Precautionary Measures: A Friendly or Hostile Tool of Limiting Insurance Coverage?

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1. Introductory

Part of Chapter 4 of the Principles of European Insurance Contract Law (PEICL) on “The Risk Insured” deals with the so-called “Precautionary Measures” or “Warranties” as those clauses are called under English law in par. 33 MIA 106.¹ During the discussions it appeared that this subject was definitely one of the most controversial ones.

The ultimate result of the discussions is a regulation, based on three articles:

Article 4:101. Precautionary Measures: Meaning

A precautionary measure means a clause in the insurance contract, whether or not described as a condition precedent to the liability of the insurer, requiring the policyholder or the insured, before the insured event occurs, to perform or not to perform certain acts.

Article 4:102. Insurer’s Right to Terminate the Insurance Contract

(1) A clause which provides that in the event of non-compliance with a precautionary measure the insurer shall be entitled to terminate the contract, shall be without effect

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¹ German law speaks here about “Obliegenheiten” and Finnish law about “precautionary guidelines”.

unless the policyholder or the insured has breached its obligation with intent to cause the loss or recklessly and with knowledge that the loss would probably result.

(2) The right to terminate shall be exercised by written notice to the policyholder within one month of the time when the non-compliance with a precautionary measure becomes known or apparent to the insurer. Cover shall come to an end at the time of termination.

Article 4:103. Discharge of the Insurer's Liability

(1) A clause that non-compliance with a precautionary measure totally or partially exempts the insurer from liability, shall only have effect to the extent that the loss was caused by the non-compliance by the policyholder or insured with intent to cause the loss or recklessly and with knowledge that the loss would probably result.

(2) Subject to a clear clause providing for reduction of the insurance money according to the degree of fault, the policyholder or insured, as the case may be, shall be entitled to insurance money in respect of any loss caused by negligent noncompliance with a precautionary measure.

The controversial character of “Warranties” manifests itself in particular in a growing critical feeling about the way these clauses are being applied in practice and about the impact the non-fulfillment thereof has on the position of the insured. I may refer to the Joint Consultation Paper of the Law Commission and Scottish Law Commission of 17 July 2007:

“It is also possible to give a warranty as to the future, often that the insured will take precautions against a risk. The 1906 Act sets out harsh consequences for any breach. If the warranty is not strictly complied with, the insurer is automatically discharged from liability, and may refuse to pay any claim that arises after the breach.

These rules have the potential to be applied arbitrarily, so as to defeat the insured's reasonable expectation of cover. A policyholder who warrants to maintain a sprinkler system might expect that the insurer will not pay for fire damage while the sprinkler was not working. They would not expect the insurer to refuse a storm damage claim or a fire claim that arises after the sprinkler has been repaired.

The 1906 Act is also out-of-line with the expectations of an international marketplace.

The provisions on warranties have no equivalent in civil law systems, and many common law systems have reformed them. We think that reform is needed to prevent insurers from relying on technical breaches that have no connection with the claim, where this result defeats the reasonable expectations of the policyholder.”²

² The Law Commission is the statutory independent body created by the Law Commissions Act 1965 to keep the law under review and to recommend reform where it's needed.

2. The concept of precautionary measures or warranties

According to Article 4:101 PEICL a precautionary measure means a clause in the insurance contract, whether or not described as a condition precedent to the liability of the insurer, requiring the policyholder or the insured, before the insured event occurs, to perform or not to perform certain acts. Basically this description conforms to that of a warranty in par. 33 MIA 1906, providing as follows:

“A warranty means a promissory warranty, that is to say a warranty by which the assured undertakes that some particular thing shall or shall not be done, or that some condition shall be fulfilled, or whereby he affirms or negatives the existence of a particular state of facts”

One of the major problems in reforming the law of warranties is that it is not always easy to distinguish between a warranty and another type of contractual term which aims to confine the scope of coverage. A precaution may be phrased as a warranty (where, for example, the insured warrants that a vehicle will “be kept in a roadworthy condition”). It may also be phrased as an exception belonging to the terms descriptive of the risk (the accident will not be covered “while the vehicle is not in a roadworthy condition”).

A distinction which may have a substantial impact in practice, in particular in those countries where differences in requirements to be fulfilled to deny coverage successfully with an appeal to these clauses, are accepted. Illustrative is The Joint Consultation Paper which proposes a causal connection requirement as to warranties and not to exception clauses.³ The differences are even more absolutely established in a recent judgment of the Dutch Supreme Court of 9 June 2006: exception clauses are part of the primary description of the coverage and as such they cannot be set aside – as it applies to warranties – with an appeal to principles of equity and reasonableness because the reasons for inserting such clauses in the policy do not play in the actual case. The insurer is free to determine the borderlines of the primary coverage he is prepared to offer.⁴

The question arises whether this difference may be eliminated by the appliance of another legal rule. In that respect the Joint Consultation Paper points out that it is open to a court or ombudsman to use the Unfair Terms in Consumer Contracts Regulations 1999 to prevent those clauses from being used unfairly, in a similar way. However, generally speaking, all national legislation which is based on the Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts, shall be in line with Article 4 sub 2 therein, saying that assessment of the unfair nature of the terms shall relate neither to the definition of the main subject matter of the contract nor to the adequacy of the price and remuneration, on the one hand, as against the services or goods supplied in exchange, on the other, in so far as these terms are in plain intelligible language. One may argue that exception clauses fall under the scope of Article 4 sub 2, being a part of the definition of the main subject matter of the contract and/or being taken into account in the calculation of the premium.

³) The insured should be entitled to be paid a claim if they can prove on the balance of probabilities that the event or circumstances constituting the breach *did not contribute to the loss*. In consumer insurance this rule would be mandatory, while in business insurance it would be a default rule. They would apply only to warranties, as narrowly defined, and not to other terms such as exceptions.

⁴) NJ 2006, 326.

3. Discharge of the insurer's liability (causation and fault)

Article 4:103 shows that the PEICL not only adopt the principle of causation as a condition precedent to the discharge of the insurer's liability, but adds to it the requirement of fault at the side of the insured.

Firstly the requirement of causation. Article 4:103 is clear: non-compliance with a precautionary measure shall only have effect to the extent that the loss was caused by the non-compliance by the policyholder or insured. Taking into account the ratio for inserting a warranty into the policy like the presence of a sprinkler device in full operation as a condition precedent of coverage, it is reasonable to assume that in case of a policy of fire insurance, the requirement of causation will also be met if the non-compliance did not start the fire but did not prevent the large extent of the damage as a result of the fire.

The text of the clause is also clear in so far the onus of proving a causal link between the non-compliance and the loss is on the insurer. One may argue that the insurer should be free to protect itself against temporarily aggravation of risk by using the technique of a warranty which suspends coverage on the basis of the mere fact that an agreed condition precedent of coverage is not fulfilled. On the other hand in that case it's fair and in accordance with principles of equity and reasonableness that the insured is entitled to prove a lack of causation between the non-compliance and the loss and – by doing so – to secure its coverage.⁵

As mentioned here above, the PEICL introduce a second requirement for the discharge of the insurer's liability: the loss should be caused by the non-compliance by the policyholder or insured with intent to cause the loss or recklessly and with knowledge that the loss would probably result. In any case the policyholder or the insured shall be entitled to insurance money in respect of any loss caused by merely negligent non-compliance with a precautionary measure. The basic philosophy for the majority of the Group was that without any requirement of fault the rule was felt to be unjust and incomplete; freeing the insurer from covering the loss can generally not be legitimized if fault on the insured's part is only "slight" negligence. However on the other hand one may argue that putting the threshold on the scale of degrees of fault at the level of at least reckless behavior with knowledge that loss will probably result, undervalues the rationale of a warranty and – moreover – creates a burden of proof on the insurer which the latter will not able to meet in the majority of cases.

4. Insurer's right to terminate the insurance contract

Article 4:102 implies that the right to terminate the contract in the event of non-compliance with a precautionary measure is limited to cases wherein the policyholder or the insured has breached its obligation with intent to cause the loss or recklessly and with knowledge that the loss would probably result. The right to terminate shall be

⁵⁾ See Joint Consultation Paper which proposes to enshrine the existing guidelines of FOS (Financial Ombudsman Service) into law by stating that the consumer and a business should be entitled to be paid a claim if they can prove on the balance of probabilities that the event or circumstances constituting the breach of warranty did not contribute to the loss.

exercised by written notice to the policyholder within one month of the time when the non-compliance with a precautionary measure becomes known or apparent to the insurer. Cover shall come to an end at the time of termination.

Here the impact of the requirement of a fault on the level of intent or reckless behavior will be less for the insurer as according to Article 2:601 the duration of the insurance contract shall be one year. One may presume that it is reasonable that a insurer will be entitled to refuse prolongation in case it was confronted during the period of insurance with a non-compliance of a warranty by the policyholder or insured based on a lower level of fault which justifies a lack of confidence in respect with the observance of a reasonable degree of care by the latter to comply with the agreed warranties in future.

5. Some final reflections

It's clear that the PEICL, in providing rules for precautionary measures in Article 4:101-103, secure a higher level of protection on behalf of the policyholder and the insured than the latter enjoy under the national law on contracts of insurance in many European Member states. It is a free choice which one has to respect as long as it does not interfere with the freedom of tariff and product as a basic principle of European supervision on insurance. At the same time it is unlikely that under the regime of the PEICL an insurer will choose precautionary measures as the main tool to limit the scope of the primary cover, given the delicate position the PEICL put the insurer in and taking into account the alternatives available. Let us take by way of example a household insurance policy under which the insurer only wants to cover the risk of house-breaking. The following solutions are at its disposal:

1. The cover includes:
 - (...)
 - Theft through actual forcible and violent entry to the premises
2. No coverage for theft, unless through forcible and violent entry to the premises
3. The risk of theft is covered while the premises are locked and not accessible otherwise than through actual forcible and violent entry.

It is likely that an insurer will prefer a choice of 1) or 2). By doing so, it secures the limitation of the cover desired, regardless of any requirement of causation and fault. Anyone in favour of the higher level of protection accorded the policyholder and the insured by the PEICL, shall restrain an incentive to construe the wording of any clause in accordance with 1) or 2) as a precautionary measure in the sense of Article 4:101. Otherwise there will be a violation of the freedom of tariff and product as a basic principle of European supervision on insurance. That would be an outcome contrary to the most essential goal of the PEICL, i. e. a role as an optional instrument making a significant contribution to the functioning of the internal insurance market.