liability of the insurer in case of simply negligent breach of obligation by the policy holder

Contrary to grossly negligent or intentional breaches which allow for a reduction of insurance coverage, simply negligent non-observance of obligations by the policy holder has no negative impact on coverage. Jurisdiction on the new VVG did not yet clarify whether this principle can be regarded as guiding with regard to major risks.

The VVG takes account of this principle in different contexts.[11] The Federal Court of Justice held for credit insurance (applying the former version of the VVG) that policy holders should not lose coverage only because of blameless or slightly negligent delay of balance reporting. Even experienced business people might be late with reporting of balances, blamelessly or with slight negligence[12]. By carefully weighing interests, the

[10] Government draft, reference as above, page 49.

[11] Cf. sec. 28 about breach of obligation, sec. 23 about increased risk, sec. 81 about causation of insured event.

[12] Cf. BGH, judgment of 2 December 1992, NJW 1993, 590. 591.

legislator (and jurisdiction) intended to principally protect policy holders from losing coverage only because of slight negligence.[13]

Considering this, the quota principle has guiding character. Any clause of a policy covering major risks that does not comply with this principle will be ineffective.

4.4 Provisions on the burden of proof

The VVG contains different provisions on the burden of proof. Statutory provisions on the burden of proof contain guiding principles. General terms on insurance in policies covering major risks may therefore be ineffective if they change the legally determined burden of proof to the detriment of the policy holder.

For example, trade credit insurance contracts may contain such provisions on the burden of proof to the detriment of the policy holder. A trade credit insurance policy could be regarded as an open policy pursuant to sec. 53 et seqs VVG. Sometimes insurers claim to be released from payment because of a breach of obligation by their policy holder. The insurer has to prove, pursuant to sec. 58 VVG, that the policy holder breached the obligation culpably (i.e. at least slightly negligently). Sec. 58 VVG contains a guiding principle for the allocation of the burden of proof. If the policy holder (according to the terms of his trade credit insurance policy) has to prove that he did not act culpably to avoid the insurer's release from payment, this would be a shift in the burden of proof to the detriment of the policy holder. The clause deviates from the guiding principle. It puts the policy holder at an inappropriate disadvantage and is thus ineffective according to the legal concept of sec. 309 no. 12 BGB.

General terms on insurance regarding the burden of proof in policies covering major risks have to comply with the guiding character of legal provisions on the allocation of the burden of proof.

5. CONCLUSION

Principally, there is an extensive freedom of contract when it comes to the insurance of major risks. General principles of insurance contract law and of the law on general terms and conditions limit the freedom of contract and ensure that insurance terms do not inappropriately disadvantage policy holders.

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[13] Government draft, reference as above, page 49.

When drafting policies covering major risks and respective general terms on insurance, legal provisions and guiding principles have to be observed. Policy holders and insurers have to examine the effectiveness of contractual regulations in each individual case. So far, there is no established jurisdiction on the questions discussed above.

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