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Contract drafting

# Policy wordings set the course for future claim settlement

## 1. INTRODUCTION

The claim settlement in commercial property insurance is often a complex and sometimes disappointing process for policy holders. Policy holders and insurers often have different interpretations of the insurance cover agreed upon and the respective consequences for the claim settlement. These different understandings often have their reason in ambiguously formulated policy wordings resp. entirely missing clauses.

Parties of insurance contracts should, when concluding a contract, stipulate comprehensible clauses which consider the future claim settlement and describe such process in simple terms. The more precisely contract parties set up the policy and the principles of the claim settlement, the more smoothly the claim settlement will proceed afterwards.

## 2. CLAUSES IN INDUSTRIAL PROPERTY INSURANCES

The following – exemplarily selected – clauses can simplify the claim settlement in industrial property insurance cases (and other insurance classes) insofar as policy holders and insurers agree on such or similar clauses.

### 2.1 Clauses regarding the choice of law and jurisdiction

In commercial insurance contracts, a clause concerning the choice of the applicable national law and the jurisdiction is useful.

Without clauses regarding the choice of law, the applicable national law is often not clear. Discussions about the applicable, sometimes very different, national law involve uncertainties in assessing the enforceability of the insurance claim and thus complicate the claim settlement.

Industrial property insurance contracts are often characterized by international connections.

Industrial property insurance contracts regularly insure properties outside Germany. International companies (i.a. located in Asia, America) engaged in the construction of properties are often involved in the cover of a project insurance contract as co-insured companies. On the insurer's side, there are often several international insurers, each covering a part of the insured risk.

In order not to complicate the claim settlement in these constellations by unnecessary discussions about the applicable law, it is useful to agree on a clause regarding the choice of law.

In that case, parties to the insurance contract may agree that

> *"the insurance contract is, regarding all legal issues arising with its conclusion, effectiveness and the interpretation of clauses, subject to German law."*

Parties may regulate the jurisdiction in such way

> *"that only German courts are competent for disputes resulting from the insurance contract whereby the place of jurisdiction is the policy holder's domicile as long as this place of jurisdiction is located within the Federal Republic of Germany."*

## 2.2 Leadership clause

The agreement of a comprehensible leadership clause simplifies the claim settlement.

Due to the usually high sums insured running into hundreds of millions, the insured risk in industrial property insurances is usually covered by several (five or more) insurers pro rata. The policy holder has to negotiate with each insurer individually about its percentage of risk covered in the claim settlement.

In order to avoid such a complicated procedure, industrial property insurance contracts contain, in an appropriate manner, comprehensible leadership clauses. According to these clauses, the policy holder has to communicate solely with the leading insurer when settling the claim. The leading insurer may, in the cause of the claim settlement, *"also make effective declarations toward the policy holder on behalf of other insurers and is authorized to receive declarations made by the policy holder*

*on behalf of the other insurers".* The leading insurer may for example make a settlement offer which will be binding for all insurers involved.

In case the policy holder should not succeed with his perception of the claim settlement, he only has to assert his insurance claim by judicial process against the *"leading insurer in the amount of the leading insurer's percentage. The other insurers involved accept the final decision against the leading insurers as binding for themselve."* By this clause, the policy holder has to conduct a lawsuit only against one insurer with a lower value in dispute (in the amount of the leading insurer's percentage of the risk). To sue all insurers for the entire insurance claim will among others cause legal court costs.

### 2.3 Clauses in All-Risk-Policies

Industrial property insurance contracts are meanwhile also in Germany often designed as all-risk-policies instead of the previously common "named perils" policies.

#### 2.3.1 As few exclusions of cover as possible

All-risk-policies cover all risks that might cause damages to the property insured, independent of cause. The only risks which are not covered are those excluded by the insurance contract. Thus, the policy holder will prefer all-risk-policies with as few exclusions as possible. The less exclusions are agreed upon, the more unlikely will be a discussion about the insurance claim on the merits within the claim settlement.

Commercial policy holders constructing technologically advanced plants (e.g. such as combined cycle gas turbine plants with an efficiency of 60 percent) should not accept the common prototype exclusion in their all-risk-erection-policy. According to the prototype exclusion clause *"damages to deliveries or services which are designed as prototypes"* are only insured under restrictive conditions. In case the exclusion of the prototype is not agreed upon, no discussion arises within the claim settlement whether the additional conditions, according to which prototype damages may be covered as well, are met.

#### 2.3.2 If exclusions are made at all, they have to be formulated clearly

As far as exclusions shall apply, they have to be clearly formulated by insurers for the policy holder. Otherwise, unnecessary discussions about the scope of cover are inevitable.

Thus, for example, clauses are recommended which exactly describe the insurance claim in case a property damage occurred caused by or related to a defect of the object insured. In the cause of the settlement, insurers may otherwise claim (often very generally and inappropriately) that a defect was the reason for the occurrence of the damage and therefore there is no justified claim or at least not to the full amount.

In case insurers do not want to grant insurance cover for damages related to defects, they should express this fact when concluding the insurance contract as follows or by a similar clause:

> *"No compensation will be made by insurers for remedying the damage if this damage was caused by a defect, the damage was related to a defect or if the damage was favoured by a defect. Particularly, the insurer will not provide compensation for the costs which had to be paid independently from the insurance claim especially for the remedy of a defect of the object insured."*

If industrial / commercial insurers used the above-mentioned clause or a similarly formulated exclusion clause, no discussion among the insurer and the policy holder relating to the cover of damages due to defects would arise in the claim settlement. However, such clearly formulated exclusion clauses in commercial insurance contracts are seldom. Already during negotiations of insurance contracts, policy holders might recognize cover gaps and purchase better insurance cover elsewhere.

Claim settlements are dubious if the insurer denies cover because the damages were caused by a defect though none of the above or similar exclusion clause had been agreed upon. Entirely inacceptable are constellations in which the insurer initially agrees on highest international cover standards (such as i.e. a cover according to the London Engineering Group, LEG3) for damages in connection with defects and then handles the settlement after the occurrence of a damage as if such exclusion clause had been agreed upon.

### 2.4 Representation clause

Insurance contracts often contain provisions which have to be met by policy holders before and after the occurrence of the insured event in order to be entitled to the insurance claim (so-called obligations). Since commercial insurers are organized as legal entities, it will not be clear whose conduct (action or omission) will be relevant for the fulfillment of these obligations, if no special contractual provisions are made. If it is not regulated within in the insurance contract whose behaviour is relevant, discussions about the fulfilment of obligations and eventual rights of the insurer to reduce the benefits may arise during the claim settlement.

To avoid such discussions, it is thus advisable to agree on representation clauses. Representation clauses regulate which natural person within the legal entity of the policy holder will be responsible for the fulfilment of obligations ("representatives"). According to these clauses, only the management (board members of a corporation, managing directors of a private limited company (GmbH), general partners of a limited partnership etc.) and their behavior will be relevant when it comes to the fulfilment of obligations. The fewer persons act as representatives of the policy holder, the less likely will be discussions about breached obligations within the cause of the claim settlement.

### 2.5 Clause about proportional indemnity

Clauses about the methodology of the reduction of an insurance claim are useful as well.

If the policy holder's representative breaches obligations by gross negligence, the insurer will eventually be entitled to reduce the benefits.

The law (secs. 28 to 32 Insurance Contract Act „VVG") does not provide for a regulation according to which methodology an insurance claim might be reduced if the policy holder is accused to have breached several obligations (e.g. notification obligation, obligation to make the inspection of the unchanged place of damage possible). Insurers often sum up individually calculated quota if the representative breached more than one obligation. This addition method often reduces the insurance claim to 0 to 20 percent. Whether insurers are entitled to reduce the insurance claim according to the addition method is not regulated by law and thus dubious. For this reason the reduction of the insurance claim based on breaches of obligations will in most cases lead to discussions within the context of the claim settlement.

The following clause, providing for a method for the reduction, may at least reduce discussions during the claim settlement:

> *„The insurer may only refer to a benefit reduction for reason of a breached contractual or legal obligation, if a representative of the insurer at least grossly negligently breached the obligation. The insurer has to outline the gross negligence and provide proof in case of doubt. The policy holder may give counter evidence according to sec. 28 para. 3 VVG. If the representative breaches several obligations, a reduction quota for each breach of obligation will be calculated depending on the representative's degree of fault. Only the highest quota will be applied for the reduction. Several breaches of obligations will thus not effect an addition of reduction quotas."*

If above or similar clause has been agreed upon, the insurer will rarely claim for a reduction of the insurance claim by 100 percent.

### 2.6 Clause about reimbursement of general expenses in case of own repairs

There are often discussions about the question whether the insurer has to reimburse general expenses of the policy holder which arise in case the policy holder repairs the damage himself. General expenses are costs which are not directly attributable to the respective repair (e.g. administrative expenses, costs for leased machinery, costs for energy consumption).

If the policy holder has the damage repaired by an external company, these general expenses – not disclosed separately – will be part of the external invoice. The insurers always reimburse these invoices without deduction of general expenses.

The repair of a complex plant through own employees will often be the only reasonable choice of repair for the policy holder. The more complex the damage plant, the more difficult and time-bearing will be the repair through an external company, which hardly knew the plant before the damage. Since the policy holder's own repair is allowed according to industrial property insurances, insurance contracts should contain clauses according to which policy holders are allowed to add their general expenses (e.g. in the amount of 15 percent of the documented repair costs) in order to avoid discussions within the cause of the claim settlement.

## 3. CONCLUSION

Above clauses are not final. Some clauses (such as the clause about the choice of law) are not only useful in industrial property insurances.

Policy holders often need support of advisors (e.g. brokers) for the agreement of above mentioned and other clauses adjusted to the claim settlement.

The better the policy holder (resp. his advisor) knows the risks, the better he will be able to negotiate with the insurer about clauses. The more exact the insurance cover agreed upon considers the claim settlement; the less discussions and misunderstandings are to be expected when it comes to claim settlement. If discussions and misunderstandings arise – despite cover concretely adjusted to the insurance need and the claim settlement – insurers often wish to settle the claim according to non-agreed standard insurance terms. In these cases it will almost always be helpful if the policy holder refers to the cover agreed upon, which is usually superior to the standard insurance cover, to effect a settlement according to contract.

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