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CLIENT ALERT INSURANCE AND REINSURANCE GERMANY

In this issue of our Client Alert we would like to inform you in a concise form about the latest developments in the area of insurance law.

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I. NO APPLICABILITY OF SEC. 77 (2) VAG (OLD VERSION) TO THE QUARTERLY NETTING UNDER A PERIODIC CURRENT ACCOUNT CONTRACT

The German Federal High Court of Justice (“BGH”) ruled on 20 July 2011 (IV ZR 177/09) that Sec. 77 (2) VAG (old version) is not applicable to periodic current account contracts between primary insurers and reinsurers. The judgement concerns the relationship between primary insurers and reinsurers in case of their insolvency under the legal situation before the entry into force of the Ninth Act to Amend the Insurance Supervisory Act (“VAG”) on 1 January 2008. A primary insurer and its reinsurer had agreed on the usual quarterly rendering and subsequent settlement of accounts. Insolvency proceedings were opened over the assets of the primary insurer. The insolvency trustee made claims against the reinsurer on the basis of two statements of account, both containing claims of the primary insurer. One statement concerned a period of time before the opening of the insolvency proceedings, the other a subsequent period of time. The reinsurer’s counter-claims contained in the statements could not be netted or set off from these claims in the insolvency trustee’s opinion. The BGH has a different view on this.

The legal core is the question of the protection of the primary insurer's assets representing the technical provisions. The VAG provides for special protection of the policyholders' claims arising from insurance relationships. A very essential element is the existence of assets representing technical provisions which must be available primarily to satisfy these claims (Sec. 77 VAG). In the event of insolvency, insurance claims must take precedence in respect of these assets (Sec. 77a VAG). An obligation to this effect is imposed under EU law by Article 10 (1) (a) of the Liquidation Directive.

The required amount of these assets is determined by Sec. 66 (1a) VAG by listing certain balance-sheet liabilities to cover the policyholders' future claims against the insurer. In this respect, Sec. 66 (1a) VAG stipulates that the assets representing the technical provisions must be shown as gross amounts. This is required by Article 2 (k) of the Liquidation Directive. Reinsurance shares are therefore not to be considered. Otherwise the special protection achieved by setting up the technical provisions could be eroded. The actual status of the assets follows first from Sec. 66 (6) sentence 1 VAG: According to this provision, all assets representing technical provisions must be listed separately in a list of assets. To supplement this, Sec. 66 (6) (a) sentence 1 VAG states: *"The reinsurers' shares [...] are part of the assets representing technical provisions even without an entry in the list of assets."*

Regarding the accounts for the time preceding the insolvency proceedings, the reinsurer invoked the agreement on netting. Only the claim arising from this netting was said to be owed whereas the mutual claims contained therein were no longer part of the dissolution. As the balance concerned contained more claims of the reinsurer than of the primary insurer, i.e. resulting in a claim for the reinsurer, the insolvency trustee could supposedly derive no claim from this. The insolvency trustee wanted to apply Sec. 77 (2) VAG (today Sec. 77 (2) sentence 1 VAG) analogously. According to this provision, the assets representing the technical provisions may be disposed of by levy of execution or civil arrest only insofar as, for the claim in favour of which the disposition is to be made, the addition to the assets representing technical provisions is required (Sec. 66 (1) to (4), 6a VAG) and was in fact made.

The BGH contradicted this. Although the current account agreements ended in any case when the insolvency proceedings were opened, the netting anticipated in the current account agreement remained effective with respect to the claims arising from the current account in the time up to the opening of the insolvency proceedings. This is not inconsistent with

Sec. 77 (2) VAG (old version). According to the clear wording of the provision, the claims arising from the beginning from the current account agreement also constitute assets representing technical provisions only in this form. Insofar as, because of this limitation, the necessary cover is not reached, there is a duty to add further assets pursuant to Sec. 66 (2) VAG (*"If the assets representing technical provisions do not reach the minimum level pursuant to Clause 1a, the management board must promptly add the missing amount to the assets."*).

The primary insurer's claims contained in the accounts for any time after the opening of the insolvency proceedings came into being already before the insolvency proceedings were opened. Only the due date was after the day of the opening of the proceedings. The conditions of Sec. 95 (1) sentence 1 InsO (German Insolvency Regulation) were thus fulfilled. This provision allows a set-off in such cases. The reinsurer was therefore able to set off the overdue premium claims. The BGH discusses whether this conclusion is inconsistent with Sec. 77 (2) VAG (old version). Although the conditions for a prohibition of execution according to Sec. 77 (2) VAG (old version) were fulfilled, this provision does not contain a prohibition of set-off. In the absence of an unplanned gap in the law, no analogous application was possible.

Now Sec. 77 (2) sentence 2 VAG provides for the analogous application of Sec. 77 (2) sentence 1 VAG to the set-off from claims belonging to assets representing technical provisions. This also covers the case of a current account agreement. The reinsurer would therefore lose the case today if it concerned facts arising after 1 January 2008.

II. FAILURE TO ADJUST GENERAL INSURANCE CONDITIONS TO THE VVG 2008 ACCORDING TO ART. 1 III EGVVG RESULTS IN THE INVALIDITY OF THE PROVISIONS ON THE VIOLATION OF CONTRACTUAL OBLIGATIONS (BGH)

By judgement of 12 October 2011 (IV ZR 199/10), the Fourth Division of the BGH, which handles insurance related cases, among others, decided that the failure to adjust general insurance conditions in old contracts makes it inadmissible for the insurer to invoke the violation of contractual obligations, if the clause in the old contract is oriented by the statutory provision of Sec. 6 VVG (old version).

Whereas, under the old Insurance Contract Act (VVG), a grossly negligent breach of duty could result in the insurer's full exemption from performance, the new Insurance

Contract Act contains a more favourable provision for the policyholder in Sec. 28 (2) sentence 2 VVG, namely a reduction of performance instead of the full loss of the right to demand performance in case of a grossly negligent breach of duty. Provisions in general insurance conditions oriented by the old legal situation are said to contradict new law and therefore to be invalid.

Decision

The Plaintiff was the insolvency administrator for a piece of land with buildings owned by H Wohnungsbaugesellschaft mbH (debtor). The object was insured by the debtor through a residential building insurance contract with the Defendant based on the VGB 88 (General Residential Building Insurance Conditions). An adjustment of these general conditions to the new VVG, which has been in force since 1 January 2008, was not made within the deadline (1 January 2009) provided for in Art. 1 (3) EGVVG (Introductory Act to the Insurance Contract Act).

The building was vacant and being offered for rent. On 8 January 2009 tap water damage was found in consequence of a breakdown of the heating which caused a pipe to freeze and subsequently burst. On 13 January 2009, the Plaintiff reported the damage to the Defendant and had urgently necessary work done to repair the damage. The Plaintiff and the Defendant subsequently corresponded about the repair work. The Defendant finally stated that, after rendering accounts, it would “settle 50% of the total damage and pay this amount”. The Defendant’s letter stated, among other things: “According to the contract, the policyholder must among other things check buildings or parts of buildings which are not in use frequently and block, empty and keep empty all facilities and installations with running water there. If the policyholder violates this obligation, the insurer has the right to reduce its performance in proportion to the severity of the breach. For this reason we can only pay half of the expenditures to be expected or to be finally paid to repair the damage, as the water system was not blocked and emptied.”

The Plaintiff then ordered the work to be done. The invoice received for this was paid by the Plaintiff and then sent to the Defendant with a deadline for payment. The Defendant did not make any payment.

The Plaintiff claimed that the house had been checked on 30 December 2008 by an employee of SM Hausverwaltung GmbH. Nothing indicated any problems in the pipes. The heating was operating. All the same, the damage occurred because the heating apparently broke down. The Plaintiff argued furthermore that the Defendant partly acknowledged the debt. Apart from that, the Defendant is said not to be able to invoke the breach of duty because it did not adjust the insurance conditions to the new VVG.

The Regional Court (“LG”) ruled for the Plaintiff, except for the amount of interest. The Defendant’s appeal was unsuccessful.

The Regional Court of Appeal (“OLG”) argued in the reasons for its decision that the provision applicable in this case to the breach of duty by the policyholder in Sec. 11 no. 2 VGB 88 is inconsistent with the statutory provision in Sec. 28 VVG, as amended. Sec. 11 VGB 88 refers to termination or the exemption from performance pursuant to Sec. 6 VVG (old version). But this conflicts with the new provision in Sec. 28 VVG, as amended, which presupposes a valid agreement on the exemption from performance (“*If the contract stipulates ...*”). Under old law, a grossly negligent breach of duty can result in the full exemption from performance. The proportionate reduction of performance now provided for in Sec. 28 (2) VVG in cases of gross negligence was not provided for in the old law. As Sec. 32 VVG prohibits any deviation from Sec. 28 VVG to the policyholder’s disadvantage, the Regional Court of Appeal concluded that Sec. 11 no. 2 VGB 88 was invalid. The new provision in Sec. 28 VVG is said to be more favourable for the policyholder than the insurance conditions used by the Defendant. Referring to the specific provision in Art. 1 (3) EGVVG, which specifically deals with the non-adjustment of old insurance conditions, any reduction of the clause to its admissible content and any supplementary contract interpretation was rejected.

The BGH essentially took over the arguments of the Regional Court of Appeal. Only the clarification of the gross negligence in bringing about the insured event, which the insurer claimed, was considered by the BGH to be insufficient, and therefore the case was referred back to the Regional Court of Appeal for further consideration and a new decision.

Remark

In this decision, the BGH decided a question which had been very controversially discussed in the literature on insurance law, namely whether a failure to make an adjustment of older insurance conditions in accordance with Art. 1 (3) EGVVG within the time limits allowed for the adjustment results in the invalidity of the clauses which are inconsistent with the new law. As a main argument against invalidity, it was said that the existing insurance conditions were consistent in every respect with the earlier legal situation and that the risk of the change of the law should not be imposed upon the insurer. Now, as the Regional Court of Appeal of Köln already did, and the Regional Court of Nürnberg-Fürth in a different case, the BGH rejected this argument, invoking the clear legislative intention. However, the BGH did point out that the policyholders’ grossly

negligent acts do lead to sanctions also under the new law and the insurer can still invoke a grossly negligent causation of the insured event according to Sec. 81 (2) VVG or an increase in the risk according to Secs. 23 et seq. VVG.

III. EXCLUSION OF INDIRECT DAMAGE IN COMMERCIAL FIDELITY INSURANCE (BGH)

By judgement of 20 July 2011 (IV ZR 75/09), the BGH considered the interpretation of the exclusion of indirect damage in commercial fidelity insurance and decided that default interest is not covered by this exclusion. In addition, the exclusion of indirect damage in Sec. 4 no. 3 of the commercial fidelity insurance contracts concluded by notaries chambers in accordance with Sec. 67 (3) no. 3 sentence 1 Federal Notary Act (BNotO) is invalid pursuant to Sec. 9 AGBG (= Sec. 307 BGB, as amended).

Decision

The judgement is based on a legal dispute between an injured party and a notary's commercial fidelity insurer. According to Sec. 19 (2) sentence 2 BNotO, the notary's third-party liability insurer is obliged, also in case of wilful breach of duty, to make advance payment in the amount of recourse which can be taken against the notary's commercial fidelity insurer (see Sec. 19 (2) sentence 3 BNotO). The BGH therefore had an opportunity in the dispute with the third-party liability insurer to make a ruling on the extent of the insurance cover under the notary's commercial fidelity insurance. In Sec. 4 of the General Conditions for Commercial Fidelity Insurance, the following provision was contained: "*Exclusions: Insurance cover is excluded for damage (...) 3. which arises indirectly, e.g. lost profits, lost interest, the claimant's legal costs, etc. ...*". The lower court, the Regional Court of Appeal of Munich, awarded the Plaintiff's claims only in the amount of the damage plus interest for the time of litigation. Default interest awarded in the course of the litigation against the notary was said not to be covered, because of the provision in Sec. 4 no. 3 of the General Commercial Fidelity Insurance Conditions, and the third-party liability insurer was therefore said not to have to pay such interest in advance.

The BGH first decided, by way of an interpretation and referring to the criteria for the interpretation of exclusions developed in a consistent line of rulings (BGHZ 123, 83, 85, VersR 1999, 748, VersR 2003, 236), that the default interest according to Sec. 288 (1) BGB demanded by the Plaintiff is not covered by "*interest losses*" and "*indirect*" damage. Proceeding on the basis of the wording of the exclusion, a reasonable policyholder would primarily think of "*interest losses*" as the financial disadvantage

which arises in the form of a loss of interest in consequence of the primary loss caused by the breach of duty, i.e. the return on an investment not achieved and thus "lost". As opposed of this, the claim to default interest on the basis of Sec. 288 (1) and (2) BGB is independent of proof of an actual loss. Default interest is as such and in terms of its amount fixed by law as an objective minimum loss, and consequently the debtor is cut off from proving that in actual fact no loss arose or that the loss is smaller. The recoverability of statutory default interest is coupled only to the existence of default, and therefore the claim arises much easier than a claim to compensation for further interest losses or lost profits.

The BGH adds further thoughts on the specific situation of a notary to these arguments. As a wilful breach of duty is often combined with the notary's inability to pay, the commercial fidelity insurer can generally assume that the notary is obliged to pay default interest pursuant to Sec. 288 (1) BGB. Also the clear purpose of the commercial fidelity insurance contract and of the risk exclusion speak for a narrow interpretation of the term "interest loss". The commercial fidelity insurance is said to primarily serve to protect the injured party, and in addition the standing of the notarial profession, which is why the injured party can at least demand the statutory default interest almost inevitably involved in the primary financial loss. Statutory default interest pursuant to Sec. 288 (1) BGB is therefore said not to be covered by the exclusion in Sec. 4 no. 3 General Commercial Fidelity Insurance Conditions.

In addition to the default interest, the case concerned the commercial fidelity insurer's obligation to cover interest which would have been payable to the Plaintiff before the beginning of default without the breach of duty on the notary's trust account in the form of interest on a credit balance, i.e. the lost profit within the meaning of Sec. 252 BGB. This was classified by the BGH as lost profits and thus as an indirect loss within the meaning of the exclusion. But here the BGH considered the exclusion to be invalid under Sec. 9 of the former AGBG, now Sec. 307 BGB, as amended. But the considerations supporting the judgement in this respect are based on the specific function of commercial fidelity insurance for notaries' chambers as mandatory insurance. The court points first to the different statements in the legal literature on the validity of the exclusion for indirect loss. It is disputed in this respect to what extent further exclusions not provided for in the statutory provisions on the notary's compulsory insurance are admissible (note 26 of the judgement).

The court critically views such exclusions of cover and in the end rejects the exclusion, as a limitation of cover under commercial fidelity insurance in Sec. 4 no. 3 General

Commercial Fidelity Insurance Conditions endangers the purposes of compulsory insurance (Sec. 9 (2) no. 2 AGBG = Sec. 307 (2) No. 2 BGB, as amended). The specific feature of compulsory insurance is to compensate the injured party and is based on the consideration that the notary exercises public functions. The commercial fidelity insurance was intended by the legislator to protect assets in the same way as in the case of breaches of official duties by other public officials. This function of protection for injured parties similar to the liability of the government for the violation of official duties is said to be endangered by the general exclusion of cover for indirect losses. Also according to the general principles of public liability, there is no differentiation between indirect and direct losses. It is the negative interest which must be compensated for, i.e. the injured party must be put into the same situation which it would have been in if the public official had acted dutifully. But especially because of the exclusion of lost profits, which are named as an example, potentially large losses are not covered by commercial fidelity insurance. The clause in Sec. 4 no. 3 General Commercial Fidelity Insurance Conditions therefore puts the injured party and thus also the notaries' chamber at an unreasonable disadvantage and is invalid.

Remark

The judgement is of considerable importance for commercial fidelity insurance. The arguments of the BGH in the first part of the judgement regarding the interpretation of the exclusion of indirect losses has fundamental significance and is not limited to the compulsory insurance for notaries. Default interest is regularly not explicitly excluded from cover under commercial fidelity insurance contracts. In case of exclusions formulated in a similar manner as the disputed clause, the insurers will also have to consider compensation for default interest.

Insofar as the judgement entirely rejects the exclusion of indirect losses, the reach of the arguments of the court is limited to the specifics of compulsory insurance, especially for notaries' chambers. These arguments cannot be transferred to commercial fidelity insurance as such. However, the judgement does contain significant guidelines for the question of the extent to which exclusions may be included in compulsory insurance contracts. In this respect, the decision should have considerable significance also beyond the compulsory insurance discussed in it.

IV. THE DRAFT BILL FOR THE TENTH ACT TO AMEND THE VAG

The draft bill of a Tenth Act to amend the Insurance Supervisory Act has been available for some weeks. It intends to implement the Insurance Directive ("Solvency II") – Directive 2009/138/EC of the European Parliament and the Council.

The draft first provides for a full formal restructuring of the VAG. It is divided up into seven parts, these partly into chapters, sections and subsections, with 345 clauses and in addition three annexes. The new structure is reasonable and clear.

Although the draft formally changes the VAG very intensively, the current substance is essentially preserved. But the draft does contain very substantial amendments which go back to the Directive. Such an amendment is contained for example in the new Sec. 25 VAG ("*Qualification of the persons actually managing the company or exercising other key functions*"). Here, not only reliability and professional qualification are required for the members of the management board or the general representative, but also by those who actually manage the company or exercise other key functions. Under German law, the company is managed by its management board. Sanctions are imposed upon the management board by the German Federal Supervisory Authority (BaFin) in case of any breach of duty. In the future, in addition to the managing directors, persons exercising key functions will also be sanctioned. This considerably extends the powers of the BaFin to take action and will result in a fundamental change also in the internal company structure and responsibilities, creating, as it were, a regulatory parallel work outside the national company law.

The current provisions for the investment of capital will be repealed. They will be replaced essentially by a reference to the principle of entrepreneurial care (Sec. 115 (1) of the draft). Instead of the current principles of safety, profitability, liquidity, mixture and diversity (Sec. 54 (1) VAG), the portfolio as a whole must ensure safety, quality, liquidity and profitability in the future. It is currently not yet quite clear what is to happen with the present investment regulation.

The draft contains 23 powers to issue legal regulations. The addressee is in each case the Federal Finance Minister (BMF). He is typically granted the possibility to delegate the power to the BaFin (sub-delegation power). The draft deals in each case with the question whether the approval

of the Federal Council (“Bundesrat”) is necessary. It is typically said not to be necessary. The reason for these provisions is that the VAG is an act implemented by the “Länder” as their own affairs, insofar as they exercise the function of insurance supervision themselves (Secs. 146 et seq. VAG). In such cases, Art. 80 (2) GG makes it necessary for legal regulations issued by the Federal Government to obtain the approval of the Federal Council, subject to other federal regulations, and the explicit exclusion of the approval requirement is such a regulation.

It remains to be seen whether the numerous provisions going beyond the requirements of the Directive can remain effective, as the implementation of the Solvency II Directive is intended to fully harmonize the supervisory laws, as opposed for example to the Third Directives, which merely provided for a minimum harmonization. But the numerous provisions in the VAG which go beyond the Solvency II Directive counteract any full harmonization.

The draft bill provides for the entry into force on 31 October 2012. However, considerable delays are to be expected, also for the precise reason that the contents of the draft bill are in many ways incompatible with the Solvency II Directive; this point will surely come up in Parliament.

V. ADJUSTMENT OF THE ADVICE ON THE CANCELLATION RIGHT ACCORDING TO SEC. 8 VVG (ACT OF 27 JULY 2011, BGBl. I P. 1600)

Parts of the Civil Code regarding long distance agreements were amended on 4 August 2011. By inserting the new Secs. 311e and 312f BGB, the former Secs. 312e to 312g will be renamed and are now Sec. 312g to 312i BGB. This amendment also concerns the VVG, as the provision in Sec. 8 had to be amended accordingly there: In Sec. 8 (4) VVG, the words “*Sec. 312e (1) sentence 1 of the Civil Code*” were replaced by the words “*Sec. 312g (1) sentence 1 of the Civil Code*”; the second remark regarding the sample advice on the right to cancel the contract (Annex to Sec. 8 VVG) was also adjusted accordingly (Act of 27 July 2011, BGBl. I p. 1600).

Insurers who use an addition for electronic transactions in their advice on the right to cancel the contract are advised to include the above amendment there in order not to endanger the fictitious effect of Sec. 8 (5) VVG (lawfulness of the advice when using the legal model) or, as the case may be, not to expose themselves to the risk of an unlimited right to cancel the contract.

To conclude, we would like to draw your attention to the international newsletter in the area of the financial sector, which you can download from the following link:

http://www.dlapiper.com/files/Publication/c7306b2f-dfad-46b7-89fc-b63256e93e9c/Presentation/PublicationAttachment/2fef6a68-160d-4aa5-8fb7-bc73962b5f19/Exchange_International_Newsletter_Issue_11.pdf

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