WILHELM

RECHTSANWÄLTE

Cäsar Czeremuga, LL.M.

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Property Insurance

Security provisions: a sword of Damocles for insurance cover

1. INTRODUCTION

Under German insurance law insureds have to comply with standards of conduct. Violations of so-called obligations may entitle the insurer to service reductions in the event of a claim. Compliance with security regulations plays a major role in property insurance. Settlement practice shows that insurers frequently raise the objection of breaching security regulations in order to increase the willingness of insured companies to reach a settlement agreement in negotiations. The objection of violation of security regulations then hangs like a "sword of Damocles" over the insurance cover. The following article explains how policyholders can invalidate the objection.

2. SECURITY PROVICIONS AS OBLIGATIONS

In Germany, the compliance with security provision as obligation of the policyholder is regularly part of property insurance contracts.

2.1 Usual security provisions

Security provisions are regularly explicitly included in the insurance contract. These are, for instance, provisions which serve to prevent fire and explosion hazards. In fire insurance, for example, the general security provisions of fire insurers for factories and commercial installations (ASF) or specific security provisions for high-voltage installations. The security provisions included vary according to the type of property insurance. Most property insurance contracts have in common that they typically contain the following clause:

> *„The policyholder has to observe all statutory, official or security regulations agreed in the insurance contract.“*

The aforementioned clause is intended to urge the policyholder to comply with security regulations, including those not explicitly stated in the insurance contract. This clause is particularly dangerous for the policyholder. It constitutes a general clause which enables insurers to accuse the policyholder of a breach of duty after the occurrence of an insured event.

The wording of the clause is so widely defined that insurers could almost always find a provision of local, state, federal or European law after the occurrence of an insured event that the policyholder

might have violated in connection with the occurrence of the claim.

2.2 Consequences of the violation

Obligations are norms that require the policyholder to conduct in a certain manner. The conduct incumbent upon an insured may be an act or an omission. The insurer may not require the policyholder to behave in accordance with an obligation. However, if the policyholder fails to observe an obligation, the insurer may, if necessary, reduce the insurance payment in whole or in part in accordance with sec. 28 paragraph 2 Insurance Contract Act ("VVG"). Sec. 28 paragraph 2 VVG reads as follows:

> *„Where the contract provides that the insurer is not obligated to effect payment in the event of the non-observance of an incidental obligation on the part of the policyholder, he shall be released from the liability if the policyholder intentionally breached the obligation. In the case of grossly negligent non-observance of the obligation, the insurer shall be entitled to reduce any benefits payable commensurate with the severity of the policyholder's fault; the burden of proof that there was no gross negligence shall be on the policyholder."*

If the breach of a security provision has been established, the insurance company's right to reduce the insurance payment depends on the fact that this breach occurred in a subjectively accusable manner, namely at least through gross negligence. The obligation breached by simple negligence has no consequences for the policyholder. According to sec. 28 paragraph 1 VVG, the law assumes that the insured acted at least with gross negligence (wording "unless") insofar as the breach of the objective fact of an obligation has been established. The non-existence of gross negligence therefore needs to be substantiated and proven by the policyholder if the objective breach of the obligation has been settled.

The distinction between gross negligence and simple negligence is often a difficult question of the individual case. According to sec. 276 BGB (German Civil Code), the person who acts with simple negligence is the one who

> *„fails to exercise reasonable care."*

Gross negligence, on the other hand, is the fault of the person who,

> *„ grossly and to a large extent ignores the care required in business and does not take into account what should be obvious to everyone under certain circumstances. It must be a matter of inexcusable breaches of duty, which considerably exceed the unusual extent. The policyholder's conduct must be unconcerned and easily justified. The policyholder does not have to make the simplest considerations and take measures that everyone in a comparable situation has to understand."*[1]

Gross negligence thus actually refers to capital mistakes in which an outsider would spontaneously ask "How can one do so?" Nevertheless, settlement practice shows that insurers often object to a grossly negligent breach of duty, although if the facts of the case are correctly recorded, there is at most a simple negligence without consequences.

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[1] cf. *Armbrüster* in Prölss/Martin, VVG-Kommentar, 30. editiion about sec.28 VVG recital 205 with further reference

3. RECOMMENDATION FOR DRAFTING A CONTRACT

In order to avoid the uncertainty associated with the usual clauses on security regulations, it is advisable to take precautions already when drafting the contract.

3.1 Waiver of or clarification of clause

The policyholder or the broker acting on his behalf should negotiate the general clause to be excluded from the insurance contract if possible. If this is not possible, the insurers should at least be encouraged to specify in the insurance contract those legal and official security regulations which the policyholder must comply with. Alternatively, the insurer could acknowledge that the policyholder complies with all security regulations at the time of conclusion or renewal of the insurance contract.

3.2 Agree on representation clause

The decisive factor is whose conduct is to be taken into account in case security regulations are breached. Legal entities (a GmbH or an AG) are often policyholders. Legal entities do not act themselves and therefore cannot violate obligations themselves. The highest management bodies (e.g. the managing director of a GmbH) act for example on behalf of the legal entity. Under insurance law, the conduct of a "representative" of the policyholder is attributed to a legal entity. As a rule, the management of a company is also the representative of the policyholder.

However, this is not mandatory. According to the case-law of the Federal Court of Justice (BGH), the representative is the person who

> *„takes the place of the policyholder in the business area to which the insured interest belongs due to a representation or similar relationship. The representative needs to be authorized to deal independently with the policyholder's risk and needs to have been entrusted with the comprehensive management of the risk."*[2]

The above approach does usually not help in claims settlement, as it is formulated too generally and impractically. In claims settlement, this often leads to discussions as to whether individual persons from the policyholder's side (such as construction managers, architects, general planners, department heads) are attributable to breach an obligation as representatives. Often policyholders accept settlement with insurers about the insurance payment due to the uncertainty arising from this discussion.

In order to eliminate uncertainty about who is the representative of the policyholder, insurance contracts should provide for a so-called "representative clause". Representation clauses typically designate the highest representative body as the only representative of the policyholder. The positive effect of the representative clause is that the policyholder and the insurer know exactly in the claims settlement which conduct is to be examined with regard to compliance with obligations.

The disadvantageous effect of the agreed clause for the respective management body is the increased risk of personal liability of the decision-makers for cancelled insurance payments. Property insurers often claim that a management body as a

[2] cf. BGH NJW 1993, 1862

representative has failed to create or maintain a proper organizational structure in the company. Due to this missing or inadequate organizational structure, the breach of duty was possible in the first place. This argumentation can lead to renewed uncertainty on the part of the policyholder in claims settlement despite the agreed representative clause. Representative clauses should therefore be reviewed and adapted accordingly in order to exclude the argument of the missing or inadequate organizational structure and the resulting breach of obligation from the outset, for example by limiting the representative's organizational fault to intent.

4. RECOMMENDATIONS FOR ACTION IN CLAIMS SETTLEMENT

If the insurer argues in favor of a performance reduction for breach of obligation, the policyholder has various defense options.

4.1 Not every security provision is relevant

Not every breach of a legal or official provision constitutes a breach of duty. This is because not every legal or official provision is a security provision in the meaning of the general clause mentioned above. Security provisions may include provisions relating to the insured risk (e.g. company premises) and the insured danger (e.g. fire). This is doubtful, for example, in the case of recommendations made by machinery insurers to the policyholder to operate their machinery, or in the case of the risk assessment under occupational health and security law frequently referred to in the settlement practice of insurers. The latter serve primarily to protect employees from accidents during hazardous activities. Fire protection is at best an "annex". The protective purpose of an occupational health and security risk assessment is not congruent with the purpose of the obligation to comply with security regulations.

4.2 Possible ineffectiveness of the clause

It is doubtful whether the general clause mentioned under 2.1 constitutes an effective obligation in the sense of sec. 28 para. 2 VVG at all. The effectiveness of an obligation depends on whether the average policyholder is aware of the behavioral requirement imposed on him. However, the general reference to "statutory and official security provisions" lacks any reference to a specific statutory or official provision. After reviewing the insurance contract, the policyholder cannot see what he has to do or not to do in concrete terms. This general reference collides with the requirement of determination of an obligation.

The question also arises as to whether the general clause fulfils the statutory requirements for general terms and conditions (secs. 305 et seq. BGB). Among other things, insurers may not unreasonably disadvantage their customers by clauses in general terms and conditions (such are insurance terms). An inappropriate disadvantage exists in particular if a clause is formulated in a non-transparent manner (transparency requirement according to sec. 307 para. 1 s. 2 BGB). The transparency requirement obliges insurers to formulate the rights and obligations of their customers as clearly and comprehensibly as possible in accordance with the principles of good faith. The fact that the general clause fulfils these requirements can be doubted against the background of the general reference.

4.3 Causality counter evidence

Even if the policyholder violated an obligation with gross negligence or even intentionally, the insurer cannot reduce the insurance claim according to sec. 28 para. 3 VVG if the policyholder succeeds in proving the so-called causality counterevidence. The policyholder is only not allowed to provide causality counter evidence if he acted fraudulently. Section 28 para. 3 VVG reads as follows:

> *„(3) Notwithstanding subsection (2), the insurer shall be liable insofar as the non-observance of the obligation neither caused the occurrence or the establishment of the insured event nor the establishment or the extent of the insurer's obligation to effect payment. The first sentence shall not apply if the policyholder fraudulently breached the obligation.“*

The policyholder thus has to prove that his grossly negligent or intentional breach of obligation has no influence on the occurrence or determination of the insured event, the determination or the extent of the insurer's obligation to indemnify. If he succeeds in proving this, the grossly negligent or intentional breach of obligation by the policyholder is not suitable for successfully referring to the exemption from indemnification (not even proportionally).

4.4 Discussion of proportioning

If the policyholder breaches the obligation by gross negligence and if the policyholder fails to provide proof of causality, the insurer shall be entitled to a proportionate reduction of the insurance payment. This reduction rate can theoretically accurately be chosen in an amount of 0 to 100 percent. As a rule, the insurers proceed in 25 percent steps if they reduce the insurance payment proportionately due to allegedly grossly negligent breach of duty. Insurers often choose an initial reduction rate of 50 percent. Such entry rate is neither provided for by law nor confirmed by higher courts. The reduction rate is always a question of the individual case.

The policyholder must therefore not and should not accept lump-sum reductions. An examination of the individual case and the circumstances is necessary. Here it is important to work out all the circumstances that can lead to a discharge limiting the reduction, such as momentary failure, distraction, stress or lack of experience.

5. CONCLUSION

Security regulations play a central role in property insurance in Germany. In claims settlement, the objection of breach of security regulations is a popular lever for property insurers. Insured companies should therefore agree with their insurers at an early stage on the security regulations relevant to them and subsequently ensure and document compliance with the regulations in the company. If, in the event of a claim, the insurer nevertheless claims that a security regulation has been violated, the company should not leave this accusation unchallenged but try to refute the insurer's arguments.

Please do not hesitate to contact the author in case of any further questions:

Cäsar Czeremuga, LL.M.
Lawyer
Master of Insurance Law

WILHELM Rechtsanwälte

Tel: +49 211 687746 19
caesar.czeremuga@wilhelm-rae.de

www.wilhelm-rae.de