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AGGRAVATION OF RISK AND PRECAUTIONARY MEASURES IN NON-LIFE INSURANCE: A TRICKY SCOPE FOR THE INSURER?

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ABSTRACT

Aggravation of risk and failure to take precautionary measures are focal issues in non-life insurance in terms of potential partial or full release of the insurer from the duty to perform. Not infrequently, it is difficult to draw a line between the aggravation of risk on the one hand, and non-compliance with precautionary measures on the other, since a particular action by a policyholder may present both situations. At the same time, the legal remedies available to the insurer regarding these two situations are different in scope. The aggravation of risk and non-compliance with precautionary measures are precisely the bases on which insurers actually reduce indemnity or refuse to compensate for damages. This article explores the differences between insurance laws in the Baltic states—specifically, the Estonian Law of Obligations Act, the Latvian Insurance Contract Law and Lithuanian rules contained in the Civil Code and Insurance Law. The article explores the differences between the Baltic states' insurance laws and the Principles of European Insurance Contract Law (PEICL) with regard to a policyholder's duty in relation to aggravation of risk and precautionary measures, as the rights and obligations of policyholders do change where the optional instrument is applied. The article also includes comparisons to German, Finnish and Russian insurance law.

KEYWORDS

Aggravation of risk, precautionary measures, Baltic states insurance law, Principles of European Insurance Contract Law (PEICL)

INTRODUCTION

Throughout the European Union (EU), insurance law differs to quite a substantial degree. The EU is becoming more and more integrated, and freedom of movement has led to the modern reality that people can travel and work abroad, being in different jurisdictions on a daily basis. This article presents examples of Estonian, Latvian and Lithuanian laws, as well as Russian, Finnish and other relevant laws, that show that, in several insurance-law cases, different jurisdictions have offered quite different solutions to similar problems. To begin with, we would like to propose a simple practical problem. Hypothetically, under the same set of circumstances, would a policyholder's fault increase as he/she travels 80 kilometers south of Helsinki, Finland, to Tallinn, Estonia, even if the insurers in these neighboring countries belong to one and the same insurance group? In a real-life scenario, the outcome of such a potential question regarding the dispute between a policyholder and an insurer concerning the fault of the policyholder might have a different solution in different jurisdictions. Even if the fault *per se* is the same, it is treated in a dissimilar way by the substantial law in each country. In addition, consumers generally cannot take their insurance policies with them when moving or traveling (with the exception of travel insurance) to another country. The outcome of the hypothetical problem results in real-life difficulties in obtaining appropriate coverage. Likewise, consumers who purchase an insurance contract in one country have good reason to be surprised that they cannot maintain their previous contracts. This is because of differences in jurisdictions. However, when looking at this from the perspective of freedom of movement in EU and consumers' legitimate expectations as policyholders, this outcome does not offer the protection it perhaps should—consumers ought to be able to expect that, having procured insurance coverage, the insurance would have similar practical meaning even if the consumer travels, works or lives in different jurisdictions.

In a 2010 Green Paper,¹ the European Commission recommended seven approaches² to enhance the uniformity of contract law, including allowing consumers and companies alike to choose an optional instrument of European contract law, or second regime, for their contractual relations. On June 8, 2011, as part of its progress toward a European Contract Law for consumers and businesses,

¹ *European Commission Green Paper from the Commission on Policy Options for Progress Towards a European Contract Law for Consumers and Businesses*, COM(2010)348 final (July 1, 2010) // <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0348:FIN:EN:PDF>.

² Those seven approaches are: 1. publication of the results of the Expert Group; 2. an official 'toolbox' for the legislator; 3. a Commission Recommendation on European Contract Law; 4. a Regulation setting up an optional instrument of European Contract Law; 5. a Directive on European Contract Law; 6. a Regulation establishing a European Contract Law; and 7. a Regulation establishing a European Civil Code.

the European Parliament passed a resolution on policy options in this field.³ The resolution calls for the adoption of an optional instrument that would include insurance contract law. The so-called second regime applicable to all member states (meaning a voluntary European procedure) will become a part of the domestic laws of the member states just as with any other source of European law. This regime allows parties a choice between two layers of domestic contract law—one enforced by the legislator of the member state, the other by the European Union.

The European Commission is currently⁴ in the process of preparing a European Common Frame of Reference (CFR)⁵ concerning Europe's general contract law, with one part focusing on insurance contracts (Principles of European Insurance Contract Law - PEICL⁶). In general, the PEICL is pro-policyholder. Thus, with respect to several important issues discussed in this article, it offers the policyholder more substantial protection than that offered by the domestic laws in the Baltic states. It should be mentioned that the parts of the PEICL concerning life insurance and liability insurance have not yet been fully drafted. As a result, those particular issues are not the focus of the authors' current research.

PEICL⁷ may turn out to be an instrument that—in addition to resulting in an influx of service providers into the insurance market by means of cross-border⁸

³ *European Parliament Resolution of 8 June 2011 on Policy Options for Progress Towards a European Contract Law for Consumers and Businesses* // <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2011-0262>.

⁴ The European Commission first attempted to harmonize European insurance contract law when it presented an initial proposal for a directive in 1979 aimed at coordinating the laws, regulations and administrative provisions relating to insurance contracts (see *Commission Proposal for a Council Directive on the Coordination of Laws, Regulations and Administrative Provisions Relating to Insurance Contracts*, Official Journal of the European Union, C 190/2 (July 6, 1979)). Unfortunately, the member states were not able to reach an agreement on the draft.

⁵ See Helmut Heiss, "The Common Frame of Reference (CFR) of European Insurance Contract Law," *ERA Forum* 9 (2008).

⁶ *Principles of European Insurance Contract Law* // <http://www.uibk.ac.at/zivilrecht/restatement/sprachfassungen/peicl-en.pdf>. Helmut Heiss explains that: "The PEICL [was] drafted as an optional instrument of European insurance contract law, allowing parties to opt out of national (insurance) law by opting for the application of the PEICL. Due to the mainly mandatory character of the rules on international insurance contract law (Article 7 of Rome I) and national insurance contract law, this option does not exist at present; it requires an EU regulation on the matter" (Helmut Heiss, "Proportionality in the New German Insurance Contract Act," *Erasmus Law Review* 5 (2) (2012): 113).

⁷ Malcolm Clarke has characterized the current PEICL by saying that, "This is not a statement of current law, but in the language of law in the USA, a restatement of what a group of European scholars thinks the law should be (inevitably a compromise)" (Malcolm Clarke, "Late Payment of Insurance Money," *Erasmus Law Review* 5 (2) (2012): 120).

⁸ Mandeep Lakhan and Helmut Heiss state that: "As a result of the lack of substantive harmonization, the cross-border provision of insurance services is statistically still very rare. Yet, even in the cases where a provider is internationally active, the business is typically carried out through subsidiaries or branch offices and the products sold in different countries are not [the] same as those on offer in the country of the insurer's domicile. This leads to insurance providers being restricted by variations in national laws, consumers being prevented from having access to a full range of products, and the internal market consequently remaining incomplete" (Mandeep Lakhan and Helmut Heiss, "An Optional Instrument for European Insurance Contract Law," *Utrecht Journal of International and European Law* 27/71 (2010): 3; see also Giesela Rühl, "Common Law, Civil Law, and the Single European Market for Insurance," *International and Comparative Law Quarterly* 55 (2006)).

services⁹—will afford policyholders more effective protection compared to that which is available under their domestic laws.

The main obligations of the parties under an insurance contract are as follows: the policyholder must pay insurance premiums to the insurer, and the insurer must indemnify the policyholder in the case of an insured event. At the same time, however, in non-life insurance, the policyholder has pivotal accessory obligations *ex ante* any insured event, i.e. the obligation to refrain from aggravating risk and the obligation to take precautionary measures. In practice, the latter means that the policyholder has to do everything reasonably possible to prevent the occurrence of an insured event, as well as to decrease the damages resulting therefrom. If a policyholder breaches the obligations to refrain from aggravating risk and fails to take precautionary measures, this may significantly affect the insurer's performance obligation under the insurance agreement.

It is often difficult to draw a line between the aggravation of risk on the one hand, and non-compliance with precautionary measures on the other, since a particular act on the part of a policyholder may constitute both. At the same time, the legal remedies available to the insurer regarding these two different situations are different in scope. Aggravation of risk and non-compliance with precautionary measures are precisely the bases that insurers use to reduce the amount of indemnity or refuse to compensate for damages. At the same time, the problem arises from the added challenge of differentiating between precautionary measures and the exclusion of risk. Giesela Rühl¹⁰ noted in 2012 that:

Independent of their precise labeling, the policyholder's precautionary obligations¹¹ must be distinguished from clauses describing, delimiting or excluding the insured risk. These clauses determine the insurer's obligations without reference to the policyholder's conduct and provide which risks are covered by the policy and which not. The distinction between these clauses and precautionary obligations is usually problematic, since every precautionary obligation can also be formulated as a description, limitation or exclusion of risk.¹²

Currently, regulations concerning a policyholder's duty regarding aggravation of risk and precautionary measures vary significantly across EU member states, and

⁹ On 17 January 2013, the European Commission set up an Expert Group on European Insurance Contract law in order to assist the European Commission in examining whether and to what extent the differences in contract laws pose an obstacle to cross-border trade in insurance products (*Commission Decision of 17 January 2013 on Setting up the Commission Expert Group on a European Insurance Contract Law*, Official Journal of the European Union, C 16/6 (January 19, 2013)).

¹⁰ Giesela Rühl, "Precautionary Obligations (Insurance Contracts)": 3; in: Jürgen Basedow, Klaus Hopt, and Reinhard Zimmermann, eds., *Encyclopaedia of European Private Law* (Oxford University Press, 2012) // http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1989538.

¹¹ Precautionary measures and precautionary obligations are synonyms.

¹² See also research by Russian insurance-law scholar V. M. Akhinian, "Novyi vzgliad na dogovornye isklucheniia v strakhovom prave," *Pravovedenie* 2 (5) (2009) [in Russian]

there are different approaches to protecting the rights of policyholders. Hence, in a jurisdiction where the PEICL is subject to enforcement, insurers can also expect to avoid the differences¹³ in regulations governing the aggravation of risk and precautionary measures arising from different legal systems.

This article explores in detail the differences among the 2001 Estonian Law of Obligations Act¹⁴ (LOA), the 1998 Latvian Insurance Contract Law¹⁵ (ICL), Lithuanian rules contained in the 2000 Civil Code¹⁶ (CC) and in the 2003 Insurance Law¹⁷ (IL). The article explores the differences between the Baltic states' insurance laws and the PEICL regarding the policyholder's duty to avoid aggravation of risk and take precautionary measures. The foundation of the 2001 LOA insurance regulation was Germany's *Versicherungsvertragsgesetz*¹⁸ (VVG) enacted in 1908, which was fundamentally reformed in 2008.¹⁹ Unlike the original German law, however, insurance regulation under the LOA has not been reformed.

The purpose of our analysis is to investigate whether implementing the PEICL as a second regime in the European Union could be more favorable²⁰ and consumer-friendly for policyholders in the Baltic states than current domestic regulations (at least regarding the policyholder's duty to avoid aggravation of risk and to take precautionary measures). The authors analyzed the PEICL²¹ to determine whether policyholders would be protected in too 'radical' a manner, as explained above.²² The authors' hypothesis is that the Estonian, Latvian and

¹³ Xandra Kramer explains that: "The conflict of law rules relating to insurance contracts have always constituted one of the bottlenecks of European private international law. Because the conflict rules emanate from diverse sources and lack any cohesion or well-considered system, determining the applicable law to an insurance contract is like trying to find one's way through a labyrinth. Even for private international experts the task demands significant efforts" (Xandra Kramer, "The New European Conflict of Law Rules on Insurance Contracts in Rome I: A Complex Compromise," *The Icfai University Journal of Insurance Law* VI (4) (2008): 41).

¹⁴ *Law of Obligations Act (Estonia)* (*Võlaõigusseadus*), Riigi Teataja Part 1 (July 18, 2011), No. 21.

¹⁵ *The Insurance Contract Law (Latvia)* (*Par apdrošināšanas līgumu*), Latvijas Vēstnesis (June 30, 1998), No. 188/189, as amended (April 4, 2007), No. 56.

¹⁶ *The Civil Code of the Republic of Lithuania* (*Lietuvos Respublikos Civilinis kodeksas*), Official Gazette, 2000, No. 74-2262.

¹⁷ *Law on Insurance (Lithuania)* (*Draudimo įstatymas*), Official Gazette, 2003, No. 94-4246.

¹⁸ *German Insurance Contract Act* (*Versicherungsvertragsgesetz*), Bundesgesetzblatt, I page 2631, 23/11/2007 [in German].

¹⁹ For more on the fundamental and comprehensive reform of the VVG, see Robert Koch, "German Reform of Insurance Contract Law," *European Journal of Commercial Contract Law* 2 (3) (2010).

²⁰ Yvonne Delfos-Roy concludes: "Even if the PEICL [is] enacted as an EC Regulation, a comparison with national law remains interesting. As the PEICL [is] an optional instrument it is interesting to know which level of protection—of for instance the policyholder—is higher" (Yvonne Delfos-Roy, "The PEICL and the Duty of Disclosure," *European Review of Private Law* 1 (2011): 73).

²¹ For the PEICL's economic impact, see Filomena Chirico and Pierre Larouche, eds., *Economic Analysis of the DCFR: The Work of the Economic Impact Group Within CoPECL* (Berlin, New York: Sellier, De Gruyter, 2010).

²² By way of criticism of the PEICL, some economists have argued that the PEICL ignores the proposition that insurance contracts fulfill an essential economic function. They view the PEICL approach as too legalistic, often aiming just at protecting one party without due regard to the consequences of the legal rules on other parties' behavior, and, hence, on the effectiveness of the rules themselves and the efficiency of the final outcome. See, for example, Filomena Chirico, Eric Van Damme, and Pierre Larouche, "A Giant with Feet of Clay: A First Law and Economics Analysis of the Draft Common Frame of Reference (DCFR)," *TILEC Discussion Paper* No. 2010-025 (June 22, 2010) // http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1628558. The PEICL's potential economic impact will not be analyzed in this article.

Lithuanian insurance contract laws do not provide sufficient protection to policyholders when compared to the PEICL.

At the moment, the implementation of the PEICL is not yet possible (by agreement of the parties) because insurance-law regulations are generally imperative²³ in EU member states. Thus, there is a limited possibility for parties to deviate from the domestic law. We propose that it is in the interest of these three countries to ensure quick implementation²⁴ of the PEICL as a second regime by the EU. Accordingly, we believe that, as the PEICL proves to be more favorable and consumer-friendly, it is in the interest of the policyholders in Estonia, Latvia and Lithuania that the EU implement this second regime as soon as possible.

There is at least one more major jurisdiction that could be used for comparative purposes in this work: the Russian Federation, the biggest neighbor of the Baltic states and with whom the Baltic states have substantial economic ties. But, the purpose of this article is not to provide the reader with a full comparative analysis of the entirety of Russian insurance law²⁵ against the insurance-law regime of the Baltic republics or the PEICL. Therefore, we have chosen not to bring into this comparison all the relevant provisions of the 1994 Russian Civil Code²⁶ (primarily Chapter 48) governing Russian insurance law²⁷ in relation to aggravation of risk²⁸ and precautionary measures²⁹ and not to engage in a thorough review of relevant Russian judicial practice.³⁰ This having been said, we will include reference to

²³ For example, Art. 427, Estonian LOA, contains a long list of provisions from which the parties cannot deviate to the disadvantage of the policyholder, including different grounds for terminating the insurance contract in the LOA and the PEICL.

²⁴ "The PEICL [needs] rules of general contract law to supplement them, such as rules on offer and acceptance, on the computation of time periods, on the compliance with certain formal requirements, and on prescription. In this context, a body of general contract law is urgently needed. Could such a body of general contract law be adopted in the form of [a] nonbinding instrument such as the CFR? It would be sufficient if the specific instruments incorporate the general rules by an appropriate reference as it has been suggested in the PEICL. The incorporation provision of [the] PEICL confers the character of an opt-in instrument to the incorporated rules of general contract law, be it the PECL or CFR" (Jürgen Basedow, "Transjurisdictional Codification," *Tulane Law Review* 83 (4) (2009): 973).

²⁵ See also the work by Russian insurance-law scholar A. Karapetov, "Pravo na otkaz ot vyplaty strakhovogo vozmeshcheniia s točki zreniia printsipa svobody dogovora," *Zakon* 1 (2010) [in Russian].

²⁶ Kazimieras Zaveckas, for example, asserts that the Lithuanian Civil Code has been influenced by the Civil Code of the Russian Federation (see Kazimieras Zaveckas, *Pareigos atskleisti informaciją draudimo santykiuose turinys: teoriniai ir praktiniai aspektai*, Summary of a doctoral dissertation (Vilnius: Mykolas Romeris University, 2008) // http://vddb.library.lt/fedora/get/LT-eLABa-0001:E.02~2008~D_20081111_091934-44116/DS.005.1.01.ETD [in Lithuanian]).

²⁷ *Russian Civil Code (RF Federal'nyi Zakon "Grazhdanskiy Kodeks Rossiyskoy Federatsii")* (30 November 1994, with subsequent amendments), No. 51-FZ, SZRF (1994), No. 32, item 3301. Comments on insurance issues found in Chapter 48 of the RF Civil Code can be found in Iurii Fogel'son, "Kommentarii k stat'iam glavy 48 Grazhdanskogo kodeksa RF 'Strakhovanie'," *Fond Zashchity prav strakhovatelei* // <http://insurant.ru/law/48-com> [in Russian].

²⁸ On the aggravation of risk in Russian insurance law, see V. Iu. Abramov and S. V. Dedikov, *Sudebno-prakticheskii kommentarii k strakhovomu zakonodatel'stvu* (Moskva: Wolters Kluwer, 2004), 209-215 [in Russian].

²⁹ On precautionary measures in Russian insurance law, see S. V. Taradonov, *Strakhovoe pravo* (Moskva: Iurist, 2008); or A. I. Khudiakov, *Teoriia strakhovaniia* (Moskva: Statut, 2010) [in Russian].

³⁰ On court practice dealing with Russian insurance law, see S. A. Sukhorukova, *Strakhovye spory: sbornik sudebnoi praktiki* (Moskva: Wolters Kluwer, 2006), and *Fond Zashchity prav strakhovatelei* // <http://insurant.ru/defence/court-review> [in Russian].

selected Russian court judgments that were analyzed in an early 2013 review (*obzor*) of judicial practice prepared by the RF Supreme Court's Presidium³¹ in this field and, furthermore, occasionally will refer to some of the more recent works of Russian insurance theorists to offer the reader of this work an additional, albeit highly selective, comparative frame of reference since the principles of insurance remain the same regardless of differences between the legal systems. A truly comprehensive comparison of developments relating to aggravation of risk and precautionary measures in Russian 'law in books' and 'law in action' will have to be the subject of future research.

1. AGGRAVATION OF RISK

1.1. INSURED RISK AS THE OBJECT OF AN INSURANCE CONTRACT

The element of risk, which is inseparable from human activity, is the possibility that a certain action or activity will lead to a loss. Valeria Gavrilova³² explains that people use four different risk-management techniques in everyday life as protection against risks: (1) risk avoidance; (2) loss avoidance; (3); risk acceptance; and (4) risk transfer. For the purposes of insurance contracts, we are only interested in the fourth technique, risk transfer. One means of risk transfer is to conclude an insurance contract, which transfers the policyholder's risk to an insurance company. An insured risk, as the term clearly suggests, is that risk against which insurance coverage is procured.³³ For instance, in insuring a house, insured risks may include fire, acts of God, floods, vandalism, theft, etc. When a car is covered with motor hull (CASCO) insurance, insured risks can include the risk of a traffic accident, fire, theft, etc. Insurance is a risk treatment option involving risk sharing. In non-life insurance, an insured event means the realization of an insured

³¹ *Obzor po otidel'nyim voprosam sudebnoi praktiki, svyazannym s dobrovol'nyim strakhovaniem imushchestva grazhdan*, Prezidiumom Verkhovnogo Suda Rossiyskoy Federatsii (January 30, 2013): 15-16 // http://www.vsr.ru/Show_pdf.php?Id=8412 [in Russian]. Since 2009, all courts in the Russian Federation have been required by federal law to publish their judgments in full text form. For several reasons, the success of this project is virtually complete in Russian arbitrazh (commercial) courts, which provides a great wealth of case-law data on insurance claims in general and those involving aggravation of risk and precautionary measures in particular. However, we were not in a position to conduct a careful analysis of this data, which remains a project for the future. The 2008 federal law is: *Federal'nyi Zakon RF "Ob obespechenii dostupa k informatsii o deiatel'nosti sudov v Rossiiskoi Federatsii"*, No. 262-FZ (December 22, 2008), Rossiiskaia gazeta (December 26, 2008) // <http://www.rg.ru/2008/12/26/sud-internet-dok.html> [in Russian].

³² V. E. Gavrilova, *Strakhovanie* (Moksva: Izdatelstvo Moskovskogo Universiteta, 2012), 47-48 [in Russian].

³³ The definition of 'insured risk' raises a question about the insurer's performance. According to the *theory of risk bearing* (*Gefahrtragungstheorie*), the performance of the insurer means that the insurer assumes—upon entering into an insurance contract—the risk that an insured event will occur. The payment of an indemnity after an insured event merely flows from realization of the insured risk. According to the *cash-benefit theory* (*Geldleistungstheorie*), the insurer's performance obligation emerges only after the occurrence of an insured event (see Hans-Leo Weyers and Manfred Wandt, *Versicherungsvertragsrecht* (Idstein, Hessen: Luchterhand Verlag GmbH, 2003), 130 [in German]).

risk, i.e., there is a fire in an insured house or a vehicle is stolen, etc. Thus, it would seem that insurance risk—as an object of an insurance contract—is easy to grasp in theory and should not lead to many disputes. In practice³⁴, however, there is a problem: there are instances where insurers interpret common terms in referring to insurance risks more narrowly than a consumer would.³⁵ From a practical point of view, this leads to the question of why the policyholder and the insurer interpret a contract in different ways and also why it is important for insurers to have such contractual clauses that can be interpreted as excluding certain risks. It has been found that extrinsic evidence can be an appropriate instrument for interpretation,³⁶ e.g., at the time of sale, insurers usually want to leave the impression that their product will offer exceptionally wide protection. In his 2012 critique of the Latvian ICL, legal scholar Vadims Mantrovs explains:

One of such important missing aspects is the lack of interpretation rules specific to insurance contracts. Their specifics lie in the fact that insurance contracts are drafted in advance and one side, namely, insurers, are professionals in the insurance services' market. Therefore, such specific interpretation rules should exist which provide that any ambiguity of any term of an insurance contract is interpreted against a person who, as a professional, drafted such contract, i.e., against an insurer. Such [a] modern approach is provided in [Latvia's] neighboring states: in Estonia, in case of doubt in relation to standard terms, standard terms shall be interpreted to the detriment of the party supplying the standard terms, in this case: against an insurer; there is also a similar provision in Lithuania. Neither the *Insurance Contract law*, nor any other law contains interpretation rules for interpretation of standard insurance contract terms drafted in advance by one of [the] parties [who is] a professional in that area, in this case—drafted by insurers.³⁷

³⁴ *OÜ Baltic Group Investments vs. AS If Eesti Kindlustus*, Supreme Court of Estonia, Case No.3-2-1-64-07, 2007 // <http://www.nc.ee/?id=11&tekst=RK/3-2-1-64-07>. A dispute arose when the policyholder suffered property damage as a result of a seawater flood, as the insurer interpreted the terms more narrowly than the policyholder and found that the contract only covered groundwater floods. The court ruled that the insurers could not interpret the risk of a flood in a manner that included only groundwater floods but not seawater floods. The policyholder had reasoned that a natural disaster could include a possible sea-level rise and a subsequent flood. The court held that this standard term needs to be interpreted, along with others, in consideration of the principle of reasonableness as provided in Art.7 of Estonia's 2001 Law of Obligations Act.

³⁵ Peter Hinchliffe arises a similar problem in his analysis of the PEICL: "Can insurers exclude all liability for medical expenses incurred overseas, all loss of possessions for which a carrier has not admitted liability, all liability if the policyholder consumes alcohol whilst travelling?" (Peter Hinchliffe, "Review of Principles of European Insurance Law," *ERA Forum* 9 (2008): 168).

³⁶ Oliver Brand notes that: "In Continental Europe, legal systems like Germany, Austria, Switzerland and Greece have traditionally been liberal in admitting extrinsic evidence, for example marketing statements of [insurers]. This view is now embodied in the extrinsic evidence rule in [the] PEICL" (Oliver Brand, "Contract Terms: Judicial Approaches to the Interpretation of Insurance Contracts": 102; in: Julian Burling and Kevin Lazarus, eds., *Research Handbook on International Insurance Law and Regulation* (Edward Elgar Publishing Ltd., 2011)).

³⁷ Vadims Mantrovs, "Problem Questions of Insurance Contract Regulation in Latvia"; in: *The Quality of Legal Acts and its Importance in Contemporary Legal Space* (Riga: University of Latvia, 2012) // http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2116997.

This means that insurers in Estonia, Latvia³⁸ and Lithuania have taken different routes to resolving this issue. However, Article 1:203 of the PEICL states that when there is doubt about the meaning of the wording of any document or information provided by the insurer, the interpretation most favorable to the policyholder, insured or beneficiary, as appropriate, shall prevail. And Article 1:104 states that the PEICL shall promote good faith and fair dealing in the insurance sector, certainty in contractual relationships, uniformity of application and the adequate protection of policyholders. Applying the PEICL should thus alleviate the situation of policyholders in this sense. Still, why do insurers add clauses that can be interpreted as abusive? Marcel Fontaine explains:

Most domestic systems in the European Union have gone through an evolution where, initially, the main concern was to protect the insurer against various types of fraudulent behavior by the insured. Of course, this concern is still there. But now the stress is on providing the insured with protection against various types of abusive clauses which, in the past, were frequently imposed by [the] insurer, and submitting the insurer to several new types of obligations.³⁹

The authors of this article conclude that contemporary insurance law should not prioritize protecting insurers against potential insurance fraud above protecting policyholders against various types of abusive clauses. Although the insured risk seems to be clear and constant in legal terms, the applicable regulations vary within the Baltic states. Thus, consumers traveling frequently among these three small countries may have significant difficulties understanding their obligations when concluding insurance contracts in different jurisdictions. The question of insurance risk exclusions and limitations also arises in relation to the topic of precautionary measures (addressed in Section 3).

1.2. WHICH AGGRAVATION OF RISK MUST BE COMMUNICATED TO AN INSURER?

Upon entering into an insurance contract,⁴⁰ the insurer assumes that the insured risk will remain unchanged during the insurance period—by assessing the

³⁸ See, for example, BTA's commercial property insurance terms and conditions No. 4A, para.2.2.3: *BTA "Commercial Property Insurance: Terms and Conditions No. 4A" //* http://www.bta.eu.com/files/24511_Kommercialo_Ipasuma_apdrosinasanas_Noteikumi_Nr.4A_EN.pdf. Compare *OÜ Baltic Group Investments vs. AS If Eesti Kindlustus*, *supra* note 34. The Court takes a similar position regarding the interpretation of standard terms and conditions of contracts. The regulation on interpreting such terms and conditions comes from Directive 93/13/EEC, which is examined more closely in Section 3 of this article.

³⁹ Marcel Fontaine, "An Academic View": 35; in: Helmut Heiss and Mandeep Lakhan, eds., *Principles of European Insurance Contract Law: A Model Optional Instrument* (Munich: Sellier European Law Publishers GmbH, 2011).

⁴⁰ In the 1993 Council Directive on unfair terms in consumer contracts (*Council Directive 93/13/EEC of 5 April 1993 on Unfair Terms in Consumer Contracts*, EU Official Journal L 095 (April 21, 1993):

level of the insured risk, the insurer determines the amount of the premium. It is the insured risk that is the object of an insurance contract; this risk may be presented in the form of a deterioration of the policyholder's economic situation (procuring coverage against damage in non-life insurance), claims filed against the policyholder (in the case of liability insurance), or any other adverse consequence for the policyholder (e.g., illness or death of the policyholder).⁴¹

As a rule, aggravation of risk occurs in a situation where the insurer would not have assumed the risk at the given price, i.e. the premium would have been higher for a greater risk,⁴² or the insurer would not have concluded the insurance contract in the first place. The policyholder is obliged to maintain the level of the insured risk and, if this level changes, the policyholder must notify the insurer. In certain situations, the aggravation of risk entitles the insurer to only partially indemnify (or to refuse to indemnify altogether). The prohibition against aggravation of risk aims to preserve the stability of the insurance relationship. Aggravation of risk leads to asymmetric information. Where an insurance contract specifies risk of fire as the insured risk, that risk is aggravated by an increased fire hazard; if risk of a traffic accident is insured, that risk is aggravated by an increased traffic accident hazard, etc. At the same time, one must pose the question: which increase of the relevant risk and to what extent? Since policyholders, as consumers, are subjectively different, it is also a question to deliberate on what knowledge should be ascribed to the policyholder. In our view, this issue alone already makes clear to an average insurance consumer that the field is complicated—and these problems pose even more questions in practice.

Insurers bear the additional risk in an aggravation situation; thus, clauses often are inserted into policies to provide insurers with escape routes. In order to protect consumers against unreasonable escape routes on the part of insurers,

0029–0034) it is *expressis verbis* stated that, in insurance contracts, the terms that clearly define or circumscribe the insured risk and the insurer's liability shall not be subject to assessment by the court since these restrictions are taken into account in calculating the premium paid by the consumer. Therefore, in applying the directive protecting consumers from unfair general terms, unfairness is not assessed where the insured risk is restricted because this is what the *pretium periculi* depends on. In its 2010 judgment in case No. C-484/08, the European Court of Justice concluded that the principle of minimum harmonization—on which Council Directive 93/13/EEC is based—reflects the competence contained in Art.8 of this directive. That article allows member states to adopt or maintain stricter provisions to ensure protection beyond the minimum standard provided for in the directive even if such conditions are in plain and intelligible language (see *European Court of Justice Judgement in Case No. C-484/08, 2010*, Official Journal of the European Union, C 209/6, 6 (July 31, 2010)).

⁴¹ Erwin Deutsch, *Versicherungsvertragsrecht* (Karlsruhe: Verlag Versicherungswirtschaft GmbH, 2005), 6 [in German].

⁴² For instance, the Estonian Supreme Court affirmed in its judgment No.3-2-1-131-04 (17 November 2004) the insurer's right to only partially indemnify in a situation where the policyholder had informed the insurer, at the time of signing the contract, that there was a 24-hour manned guard station in the insured building. During the validity of the insurance contract, however, the policyholder waived the guard's services. The court found that this represented a significant increase in the insured risk and, therefore, the insurer was justified in reducing the indemnity by 80% after a fire occurred. (*OÜ Jõe Motell (pankrotis) vs. AS ERGO Kindlustus*, Supreme Court of Estonia, Case No 3-2-1-131-04, 2004 // <http://www.nc.ee/?id=11&tekst=RK/3-2-1-131-04> [in Estonian]).

however, the PEICL deals with these cases to establish minimum safeguards for policyholders.⁴³ Article 4:201 of the PEICL provides that if an insurance contract contains a policyholder-protection clause concerning aggravation of insured risk, the clause shall be without effect unless the aggravation of risk in question is material and of a kind specified in the insurance contract. Hence, through this regulation the PEICL establishes a precondition that the aggravation of risk must be material and of a kind specified in the insurance contract. Jürgen Basedow argues that:

An aggravation which is due to natural wear and tear of property insured in indemnity insurance or to the increasing age of the person insured in life insurance is not material. The further requirement that the aggravation of risk be 'of a kind specified in the contract of insurance,' is to meet the need to alert and inform policyholders about what is a material aggravation of risk, and assumes that reasonable policyholders read their policy. Reference might be made, as does the law in some countries, to elements of risk which are the subject of questions in the application. However, reference to the policy was preferred as being an intuitive and convenient reference point for policyholders.⁴⁴

For example, in his 2004 analysis of German insurance law, Wandt concludes that material circumstances must have changed to an extent that a performance claim against the insurer would have become more probable than at the time of signing the contract. He adds that, in assessing materiality, insurers also should assess whether they would have concluded the insurance contract at all in light of the changed circumstances and, if they would have, whether they would have required a higher premium.⁴⁵ In Germany, it is common to talk about risk compensation (*Gefahrkompensation*). A risk that increases due to one factor may be compensated by a lessening of risk in another respect. For instance, in the case of a vacant guesthouse, a lack of supervision may increase risk; however, this risk is compensated by a total lack of human activity. Risk is not aggravated⁴⁶ when the circumstances increasing and reducing the risk are in balance.⁴⁷ In Germany, the

⁴³ Helmut Heiss, Malcolm Clarke, and Mandeep Lakhnan, "Europe: Toward a Harmonised European Insurance Contract Law—The PEICL": 613; in: Julian Burling and Kevin Lazarus, eds., *Research Handbook on International Insurance Law and Regulation* (Edward Elgar Publishing Ltd., 2011)).

⁴⁴ Jürgen Basedow, et al., *Principles of European Insurance Contract Law (PEICL)* (Munich: Sellier European Law Publishers, 2009), 182.

⁴⁵ Manfred Wandt, "1. Kapitel Allgemeines Versicherungsvertragsrecht": 69; in: Andres Engelbrecht, Wolfgang Halm, and Frank Krahe, eds., *Handbuch des Fachanwalts: Versicherungsrecht* (Luchterhand, München, 2004) [in German].

⁴⁶ See also VVG § 23 explanations by Leander D. Loacker at Hans-Peter Schwintowski, Christoph Brömmelmeyer, et al., *Praxiskommentar zum Versicherungsvertragsrecht* (Münster: LexisNexis Deutschland GmbH, 2011), 266-311 [in German].

⁴⁷ Horst Baumann, et al., eds., *VVG Großkommentar zum Versicherungsvertragsgesetz, Band 1 Einführung; Article 1-32 VVG* (Berlin, Boston: De Gruyter, 2008), 737-738, para. 9 // <http://www.degruyter.com/view/product/19457> [in German].

court has also defined 'risk exchange' (*Gefahrenwechsel*), which means a situation where there exist both risk-reducing and risk-increasing circumstances, circumstances that eventually cancel one another's impact.⁴⁸ In Germany, 'non-voluntary risk compensation' also is regulated separately, i.e. in a case where the policyholder knowingly and intentionally increases the insured risk but where there are certain risk-compensating circumstances beyond her control and, despite her intent, the risk is deemed to be compensated.⁴⁹ Given the influence of German law on Baltic insurance law (especially Estonian insurance law) and the PEICL's high standard of consumer protection, this raises the question of how the issue (aggravation of the risk) of substantive law has been resolved in Estonia, Latvia and Lithuania, and if the law in action also supports an approach centered on consumer protection.

Article 6.1010(1) of the 2000 Lithuanian CC establishes a precondition that the circumstances stipulated in an insurance agreement must have changed and that the change substantially causes an increase or a possible increase in insurance risk, i.e. the Lithuanian policyholder does not need to provide the insurer with a notification for an abstract aggravation of risk but only for the aggravation of risk elements expressly set out in the contract.⁵⁰ Pursuant to the Lithuanian CC, material circumstances are the circumstances indicated in the standard conditions of the insurance agreement (rules of the type of insurance), as well as where the insurer has requested in writing that the insured provide information. For instance, home insurance policy wording No. 064 of the Lithuanian insurance company Lietuvos Draudimas⁵¹ (hereinafter, "Lithuanian Lietuvos Draudimas Policy Wording") sets out in Clause 42 that increased insured risk refers to a change or emergence of circumstances defined in the Policy Wording, the insurance policy and/or other documentation submitted to the insurer. The change or emergence must substantially impact the likelihood of the occurrence of an insured event on the level of potential loss caused by such an event. Applicable circumstances include the circumstances that the insurer enquired about at the time of entering into the insurance contract by providing written questions to the insured in the request to conclude an insurance contract and/or by written enquiry in any other form. The relevant provision lists eight different situations deemed to constitute aggravation of risk (e.g., non-operation of the security measures specified in the insurance contract, a change to the intended purpose of insured property, etc.). This leads the

⁴⁸ *Ibid.*, 739, para. 13.

⁴⁹ *Ibid.*, 748, para. 42.

⁵⁰ Malcom Clarke noted in 2003 that: "whatever the substance of a special rule for aggravation of risk, the aggravation that triggers it is usually defined. Some legislation speaks simply of a 'material increase' but most national legislation goes further" (Malcolm Clarke, "Aggravation of Risk During the Insurance Period," *Lloyds Maritime and Commercial Law Quarterly* 1 (2003): 116).

⁵¹ *Lithuanian Lietuvos Draudimas Policy Wording* // http://www.ld.lt/uploads/files/dir52/dir2/13_0.php.

authors of this article to the conclusion that in Lithuania policyholders are protected on the basis of a modern pro-policyholder approach to insurance law (both regarding the substantive law and the standard terms)—the policyholder knows from the insurance contract what aggravation of risk is and in what types of situations it will be considered.

Pursuant to Article 14(1) of the Latvian ICL, the policyholder must notify the insurer about any aggravation of risk and must give notice of any risk requested by the insurer upon entry into an insurance contract (Article 5 of the ICL). As another example, the terms and conditions of individual property insurance as provided by the Latvian branch⁵² of Seesam Insurance AS (hereinafter, “Seesam Latvia Terms and Conditions”) set out in Clause 3.1 that the policyholder and/or the insured are obliged to inform the insurer in writing as soon as possible of all circumstances that may increase the likelihood of the occurrence of the insured risk or the amount of possible loss, and must inform the insurer of any changes in the information provided in the insurance proposal. Thus, the authors of the present work have reached the conclusion based on their current research that Latvian insurance law is also based on the assumption that the policyholder should be able to determine from the insurance contract what could be considered an aggravation of risk *per se*.

Article 443 of the LOA requires that the policyholder notify the insurer of any abstract aggravation of risk; the only precondition, subject to Article 447(2) of the LOA,⁵³ is that the aggravation of risk must be material. Similarly, in practice Estonian insurers often do not clarify what is meant by aggravation of risk. For instance, the general terms and conditions of the Estonian-based Seesam Insurance AS⁵⁴ (hereinafter, “Seesam Estonia General Terms and Conditions”) set out in Clause 15.1 that, after entering into a contract, the policyholder shall not, without Seesam’s prior written consent, increase the insured risk. Unfortunately, the household insurance terms and conditions⁵⁵ as provided by Seesam Insurance AS (hereinafter, “Seesam Estonia Household Insurance Terms and Conditions”) also fail to clarify this point when comparing the general terms and conditions. The authors

⁵² *Seesam Latvia Terms and Conditions of Individual Property Insurance* // http://www.seesam.lv/uploads/files/ipasuma-apdrosinasana/Seesam_Ipasums_PPWL-09.01_EN_PDF.pdf.

⁵³ Article 447(2) of the LOA sets out that the provisions regarding aggravation of risk do not apply if the aggravation of risk is insignificant or if the parties to the contract agree that the aggravation of risk does not affect the insurance contract. In interpreting the LOA, Estonian legal scholars have taken the stance that the significance of the aggravation of risk is a question of assessment and can be answered by interpreting the insurance contract (see Paul Varul, *et al.*, *Võlaõigusseadus II. Kommenteeritud väljaanne* (Tallinn: Juura, 2007), 487, point 3.2 [in Estonian]).

⁵⁴ *General terms and conditions of Seesam Estonia* // http://seesam.ee/uploads/files/%C3%9CIdised%20lepingutingimused%20%2801.07.2008%29_ENG_2011.pdf.

⁵⁵ *Seesam Estonia Household Insurance Terms and Conditions* // [http://seesam.ee/uploads/files/household-insurance/Kodukindlustuse_tingimused_3_2011_\(15.03.2011\)_ENG.pdf](http://seesam.ee/uploads/files/household-insurance/Kodukindlustuse_tingimused_3_2011_(15.03.2011)_ENG.pdf).

agree with Herman Cousy, who wrote in 2008 that that a contract must be clear and exhaustive regarding its stipulation of the aggravation of risk: "Aggravation must be 'of the kind stipulated in the insurance contract.' The idea is here that the policyholder must be made aware of his obligation through the insurance contract."⁵⁶

Such abstract prohibitions of aggravation (as described in Chapter 23 of the LOA) raise concerns that they are too burdensome for the policyholder. While the authors are not aware of any rulings on by the Estonian Supreme Court or higher courts interpreting these abstract prohibitions, this kind of an abstract approach is incompatible with modern pro-policyholder insurance law. Regardless of the fact that the wording of Article 447(2) of the LOA suggests the conclusion that only ignoring the requirements of risk aggravation would lead to negative consequences for the policyholder, it is unreasonable to burden the policyholder with the obligation to report any even vague aggravation of risk. However, it is reasonable that the policyholder be required to report if there is a substantial aggravation of risk. The requirement of the PEICL—that aggravation may occur only *vis-à-vis* a risk that was expressly specified in the insurance contract—not only serves the goals of alerting the policyholders and making them read their contract carefully, but also gives the weaker party (the consumer, the policyholder, etc.) an opportunity to understand what the insurer deems to constitute aggravation of risk. Such legal clarity in the policyholder's obligation to inform the insurer only about substantial changes in the aggravation of risk also places fewer burdens on the insurer in terms of notices concerning inconsequential risks.

Consequently, we may conclude that policyholders are protected on the basis of a modern pro-policyholder approach to insurance law in Lithuania in line with the PEICL. We cannot say the same for Latvia and Estonia. Therefore, implementation of the PEICL would be beneficial for Latvian and Estonian policyholders with respect to the issue of aggravation of risk.

1.3. CONSEQUENCES OF THE AGGRAVATION OF RISK IF THERE IS NO INSURED EVENT

When a risk is aggravated, the insurer questions whether the insurance contract would have been concluded at all in the beginning, because the risk might have been unsuitable for the insurer or it might have been suitable only if the premiums were higher. We return to Malcolm Clarke, as he notes:

⁵⁶ Herman Cousy, "The Principles of European Insurance Contract Law: Duty of Disclosure and the Aggravation of Risk," *ERA Forum* 9 (2008): 131.

Laws across Europe currently favor the policyholder insofar as, when it comes to the consequences of an aggravation of risk, they tend to opt for contract modification rather than termination of the contract altogether. However, the scales tip the other way when aggravation is brought about by the act of the policyholder. The act, of course, may be innocent in [the] sense that the policyholder did not realize its effect on the risk. The scales tip most when the policyholder is at fault in any way, notably, when in breach of duty of notification. In that case many legislators start from the position that [the] insurer 'must not be put in worse position than if the duty had been fulfilled by the policyholder: therefore, in such case the insurer must [...] have the right to put an end to the contract or adapt it'.⁵⁷

For instance, Article 6.1010(2) of the Lithuanian CC entitles the insurer to request to change the conditions of the insurance agreement or increase the insurance contribution (premium) upon notification of an increase in the insurance risk. In such cases, if the insured declines to change the conditions of the insurance agreement or pay a larger insurance contribution (premium), the insurer will be entitled to apply to a court for termination or amendment of the insurance agreement based on the changed circumstances. Article 16 of the Latvian ICL provides for an alternative to the insurer: if an increase in the likelihood of the occurrence of an insured risk has taken place during the period of the validity of the contract, and if the insurer can prove that, had it known about the increase upon conclusion of the contract, it would have included different terms and conditions in the insurance contract, the insurer: (i) during a 15-day period from the day the insurer learns about the increase in the likelihood of the occurrence of the insured risk, may propose amendments to the insurance contract to the policyholder in writing and indicate the date on which they will take effect; or (ii) may terminate the insurance contract by notifying the policyholder thereof in writing. On the other hand, if the policyholder does not agree to amend the contract or does not communicate his/her decision, the Latvian insurer has two options: the insurer may (i) terminate the insurance contract; or (ii) allow the contract to continue on the same conditions. If an insured event occurs during the period when the amendment is possible, the insurer has to indemnify the insured for the damages as per the contract. On the other hand, Article 16(8) of the ICL provides that, if the insured or the policyholder acted in bad faith or with gross negligence so as to increase the likelihood of occurrence of the insured risk, the insurer is entitled to terminate the insurance contract and retain the paid insurance premium. Article 446 of the LOA distinguishes between two situations: (i) aggravation of risk due to circumstances under the policyholder's control (subjective aggravation of risk); and (ii)

⁵⁷ Malcolm Clarke, *supra* note 50: 120.

aggravation of risk due to circumstances beyond the policyholder's control (objective aggravation of risk).

In the former case (subjective aggravation of risk), the LOA ties the insurer's options to the policyholder's culpability: (i) if the risk was aggravated due to the fault of the policyholder,⁵⁸ the insurer may cancel the insurance contract without prior notice, while (ii) if there is no fault, the insurer may cancel the contract by giving one month's notice. In the latter case (objective aggravation of risk), the insurer may demand that the contract be amended retroactively, i.e. in light of the aggravation of risk. If the policyholder does not agree to amend the contract or if the insurer would not have entered into the contract due to the aggravated risk, the insurer may cancel the contract by giving one month's notice. For the purposes of the LOA, it is also important that legal remedies be available to the insurer for one month after learning of the aggravation.

This means that there are significant differences in how Estonia, Latvia and Lithuania choose to regulate this issue—in Estonia and Latvia, insurance coverage depends on the policyholder's culpability in aggravating the insured risk, while in Lithuania the policyholder's culpability bears no significance. By comparison, the PEICL leaves it to the insurer's discretion to decide whether they wish to cancel or modify an insurance contract. Under Article 4:203(1) of the PEICL, if a contract entitles the insurer to terminate the contract in the event of aggravation of the insured risk, such right shall be exercised by written notice to the policyholder within one month of the time when the aggravation becomes known or apparent to the insurer. Upon termination of the contract, however, the policyholder must be afforded the opportunity and sufficient time to find an alternative insurance offer and thus ensure consistency of insurance coverage. It is for this reason that the PEICL requires that the insurer exercise its right to cancel the contract within one month after learning about the aggravation of risk at the latest. It should be noted here that an insurance contract will be terminated one month after receipt of the related notice, but only subject to the condition that the policyholder did not intentionally breach the obligation to provide notification. If the policyholder's obligations are violated intentionally, the insurance contract will be terminated at the moment it is canceled by the insurer. Herman Cousy explains the notification procedure:

⁵⁸ Malcolm Clarke notes that the notion of fault as a determining factor has a certain attraction from a moral point of view. With one reservation, in view of widespread ignorance about materiality on the part of consumers (and hence when they should notify their insurer), there must be doubt whether 'fault' is a useful element here. The likelihood is that it would be a source of fruitless disputes or, worse, an allegation which claims' handlers could use to fend off claims which they felt, on the basis of instinct rather than evidence, were without merit. If fault is to be a factor at all, it should be one that is easy to prove or disprove. The reservation concerns serious fault such as fraud and willful misconduct. Most countries have a rule of some kind that blocks recovery by a policyholder in respect of loss caused by 'willful misconduct', i.e., intentionally or recklessly (see *ibid.*).

One possibility is that a contract provides that in case of aggravation of risk, the insurer shall be allowed to terminate the contract. The Principles recognize that an insurer may have good reasons to do so, but the Principles submit the insurer's right to do so to a number of restrictions. A written notice is required to be given to the policyholder within one month of the moment when aggravation was known or apparent to the insurer. Cover is to expire one month after termination, and only immediately if the policy-holder was in intentional breach of his duty. If an insured event occurs *before cover has expired*, then insurance money is to be payable. However, if the insured event is caused by the aggravated risk, and if the aggravation is one of which the policy-holder was aware/or should have been aware prior to the event, then the proportionality rule must apply. This means that there can only be a proportional reduction of the insurance payment if the insurer would have insured at a higher price. Only in the hypothesis of an uninsurable risk, can there be an entire loss of cover.⁵⁹

As demonstrated, the legal consequences stemming from aggravation of risk where there has been no insured event are different in Estonia, Latvia and Lithuania. We conclude that the regulation of the PEICL, which, on the one hand leaves it to the insurer's discretion to decide whether they wish to cancel or modify an insurance contract, and on the other makes it possible (except in case of intent) for the policyholder to attain a new insurer in a reasonable time frame, is more consumer-friendly than the relevant insurance laws of the Baltic states.

1.4. CONSEQUENCES OF THE AGGRAVATION OF RISK IN THE CASE OF AN INSURED EVENT

In practice, it is not extraordinary that the probability of an insured risk would change after the signing of an insurance contract. Under such circumstances, the insurance premium calculated by the insurer on the basis of disclosed information upon the signing of the contract would no longer be proportionate to the risk (*adverse selection*) that the insurer now has to bear. The law generally prohibits an increase of the probability of an insured risk by the policyholder or by third parties for which the policyholder is responsible. In the PEICL, the consequences of breaching the duty of notification are set out in Article 4:202(3): an insurer may not refuse to indemnify for losses resulting from an insured event on the grounds that the insured breached a duty of notification, unless the loss was caused by the aggravation of risk.⁶⁰

⁵⁹ Herman Cousy, *supra* note 56: 132.

⁶⁰ "Breach of the duty of notification on the part of policyholders does not necessarily have serious consequences for insurers. Thus, Article 4:202 (3) seeks to nullify policy clauses whereby, in the event of a breach, cover is automatically terminated. In that regard the intention behind Article 4:202 is that the legal consequences of [a] breach should be related and proportionate to the breach. In particular, as

Similar regulations can be found in Article 445(3)(2) and (3) of the LOA, which establishes that an insurer is not released from the obligation to perform the insurance contract to the extent of the increase in the insured risk due to circumstances caused by the policyholder if the insured event occurs after the aggravation of the insured risk and if the increase in the insured risk had no bearing on the occurrence of the insured event or if a higher insured risk would not have affected the validity or scope of the insurer's performance obligation.⁶¹ Accordingly, in this case the protection mechanisms for the policyholder in the PEICL and LOA coincide. Pursuant to Article 445(2) of the LOA, if the policyholder violates the prohibition provided for in Article 444 of the LOA, the insurer may be released from the obligation to perform the insurance contract to the extent of the increase in the insured risk due to the circumstances caused by the policyholder or by parties the policyholder is responsible for.⁶² Some have argued that Article 445 of the LOA is aimed at regulating the insurer's performance obligation in case of an increase in insured risk or failure to give notice of such an increase. This regulation must also ensure that any increase in insured risk does not lead to the insurer's release from the performance obligation.⁶³

Hans-Peter Schwintowski notes that the principle employed by the German 2008 VVG created a causal correlation between the degree of fault⁶⁴ of the policyholder and the scope of the insurer's performance obligation, which releases the insurer from its performance obligation only in rare cases.⁶⁵ Pursuant to Article 26(1) of the VVG, the insurer is released from the obligation to perform the insurance contract only if the policyholder intentionally aggravated the risk. If the policyholder aggravates the risk by being grossly negligent, the insurer may be only

provided by Article 4:202 (3), insurers are not on that ground entitled to refuse to pay any subsequent loss resulting from an event within the scope of the cover but not caused by aggravation of risk, nor other losses resulting from events within the scope of the cover but lacking a causal connection with [the] breach; these remain payable on a proportional basis in accordance with Article 4:203 (3)" (Jürgen Basedow, *et al.*, *supra* note 44, 184–185).

⁶¹ For instance, Clause 12.5 of Seesam Estonia's General Terms and Conditions sets out that if Seesam withdraws from a contract based on Clause 12.1 or 12.2, Seesam shall have to perform the obligations arising from the contract if an insured event occurs before the withdrawal from the contract and if the circumstance about which the policyholder failed to notify Seesam did not affect the occurrence of the insured event.

⁶² Furthermore, if a more specific perspective is needed, Art.446 of the LOA affords the insurer the possibility to cancel an insurance contract without prior notice or retroactively from the date when the aggravation of risk took place if there is an increase in an insured risk. Arts.443–447 of the LOA together indicate that if a policyholder aggravates an insured risk and if such aggravated risk affects the occurrence of an insured event, as well as the validity and scope of the insurer's performance obligation, the insurer may be released from its obligation to indemnify.

⁶³ Paul Varul, *et al.*, *supra* note 53, 482.

⁶⁴ Helmut Heiss states that: "the new German ICA 2008 introduces an entirely new principle through which the ability of an insurer to discharge his liability is limited. This is achieved by reducing the insurance money in proportion to the degree of fault apportioned to the policyholder. However, the right of an insurer to reduce the insurance money payable is limited to cases in which the policyholder has acted with gross negligence. In cases of ordinary negligence, the entire amount of the insurance money will be payable. In contrast, the insurer will be fully discharged in cases of intentional or fraudulent behavior by the policyholder" (Helmut Heiss, *supra* note 6: 106).

⁶⁵ Hans-Peter Schwintowski, *Neuerungen im Versicherungsvertragsrecht* (Berlin: Zeitschrift für Rechtspolitik, 2006), 139 [in German].

partially released from the performance obligation.⁶⁶ Compared with the LOA, the VVG is thus significantly more consumer-centered, since in the case of a potential violation the insurer is not released from its performance obligation in the case of negligence (a light form of fault).⁶⁷ In case IV ZV 183/03,⁶⁸ for example, the German Federal Court of Justice affirmed the fact that there must be a causal relationship between the increase of risk and damages, and that the compensation of the risk must additionally be weighed. In this case, the plaintiff demanded compensation for damages caused by a fire in a guesthouse. The insurance contract contained different restrictive clauses, e.g. it established that the building must not be used as a discotheque. When needed, however, parties were held in the building on some weekends, and its use as a discotheque became its main function. After some time, however, the building became vacant and there was a fire. The insurer refused its obligation to perform because the risk had increased and the insured had violated the relevant notification obligation. The court held that, although the risk may have increased due to use as a discotheque, causality must be assessed in every case. Based on the facts of the case, the fire was in no way connected with the activities that had been discontinued in the building several months earlier. The court emphasized that causality must be established in each case and that this

⁶⁶ The VVG also provides for similar consequences for the policyholder where the duty of notifying the insurer about the aggravation of risk is violated. Pursuant to Art.26(2) of the VVG, the insurer is released from the obligation to perform the insurance contract if the policyholder intentionally fails to give notice of the aggravation of risk. However, if the policyholder is careless and fails to exercise necessary care and the policyholder's behavior can be qualified as gross negligence, the above-mentioned provision releases the insurer from the performance obligation only partially. But the *onus probandi* to show there was no gross negligence is on the policyholder, i.e., it is assumed that the policyholder was grossly negligent.

⁶⁷ The Estonian Supreme Court noted in its judgment No.3-2-1-17-08 of 9 April 2008 that: "The courts incorrectly failed to notice and implement Article 445 (2) of the LOA under which, if a policyholder violates the requirement provided for in Article 444 of the LOA, the insurer shall be released from the obligation to perform the insurance contract to the extent of the increase in the probability of the insured risk due to the circumstances caused by the policyholder, if the insured event occurs after an increase in the insured risk. Based on Article 445 (2) of the LOA, Article 452 (2) 2) of the LOA does not grant the insurer the right to not pay the insurance indemnity in full if the policyholder violates an obligation with respect to the insurer to reduce the insured risk or prevent an increase of the insured risk and the violation had no bearing on the occurrence of the insured event or the insurer's performance obligation. Pursuant to the first sentence of Article 452 (1) of the LOA, an insurer shall be released from the performance obligation if the policyholder, the insured person or the beneficiary intentionally caused the occurrence of the insured event. As under Article 427 (1) of the LOA, any agreement in derogation of Article 452 (2) of the LOA to the detriment of the policyholder is void, Clause 23 of the general terms and conditions and Clause 15.8 of the general terms and conditions of casco are void to the extent they allow the defendant to not pay the indemnity in full if the policyholder has violated the obligation not to increase the probability of the insured risk. In reviewing the case, the circuit court must assess whether the plaintiff increased, by his violation of his obligations, the probability of the insured risk (Article 444 of the LOA) and to what extent the probability of the insured risk increased (Article 445 (2) of the LOA)" (*AS Hansa Liising Eesti vs. Salva Kindlustuse AS*, Supreme Court of Estonia, Case No. 3-2-1-17-08, 2008 // <http://www.nc.ee/?id=11&tekst=RK/3-2-1-17-08> [in Estonian]).

⁶⁸ The Court held that the issue was not whether this single new source of risk (in this case, operating a discotheque) had emerged, but whether this source increased the risk of the insured event. The defendant also invoked the fact that the building was vacant also resulted in an increased risk. For the purposes of insurance law, the Court stressed that leaving a building vacant does not increase the risk of an insured event, adding that, while doing so may add certain new sources of risk, other sources may also disappear (*German Federal Court of Justice, Case No. IV ZV 183/03* // <http://juris.bundesgerichtshof.de/cgi-bin/rechtsprechung/document.py?Gericht=bgh&Art=en&sid=74a0782d14e3d389592b352ebfd847fb&nr=29409&pos=0&anz=1> [in German]).

must be the basis of the decision. Even though a violation is unjustifiable, it does not release the insurer from its duties.

Under Article 6.1010(3) of the Lithuanian CC, however, if the insured does not give notification about the aggravation of risk, the insurer is entitled to indemnity from the loss to the extent such loss is not covered by the received insurance contribution (premium).⁶⁹ As a typical example, consider the 7 June 2004 Decision No. 3K-3-354/2004 of the Lithuanian Supreme Court⁷⁰ related to the above-mentioned Article 6.1010(3). The Lithuanian Supreme Court pointed out that the policyholder failed to fulfill the obligation to inform the insurer about changes of circumstance, as stipulated in the insurance contract. Nevertheless, the court held that this risk was not a substantial risk for termination of the contract. The court said⁷¹ that the failure to notify the insurer about the increased risk could be a basis for the insurer to reduce insurance benefits, but not a basis to refuse to pay.⁷²

Under Article 16(7) of the Latvian ICL, if the insured or the policyholder behaved in bad faith or was grossly negligent and failed to notify the insurer of the aggravated risk, the insurer would be released from its performance obligation.⁷³ If the policyholder is without fault, the insurer must, under Article 16(6) of the ICL, pay out the indemnity as stated in the insurance contract, provided the insured or the policyholder cannot be considered at fault for not notifying the insurer of the increase in risk. In the case of ordinary negligence on the part of the policyholder, however, the insurer must indemnify as stated in the insurance contract in proportion to the paid insurance premium and the insurance premium to be paid by the policyholder, provided he or she notified the insurer of the actual conditions of the increase in the likelihood of the occurrence of an insurable event. The latter leads to the conclusion that, from a comparative point of view, insurance law regarding aggravation of risk in the case of an insured event taking place, the laws of Estonia, Latvia and Lithuania are not very policyholder-friendly compared, for example, to German law. Thus, the PEICL offers more substantive protection and would be preferable for policyholders of Baltic states.

⁶⁹ See, for example, Clause 66.1 of the *Lithuanian Lietuvos Draudimas Policy Wording*, *supra* note 51.

⁷⁰ The facts of the case in question are that the company that insured its car promised to insurance company not to lease it, but the company transferred the car for commercial purposes to other persons not related to the insured. An accident occurred.

⁷¹ *AB Lietuvos draudimas vs. UAB Hanza Lizingas*, Supreme Court of Lithuania, Case No. 3K-3-354/2004 // http://www.infolex.lt/lat_web_test/3_nutartys/senos/nutartis.aspx?id=25433 [in Lithuanian].

⁷² In its 30 January 2013 review of judicial practices in insurance issues, the Russian Supreme Court pointed out that lower courts in Russia follow different principles in similar cases. The Russian Supreme Court held, for example, that when a vehicle is used by a person who is not included in the casco insurance policy, that fact does not provide a basis to release the insurer from remunerating the damages (see *Obzor po otidel'nyim voprosam sudebnoi praktiki*, *supra* note 31: 15-16).

⁷³ See, for example, Clause 9.2 of the *Seesam Latvia Terms and Conditions*, *supra* note 52.

2. PRECAUTIONARY MEASURES

2.1. WHAT ARE PRECAUTIONARY MEASURES (WARRANTIES)?

It is characteristic of precautionary measures that they include guidance on how to avoid damages or reduce damages that occur.⁷⁴ By providing for precautionary measures,⁷⁵ the insurer determines what reasonably can, and cannot, be expected from policyholders. The insurer may, in certain cases, use precautionary measures to specify the qualifications a policyholder must meet, e.g., in order to qualify for vehicle insurance, a driver is required to hold a valid driver's license. In terms of the PEICL, Article 4:101 states that a precautionary measure is a clause in an insurance contract, whether or not described as a condition precedent to the liability of the insurer, requiring the policyholder or the insured to perform or not to perform certain acts before an insured event occurs. Regarding the PEICL, Martin Schauer commented that: "both the definition and the purpose of the provision [PEICL] seem quite clear: The risk shall not be aggravated by acts of the policyholder or the insured. Therefore, certain acts of those persons may be prohibited in the contract."⁷⁶

The concept of precautionary measures is similar but not identical to that of 'promissory warranties' in English law or contractual '*Obliegenheiten*' in German law.⁷⁷ Article 4:101 of the PEICL⁷⁸ is modeled on Article 31 of Finland's Insurance Contracts Act.⁷⁹ In this section, the authors address the works of Finnish legal theorists and Finnish practice in the context of aforementioned sources. The Estonian LOA, Latvian ICL and Lithuanian CC and IL do not provide for a separate definition of precautionary measures, which belong to the general contractual obligations of the policyholder. In addition, the Russian Civil Code does not have a separate part about precautionary measures, thus insurance companies use terms of precautionary measures basing on the general part of the Civil Code. Vladimir

⁷⁴ Esko Hoppu and Mika Hemmo, *Vakuutusoikeus* (Helsinki: WSOYpro, 2006), 165 [in Finnish].

⁷⁵ 'Precautionary measures' clauses are included in insurance contracts for the purpose of requiring that the insured take, or avoid taking, certain actions prior to the occurrence of an insured risk for the purpose of reducing the likelihood of the occurrence of said risk or minimizing the loss resulting from such risk if an insured event were to happen. An example of a precautionary measure might be that an insured is required to have an activated security or fire alarm system (see Greg Pynt and Kyriaki Noussia, "Report on, and Minutes of, the Consumer Protection and Dispute Resolution Working Party Session on Precautionary Measures," Consumer Working Party Session, IV AIDA Europe Conference, London (September 13-14, 2012): 9 // <http://www.aida.org.uk/pdf/Consumer%20Protection%20London.pdf>).

⁷⁶ Martin Schauer, "Comments on Duration of Contract and Precautionary Measures," *ERA Forum* 9 (2008): 163.

⁷⁷ Jürgen Basedow, *et al.*, *supra* note 44, 168.

⁷⁸ *Ibid.*

⁷⁹ Finnish Insurance Contract Act (*Vakuutusopimuslaki*), No. 28.6.1994/543 // <http://www.finlex.fi/fi/laki/ajantasa/1994/19940543> [in Finnish].

Belykh⁸⁰ postulates that an analysis of Russian case law confirms that insurance companies use mostly standard contract terms to refuse to indemnify clients in the case of the occurrence of an insured event. This is in accordance with Article 310 of the Russian Civil Code, which allows standard terms to be used as a possible tool to refuse to pay an indemnity. Perhaps this is one of the reasons why there is more confusion in these countries' practice in differentiating between the aggravation of risk and breach of precautionary measures. Finnish legal literature notes that precautionary measures have a significant role in non-life insurance, and compliance with precautionary measures may be regarded as the most pivotal obligation of the policyholder.⁸¹

From the perspective of EU law article 4(2) of Council Directive 93/13/EEC excludes from the scope of the directive, as a material derogation, general terms and conditions regarding the main subject matter of a contract or the relationship between price and remuneration. The relationship between price and remuneration basically means whether the quality of a service or thing is proportionate to the price paid for the thing. Giesela Rühl notes:

Most European countries⁸² agree that Article 4 (2) of Council Directive 93/13/EEC only covers terms that describe the core of the contractual agreement—meaning a brief description of the insured risk as well as the premium to be paid—but not contractually created precautionary obligations.⁸³

A similar conclusion may be drawn after interpreting Article 2:304(3) of the PEICL. Thus, for precautionary measures, minimum protection mechanisms created by Directive 93/13/EEC against unfair general terms and conditions must be complied with as prescribed in Article 2:304(3) of the PEICL.

Martin Schauer observes that the definition provided in Article 9:101 of the PEICL, which explains the causation of loss, raises two questions: (i) where should the line be drawn between a precautionary measure and an exemption from the risk covered by the contract;⁸⁴ and (ii) what is the relationship between

⁸⁰ V. S. Belykh, *Strakhovoe pravo Rossii* (Moskva: Norma, 2009), 245. For more about the implementation of precautionary measures by Russian insurance companies, see V. V. Shakhov, V. N. Grigor'ev, and A. N. Kuzbagarov, *Strakhovoe pravo* (Moskva: Zakon i pravo, 2012), 92–95 [in Russian].

⁸¹ Jaana Norio-Timonen, *Vakuutusopimuksien pääkohdat* (Helsinki: Talentum, 2010), 155 [in Finnish].

⁸² It has been argued that precautionary obligations are not assessed for their fairness. In England, in particular, it is widely held that warranties are not subject to review under Art.3 of the Unfair Terms in Consumer Contracts Directive because they determine when the insurer is required to pay in case an insured event occurs (see Giesela Rühl, *supra* note 10: 5).

⁸³ *Ibid.*

⁸⁴ The authors find that this question is a common subject in court disputes. Exemption from risk means that a situation is not covered by insurance, and the insurer does not have any obligation to perform. In case of an exemption from risk, the insurer does not have the obligation to perform regardless of the causality between the exemption from risk and the circumstances that led to the occurrence of damages. For example, in case No. 3-2-1-76-07 (*Citygraaf OÜ vs. Salva Kindlustuse AS*, Supreme Court of Estonia, Case No. 3-2-1-76-07, 2008 // <http://www.nc.ee/?id=11&tekst=RK/3-2-1-76-07> [in Estonian]) the Estonian Supreme Court considered whether the insurer could include in its exemptions from risk a

precautionary measures and the causation of loss by an intentional or reckless act of the policyholder or the insured as defined in Article 9:101? If the insured does not comply with the precautionary measures, can Article 9:101 be applied as well⁸⁵ (see Section 2.3 of this article for more on this question)? J. Han Wansink gives the following example in response to the first question:

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'). [...] The distinction 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.⁸⁶

Giesela Rühl, in turn, notes that:

The distinction between the two terms is of enormous practical significance: if the clause in question is construed as [a] clause describing or excluding the risk, coverage is denied without any consideration of fault or causation. Where, however, the clause in question is a precautionary obligation, the coverage is denied in most legal orders only where the policyholder was at fault and where his conduct has caused or increased the damage. The determination of whether the term is a precautionary obligation or a description of the risk can be difficult at times. However, if the meaning of a contractual term remains unclear the *contra proferentem* doctrine (or *ambiguity doctrine*) mandates that these terms are construed against the party that has drafted them, which is usually the insurer.⁸⁷

For instance, in the 2005 case No. 3-2-1-59-0 before the Estonian Supreme Court, for the purposes of the general terms and conditions, the insurer had defined the risk of theft as follows: "Where a theft of [a] vehicle is committed with the use of keys, the damages shall be compensated if the person committing the act gained

situation where a vehicle is stolen using keys that were taken from the driver's pocket while his jacket was in his office. The court found that a general contractual term that, as a result of its content, presentation or phrasing, is so unusual or incomprehensible that it could not be reasonably understood by the other contractual party or expected to be included in the contract would not be regarded as part of the contract. Because theft was included as part of the insurance risk, the Court decided that this situation could not be considered an exemption from risk. The authors believe, however, that, in theory, precautionary measures could be up for discussion here, *i.e.*, whether the policyholder was sufficiently prudent with his vehicle keys. See also Kadi Aavik, *Kindlustusandja täitmiskohustuse piirangud vabatahtlikus kahjukindlustuses* (Tartu: University of Tartu, 2009), 52 // <http://www.just.ee/orb.aw/class=file/action=preview/id=49246/Kindlustusandja+t%E4itmiskohustuse+piirangud+vabatahtlikus+kahjukindlustuses.pdf> [in Estonian].

⁸⁵ Martin Schauer, *supra* note 76: 163–164

⁸⁶ J. Han Wansink, "Precautionary Measures: A Friendly or Hostile Tool of Limiting Insurance Coverage?" *ERA Forum* 9 (2008): 153.

⁸⁷ Giesela Rühl, *supra* note 10: 3.

possession of the vehicle's keys by robbery or break-in along with traces of break-in."⁸⁸

In other words, the insurer had to indemnify only if the policyholder had attempted to restrict the risk of theft. In this particular case, the vehicle was stolen after the vehicle's keys were first stolen from the policyholder's house. The thief gained access to the keys by opening the unlocked front door. The court denied⁸⁹ the insurer's right to restrict the insured risk in this way, referring to the need to apply the *contra proferentem* doctrine and stating that, under the circumstances, only the policyholder's failure to take precautionary measures could affect the insurer's performance obligation.⁹⁰

Besides, one can claim that insurance contracts need to be construed according to the policyholder's reasonable expectations—in the above case, this assumption was certainly not met, because the policyholder could presume that the contract stipulated theft in all reasonable interpretations. The court might also have invoked the reasonable expectations doctrine. Martin Schauer notes that:

Both problems are well known in national law. Dozens of theories have been developed by legal scholarship, especially in Germany. These problems will have to be discussed with regard to the PEICL as well, and European solutions will have to be found.⁹¹

In general, violation of precautionary measures can have two consequences: (i) in the first case, the insurer accepts the violation, and it does not affect the duration of the insurance contract or the insurer's performance obligation; (ii) in the second case, the insurer does not accept the violation and in turn has two *ipso iure* options: (a) in the first case, the insurer has a right to terminate the contract; and (b) in the second case, the insurer's liability is discharged.

⁸⁸ OÜ Aravete Agro vs. Seesam Rahvusvaheline Kindlustuse AS, Supreme Court of Estonia, Case No. 3-2-1-59-05, 2005 // <http://www.nc.ee/?id=11&tekst=RK/3-2-1-59-05> [in Estonian].

⁸⁹ The court found that: "insured risk is a risk against which insurance is procured. The vehicle was insured against the risk of theft. The court believes that such a provision is contrary to Article 452 (2) 2) of the LOA as the presence of break-in traces does not affect the occurrence of an insured event for the purposes of this clause. The occurrence of an insured event may be affected by other factors, in particular the behaviour of the policyholder before the occurrence of the insured event. A general term whose content, form of expression or mode of presentation is so unusual or unintelligible that the other party to the contract could not have expected the presence of such a term in the contract based on the principle of reasonableness or understand the term without substantial effort, shall not be deemed to be a part of the contract."

⁹⁰ In its judgement regarding similar circumstances in Decision No. 5-B12-24 of 24 April 2012, the Russian Supreme Court ruled that an insurer could not limit the definition of a risk of a vehicle being stolen so that it excludes cases where the vehicle registration is stolen along with the vehicle. Allowing a release from liability to pay damages in such a case does not comply with Article 963 of the Russian Civil Code (*Russian Supreme Court Decision No. 5-B12-24 of April 24, 2012* // <http://base.consultant.ru/cons/cgi/online.cgi?req=doc;base=ARB;n=274209> [in Russian]).

⁹¹ Martin Schauer, *supra* note 76: 163-164.

2.2. INSURER'S RIGHT TO TERMINATE A CONTRACT UPON BREACH OF PRECAUTIONARY MEASURES OBLIGATIONS

Article 4:102(1) of the PEICL states that if a clause provides that an insurer is entitled to terminate a contract in the event of non-compliance with a precautionary measure, that clause will be without effect unless the policyholder (or the insured) has breached his/her obligation with intent to cause a loss or recklessly with knowledge that a loss would probably result.⁹² The wording of the PEICL provision shows that those sanctions apply only if the implementation of sanctions is defined in a clause of a contract. Hence, without incorporating a relevant provision in the general terms and conditions, the insurer cannot unilaterally terminate a contract. Thus, the PEICL restricts the insurer's right to terminate a contract in case of non-compliance with precautionary measures, making this right dependent on the intentional behavior of the policyholder to cause a loss or recklessness with knowledge that a loss would probably result. This is justified because an insurer should not be entitled to rid itself of a contract in a situation where precautionary measures were not complied with due to negligence or gross negligence. It is precisely due to negligence that insurance contracts are often entered into—for instance, the usual *causa causans* when a car drives off the road is that the speed was inappropriate for the road conditions or the weather, i.e. the policyholder was negligent. If an insurer had the right to terminate the contract due to non-compliance with precautionary measures because of negligence, the formation of insurance contracts might often lead to *ab absurdo*, because one of the reasons why policyholders conclude insurance contracts is to protect themselves against their own ordinary negligence. In a situation where the insurer's performance obligation is precluded due to negligence, the degree of fault and its consequences do not correspond in terms of the proportionality the parties would have achieved if they had negotiated the contract. This represents a case of ignoring the principle of transparency and thus the court should, on the basis of the *contra proferentem* rule, not agree to release the insurer from its performance obligation, because in essence it is not possible to exclude negligence in standard terms and conditions.⁹³

Article 4:102(2) of the PEICL provides that the right to terminate a contract shall be exercised by written notice to the policyholder within one month of the time when noncompliance with a precautionary measure becomes known or

⁹² *Ibid.* Schauer stresses that an insurer is entitled to terminate a contract if the policyholder or the insured has acted with intent to cause a loss or has acted recklessly with knowledge that a loss would probably result.

⁹³ However, it is possible to exclude negligence in standard terms and conditions through separate contractual negotiations. If negligence is excluded in standard terms and conditions, then this would violate Directive 93/13/EEC, because it would be unexpected and surprising for the ordinary policyholder.

apparent to the insurer. Thus, within one month after relevant circumstances appear, the insurer must decide whether or not to continue the contract with the policyholder despite noncompliance; if a notice to this effect is not sent within one month, the situation is deemed to create *ratihabitio*. The time limitation in the PEICL is justified solely by the fact that, otherwise, a policyholder with a one-year insurance contract may not know for 11 months whether the insurer has terminated the contract or not. Under the PEICL, coverage shall come to an end at the time of termination. Jürgen Basedow notes:

With regard to the clauses covered by Article 4:102 of the PEICL, a further distinction must be drawn. Article 4:102 limits the effects of clauses providing for termination of the contract *ex nunc*. This must be distinguished from avoidance taking effect *ex tunc*.⁹⁴

Accordingly, in the case of non-compliance with precautionary measures, the PEICL does not afford the policyholder a period of grace to attain a new insurer. The receipt of the notice of termination is relevant for determining the time limit.⁹⁵

Let us undertake a comparison of legal consequences, using actual general terms and conditions from Estonian, Latvian and Lithuanian insurers and apply them to a hypothetical example. In the example, an insured house is empty for one week before the winter period because the policyholder and his/her family are traveling abroad on a holiday. During this time, the house is unheated, and the outdoor temperature drops below zero degrees Celsius. As a result, the water pipes freeze and burst, causing substantial damages. Let us further abstract this example with two alternatives: (i) while the family was holidaying, the heating system stopped working due to a technical problem, i.e. the policyholder was unaware of the circumstances and had no control over them; or (ii) in order to curb costs, the policyholder switched off the heating system for the duration of the holiday. In case of the latter scenario, we can distinguish between two cases: a) when departing for their holiday, it could not have been foreseen that the outdoor temperature would drop below zero; and b) when departing for their holiday, the outdoor temperature already was below zero.

In seeking an answer to the question of whether or not the insurer has the right to terminate the contract in this case, one must take the stance that this may turn out to be an unambiguous situation. With the PEICL, the termination of the contract first requires the sanction to apply only if it is defined in a clause of the contract, and, second, that the policyholder or the insured breached its obligation with intent to cause the loss or did so recklessly with knowledge that the loss would

⁹⁴ Jürgen Basedow, *et al.*, *supra* note 44, 173.

⁹⁵ *Ibid.*, 173.

probably result. Thus, for the purposes of the PEICL, the insurer can, in this hypothetical example, terminate the insurance contract only if the outdoor temperature was below zero when the policyholder departed on holiday and the policyholder himself had switched off the heating system. If this was the case, the insurer may invoke the policyholder's reckless behavior with knowledge that the loss would probably result. In other cases, the contract cannot be terminated under the PEICL.

An analysis of Estonian, Latvian and Lithuanian insurance law, however, yields quite different results. In Lithuania,⁹⁶ for instance, the contract may be terminated upon a breach of the insurance contract by the insured (if the guilt of the latter is established).⁹⁷

In Latvia,⁹⁸ however, Seesam Latvia's Terms and Conditions do not provide for a basis to terminate the contract in case of noncompliance with precautionary measures. It is, nevertheless, debatable whether the insurer could terminate the contract by invoking the aggravation of risk (it should not be permissible, as the maxim *contra proferentem* should be applied, which says that ambiguities in a contract be construed against its drafter—in this case, precautionary measures and aggravation of risk should be strictly distinguished).

In Estonia,⁹⁹ Article 470(1) of the LOA¹⁰⁰ says that if the policyholder breaches an obligation prescribed by the contract due to circumstances under the policyholder's control, the insurer may terminate the contract within one month after becoming aware of the breach. Likewise, Seesam Estonia's General Terms and Conditions¹⁰¹ affirm that the insurer has such an option after first offering the policyholder an opportunity to fulfill the precautionary measures.

⁹⁶ An example of a precautionary measure can be seen in Clause 38.4 of the *Lithuanian Lietuvos Draudimas Policy Wording*, *supra* note 51.

⁹⁷ An example of a basis for termination can be found in Clause 43.3.a of the *Lithuanian Lietuvos Draudimas Policy Wording*, *supra* note 51.

⁹⁸ An example of a precautionary measure can be found in Clause 6.2.6 of the *Seesam Latvia Terms and Conditions of Individual Property Insurance*, *supra* note 52.

⁹⁹ An example of a precautionary measure can be found in Clause 22.2 of the *Seesam Estonia Household Insurance Terms and Conditions*, *supra* note 55.

¹⁰⁰ According to Article 470(1) of the Estonian LOA, if a policyholder materially violates an obligation prescribed by a contract due to circumstances under the policyholder's control, the insurer may cancel the contract without prior notice within one month of becoming aware of the violation. If the insurer does not exercise this right, the insurer cannot rely on such circumstances, should an insured event occur, to refuse to indemnify fully or to provide payment. Hence, if the policyholder does not comply with the relevant precautionary measures, Estonian insurers may invoke the general norm that a contract may be terminated if contractual obligations are violated. If that right is not exercised, however, it becomes a *ratihabitio* situation.

¹⁰¹ Clause 16.4 of the *Seesam Estonia General Terms and Conditions* states that, if a policyholder does not adhere to the safety requirements with regard to the insured object, Seesam shall have the right to give the policyholder an additional term for fulfillment of the safety requirements and to cancel the contract upon expiry of the term if the policyholder has not fulfilled the safety requirements.

2.3. IMPACT OF PRECAUTIONARY MEASURES ON THE INSURER'S PERFORMANCE OBLIGATION IN CASE OF AN INSURED EVENT

The occurrence of an insured event gives rise to the following question: what are the consequences if the policyholder breaches the precautionary measures included in the contract? Does the insurer have the duty to indemnify and, if so, in what proportion? Under Article 4:103(1) of the PEICL, a clause that non-compliance with a precautionary measure totally or partially exempts the insurer from liability only shall have effect to the extent that the loss was caused by the non-compliance of the policyholder or the insured with intent to cause the loss or, recklessly, with knowledge that the loss would probably result.¹⁰² Hence, non-compliance with a precautionary measure is significant only in cases where the damages are caused *causa causans*¹⁰³ by the policyholder's noncompliance. Martin Schauer notes:

A full discharge may be granted to the insurer only if the policyholder's or the insured's act is based on the intention to cause the loss or on recklessness and the knowledge that the loss would probably occur. Even in that case, the policyholder or the insured may claim the insurance money to the extent that the loss was not caused by the act of non-compliance. From this wording the conclusion may be drawn that partial indemnity is possible. If part of the loss would also have occurred if the policyholder and the insured had complied with the precautionary measures, then the insurer remains liable for this part of the loss. If the act of non-compliance is based on ordinary negligence, the amount of the insurance money may be reduced if provided in a clear clause in the contract. One may assume that the reduction of the insurance money also applies only if and insofar [as] the negligent act has caused the loss.¹⁰⁴

J. Han Wansink provides the following example:

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 noncompliance did not start

¹⁰² The basic philosophy for the majority of the PEICL Group (the international group of scholars working on the PEICL model regulation) was that, without any requirement of fault, the rule felt unjust and incomplete. Freeing the insurer from covering a loss can generally not be legitimized if the fault on the insured's part is only 'slight' negligence (see Stella Sakellariou and Kyriaki Noussia, "Precautionary Measures Under P.E.I.C.L.—Art. 4:101 & The Position Under Greek Law," Consumer Working Party Session, IV AIDA Europe Conference, London (September 13-14, 2012): 75 // <http://www.aida.org.uk/pdf/Consumer%20Protection%20London.pdf>).

¹⁰³ In Germany and under the PEICL, for example, where an insured fails to comply with a precautionary measure, the insurer must still pay for losses that are not caused by noncompliance. Even where losses are caused by noncompliance, if the noncompliance is not intentional or reckless, the insurer is expected to pay for a proportion of the loss. The insurer's main remedy is to terminate the contract for the future (*Insurance Contract Law: The Business Insured's Duty of Disclosure and the Law of Warranties*, The Law Commission Consultation Paper No. 204 and The Scottish Law Commission Discussion Paper No. 155 // http://lawcommission.justice.gov.uk/docs/cp204_ICL_business-disclosure.pdf).

¹⁰⁴ Martin Schauer, *supra* note 76: 164.

the fire but did not prevent the large extent of the damage as a result of the fire.¹⁰⁵

In Finland,¹⁰⁶ for example, in a situation where the owner of a car goes to play football in an indoor arena, leaving the car keys¹⁰⁷ in a gym bag by the field (the arena does not have lockable lockers) and, while the policyholder exercises, someone steals the keys from the bag and then uses them to steal the vehicle too, the insurer is not able to invoke the policyholder's noncompliance with precautionary measures (keys may not be kept in unlocked places or where a bystander could guess where they are). In this case, the insurer cannot refuse to pay an indemnity, as the policyholder's fault is minor and is not even grounds to reduce the indemnity. Article 4:103(2) of the PEICL also states that, subject to a clear clause providing for reduction of the insurance money according to the degree of fault, the policyholder (or the insured, as the case may be) shall be entitled to insurance money in respect of any loss caused by negligent non-compliance with a precautionary measure. Jürgen Basedow explains the question at hand as follows:

The basic philosophy is that insurance is taken out not just for accidental risk but also for cases of negligent behavior. The parties may however deviate from the basic rule by an appropriate contract clause. Such a clause must satisfy the requirements of Article 1:203. The additional requirement that it has to be clear indicates that it must be in very specific language in order to discharge the insurer in cases of negligence. If such a clause is applied in a specific case the discharge of the insurer from liability is limited by degree of causation (Article 4:103 (1)) and additionally by the degree of fault. If the fault is very slight there is no discharge,¹⁰⁸ if the degree of fault comes close to recklessness¹⁰⁹ the

¹⁰⁵ J. Han Wansink, *supra* note 86: 154.

¹⁰⁶ *Vakuutuslautakunnan ratkaisutietokanta*, August 30, 2007, Case No. VKL 312/07 // <http://www.fine.fi/ratkaisut/index.php?todo=4&id=146> [in Finnish].

¹⁰⁷ Russian judicial practice does not release an insurer from the liability to compensate for damages if, in the case of casco insurance, a policyholder fails to produce all keys to the car or its vehicle registration or a certificate of technical inspection, etc. In such cases, the insurer is not released from the liability to pay for damages, as it would conflict with Art. 963 of the Russian Civil Code (*Obzor po otdel'nym voprosam sudebnoi praktiki*, *supra* note 31: 12; see also *Obzor sudebnoi praktiki Verkhovnogo Suda Rossiiskoi Federatsii za vtoroi kvartal 2012 goda* (October 10, 2012): 33-37 // <http://img.rg.ru/pril/article/68/55/17/VS-obzor2kvart2012.pdf> [in Russian]).

¹⁰⁸ Andrei Tanaga, a Russian law professor, is of the opinion that, in Russian insurance law, negligence cannot have any impact on whether a property insurer is liable to compensate for damages. Gross negligence, however, can in certain cases release the insurer from the liability to cover damages. This can only happen in property insurance when: (i) there is gross negligence on the part of the policyholder or beneficiary; and (ii) the release from liability to pay damages is clearly stated by federal law. Tanaga calls attention to the fact that, although this principle is clearly stated in Russian law, insurers continue to include provisions in their standard terms that release the insurer from providing compensation for damages in cases of gross negligence. In Russia, intent releases the insurer from liability to compensate for damages (see A. Tanaga, "O vliianii viny sub'ektiv strakhovogo obiazatel'stva na obiazannost' strakhovshchika proizvesti strakhovuiu vyplatu," *zakon.kz* (July 23, 2013) // <http://www.zakon.kz/4568015-o-vliianii-viny-subektiv-strakhovogo.html> [in Russian]).

¹⁰⁹ In Finland, for instance, in a case where a sauna caught fire because clothes were drying on a side rail of hot stones, the court determined that the insurer could reduce its liability for payment by 25 percent because of the policyholder's failure to comply with precautionary measures, *i.e.*, the prohibition to dry clothes or put other flammable materials on hot stones at the sauna or in their immediate vicinity, was material (*Vakuutuslautakunnan ratkaisutietokanta*, 15.12.10, Case No. VKL 182/07 //

discharge may be almost complete.¹¹⁰

In Finland, for instance, it has been found that the reduction of indemnity or refusal to pay is allowed only where damages are causally linked to non-compliance with precautionary measures. The insurer must prove the existence of fault and its relationship to the damages. Only if such a relationship is proven and if the precautionary measures were upheld and if this was neither intentional nor grossly negligent may the indemnity be reduced by 25-33 percent.¹¹¹ Only in cases of gross negligence can the indemnity be reduced to a greater extent in Finland (refusal or 50 percent). In case of minor negligence, the damages are to be compensated in full. In cases of intent, circumstances such as age, illness, state of mind, or economic situation may determine whether partial compensation might be an option.¹¹² It is arguable whether the reduction proportions developed in Finnish insurance practice might be taken as a model when the PEICL is enforced. Kai-Jochen Neuhaus and Andreas Kloth take a similar position regarding the VVG, according to which the indemnity must be paid out in full if there is no fault or negligence on the part of the policyholder. In the case of gross negligence, the insurer has the right to reduce the indemnity, and in the case of intent, there is no indemnity.¹¹³

Because the Estonian LOA, Latvian ICL and Lithuanian CC and IL do not provide for a separate definition of the concept of 'precautionary measures', their relevant laws have no special provisions regarding noncompliance with precautionary measures (i.e. there is no specific legal framework that would explain the failure to take action; however, we find the provisions in insurance contracts). However, insurers may rely on the provisions laying down general contractual obligations and the consequences for violating them. For instance, Article 452(2)(1) of the LOA states that an insurer may not rely on an agreement whereby the insurer is released from a performance obligation upon the occurrence of an insured event due to the policyholder violating an obligation other than the obligation to pay the insurance premium, which is to be performed with respect to the insurer prior to the occurrence of the insured event, and if the violation is caused by a reason other than the fault of the policyholder, or if the violation did not affect the occurrence of damage or the extent thereof. Hence, the Estonian LOA sets two formal preconditions to releasing the insurer from its performance obligation in the

<http://www.fine.fi/ratkaisut/index.php?todo=4&id=146> [in Finnish]].

¹¹⁰ Jürgen Basedow, *et al.*, *supra* note 44, 177.

¹¹¹ Jukka Rantala and Teivo Pentikäinen, *Vakuutusoppi* (Sastamala: Finanssi-ja Vakuutuskustannus OY, 2009), 278 [in Finnish].

¹¹² Katriina Lehtipuro, *et al.*, *Vakuutuslainsäädäntö* (Sastamala: Finanssi-ja Vakuutuskustannus OY, 2010), 198–200 [in Finnish].

¹¹³ Kai-Jochen Neuhaus and Andreas Kloth, *Praxis des neuen VVG - Arbeitsbuch für Versicherer und Vermittler* (Münster: ZAP Verlag, 2008), 16 [in German].

case of non-compliance with precautionary measures: (i) the violation must be caused by reason of the fault of the policyholder (the form of fault is not important—it can also be simply carelessness); and (ii) the violation must affect the occurrence or extent of the damage. It is also noteworthy that the LOA allows a *priori* preclusion, in the general terms and conditions of the insurer's performance obligation, in cases of the policyholder's gross negligence (not intent, which is discussed below). Herman Cousy claims that:

Traditionally, insurance contract law was characterized by radical punitive sanctions, governed by an 'all-or-nothing' logic. This logic has changed as a result of an incorporation of a consumerist approach: more and more, punitive sanctions have been replaced by more proportionate ones, misbehavior is only sanctioned insofar as it has caused the insured event to happen, duties and sanctions have been bilateralized, and sanctions are now limited to those instances where a high degree of intention or culpability can be detected. Ultimately, these changes have accounted for the hybrid nature of modern insurance contract law as a move away from business law towards consumer¹¹⁴ law.¹¹⁵

This 'all-or-nothing' LOA regulation is questionable in modern insurance law in terms of consumer protection.¹¹⁶ Kai-Jochen Neuhaus and Andreas Kloth explain that changing of the all-or-nothing principle was one of the most important reasons for reform of the VVG.¹¹⁷ One could make a good argument that the principle 'all-or-nothing' is contrary to the doctrine of reasonable expectations. Hopefully, if specific insurance-law problems come up in the future before the Estonian Supreme Court, the Court will provide its interpretation and will not allow an insurer to provide for such an exclusion for gross negligence¹¹⁸ only if it is a separately

¹¹⁴ See also Helmut Heiss, "Insurance Contract Law Between Business Law and Consumer Protection"; in: Karen B. Brown and David V. Snyder, eds., *General Reports of the XVIIIth Congress of the International Academy of Comparative Law/Rapports Généraux du XVIIIème Congrès de l'Académie Internationale de Droit Comparé* (Dordrecht, Heidelberg, London, New York: Springer, 2012).

¹¹⁵ Herman Cousy, "About Sanctions and the Hybrid Nature of Modern Insurance Contract Law," *Erasmus Law Review* 5 (2) (2012): 123.

¹¹⁶ Mop van Tiggele-van der Velde, professor of insurance law at the Erasmus School of Law in Rotterdam, states: "The development that characterises insurance law in the past decades is most clearly reflected in the legislation itself: new insurance law legislation has strengthened the position of the insured—as a consumer—considerably. In order to achieve this higher level of protection, the number of mandatory provisions has been considerably extended, particularly where consumer insurance is concerned. The context behind this development is clear: the insurance contract must offer protection, and in order to guarantee that protection, safeguards are incorporated by the legislator, already mentioned, as well as in case law. The insurer is more and more obliged to adopt a proactive approach to protect the interests of the insured" (Mop Van Tiggele – Van der Velde, "About a New Balance in the Mutual Obligations of Both Parties to a Contract of Insurance and a New System of Sanctions," *Erasmus Law Review* 5 (2) (2012): 93).

¹¹⁷ Kai-Jochen Neuhaus, et al., *Praxiskommentar zum Versicherungsvertragsrecht* (Münster: LexisNexis Deutschland GmbH, 2011), 672 [in German].

¹¹⁸ *Obzor po otdel'nyim voprosam sudebnoi praktiki, svyazannym s dobrovol'nyim strakhovaniem imushchestva grazhdan* (A review of judicial practices on insurance issues by the Presidium of the Supreme Court of the Russian Federation) of 30 January 2013 provides an example of gross negligence where the insurer was granted a release from liabilities. In this case, the policyholder was aware that their recreational craft had not passed a technical inspection and was using the craft in the autumn and

negotiated special condition, i.e. it cannot be a standard clause of the insurance contract.

Concerning the PEICL, Rühl argues that:

In particular, many countries—notably Germany and Austria—have replaced the long-standing *all-or-nothing principle* which entailed the unraveling of the insurance policy on the occasion of a breach with a graded system of legal consequences which take account of the policyholder's fault as well as the causal relationship between the breach and the insurance claim.¹¹⁹ Today, pursuant to the relevant provisions as well as pursuant to Article 4:102 of the PEICL, the insurer is regularly discharged from liability if the policyholder acted deliberately and if the breach has caused either damage or the occurrence of the insured event or has increased the level of damage. Grossly negligent behavior normally allows the insurer to reduce the insurance sum to be paid, whereas negligent behavior has no effect on his duty to pay. According to most recently reformed legal schemes and Article 4:102 of the PEICL, the insurer may only terminate the contract in cases of intentional breach or gross negligence. Mere negligence will not absolve insurers from their responsibility.¹²⁰

In essence, the Latvian ICL allows for the precluding of the insurer's performance obligation in the case of gross negligence, and even ordinary negligence may be used to restrict the insurer's performance. Pursuant to Article 24(3) of the Latvian ICL, the insurer's duty is to indemnify if an insured event occurs because the insured, the policyholder, the beneficiary or a third person committed ordinary negligence and indemnity does not contradict the insurance contract.

However, under Article 89 of the Lithuanian IL, an insurance contract may specify cases where an insurer is released from the obligation to pay the insurance benefit if the insured event occurs due to gross negligence on the part of the policyholder or of the insured person. Nevertheless, the Lithuanian IL assumes that such cases must be negotiated individually.¹²¹

winter season, when use was prohibited. Because the law governing the use of recreational craft in Russia releases the insurer from liability to pay damages in cases of gross negligence, the court dismissed the policyholder's claim (see *Obzor po otdel'nykh voprosam sudebnoi praktiki*, *supra* note 31: 9–10).

¹¹⁹ The January 2013 review by the Presidium of the Russian Supreme Court provides an example where the court granted a policyholder's action against their insurer, who had declined to provide compensation for damages on the basis of intent. The insurer's stance was that, since the policyholder did not close the hood of the car completely (it was not fixed in place), damages were caused by intent. The court, however, ruled that the policyholder had not acted with intent (*ibid.*, 9).

¹²⁰ Giesela Rühl, *supra* note 10: 6.

¹²¹ For example, in a decision dealing with Art.89 of the IL, the Lithuanian Supreme Court held that the parties had to individually consider any term of an insurance contract under which the insurer is released from its obligation to pay insurance benefits due gross negligence on the part of the policyholder or the insured. In this case, the parties had entered into three insurance contracts covering the airplane, the pilot and the pilot's civil liability. The insured plane subsequently crashed, killing some of the passengers on board. The claimant filed an insurance claim, which was refused. The lower courts dismissed the claim. But the Supreme Court held that the parties had to individually consider any term of an insurance contract under which the insurer is released from its obligation to pay insurance benefits due to the policyholder's or insured person's gross negligence. Thus, it could not be a standard clause of the

The question of fault is often subjective. However, it is questionable whether under similar circumstances different solutions in different jurisdictions might be acceptable, particularly given the principle of free movement of persons in the EU and policyholders' expectations regarding the protection provided by the insurance contract.

The question of culpability should also be considered on a more general level—looking back to our initial question of how the law throughout the EU differs and leads to different results. Is it reasonable to expect that a person from Portugal, working in Denmark, should take different levels of precautionary measures (for example, fire safety measures) than they would at home in a similar situation? Answering 'yes' to this question means admitting that the nature of insurance is subject to great changes within the area of the EU. For instance, it is a customary precautionary measure of motor hull insurance that the keys of the vehicle be kept in such a way that does not facilitate their theft, and the doors of the vehicle must be locked after leaving the car.¹²² Thefts of vehicles where the thief first steals the keys (including situations where the keys have been left in the vehicle) are a frequent occurrence in insurance practice. However, what about the policyholder's fault in such cases? There was, for instance, a case in Finland where a car was stolen after the policyholder left the car engine idling with the keys in the ignition while retrieving medicine from the trunk of the car. In this case, it was decided that the damages were to be fully compensated by the insurance company. In another case, where the policyholder started the engine in a parking lot to warm the vehicle up, then went back home for 15 minutes and upon returning discovered that the car had been stolen, the verdict was that the policyholder was grossly negligent and that the insurer could reduce the indemnity by up to 50 percent.¹²³

As far as the latter example is concerned, in Estonian and Latvian insurance practice, insurers would according to authors experience refuse to indemnify at all, and in the first case, they would reduce the indemnity or refuse payment, claiming gross negligence on the part of the policyholder. For instance, Estonia's Harju

insurance contract. Therefore, where an insurance contract is based on standard instructions and the insurer's right not to pay an insurance benefit due to gross negligence is not considered individually in the insurance contract, then, in accordance with Lithuania's insurance law, such an article cannot be applied (*Vytautas Lapėnas vs. BTA draudimas*, Supreme Court of Lithuania, Case No. 3K-3-545/2007 // http://www.infolex.lt/lat_web_test/getdocument.aspx?id=e3411c2e-e5df-4e06-862f-c410d48b292b [in Lithuanian]).

¹²² For example, according to Clause 8.1.7 of Estonian ERGO Insurance SE's terms and conditions for vehicle insurance, the policyholder is obliged, upon leaving the insured vehicle, to lock it. According to Clause 8.1.8(P), the policyholder is obliged to keep the vehicle's keys and registration documents in such a place where they will not be easily accessible by third parties. The vehicle's mechanical and/or electronic keys, electronic remote controls for anti-theft devices and the vehicle's registration documents must not be kept in the vehicle (*Estonian ERGO Insurance SE's Terms and Conditions for Vehicle Insurance* // http://ergo.ee/files/KT_0056_11_Soidukikindlustuse_tingimused_KT_0056_11_ING.pdf).

¹²³ Katriina Lehtipuro, *et al.*, *supra* note 112: 198–199.

County Court¹²⁴ affirmed the insurer's right of refusal in a situation where a vehicle was stolen with a key taken from atop a cabinet in the policyholder's apartment. While the policyholder was sleeping, the key was stolen by an acquaintance with whom the policyholder had previously been consuming alcohol. In this judgment, the court found that the plaintiff had intentionally breached the due diligence obligation with respect to keeping the car keys, and that the breach had a direct impact on the occurrence of damages.

These two examples of law in action from Finland and Estonia illustrate how different the results can be in similar situations in neighboring jurisdictions. It is difficult—if not downright impossible—to explain why Estonian insurers should have more rights to refrain from compensation than, for instance, Finnish insurers.

But what would the solution to the above-mentioned cases be based on the PEICL? To begin with, it is questionable whether Article 9:101¹²⁵ of the PEICL could be applied if precautionary measures have not been formally observed.¹²⁶ The preclusion of the insurer's performance obligation in the presence of intent¹²⁷ is understandable because, as a rule, intent involves insurance fraud and is thus *ex injuria non oritur*. Neuhaus and Kloth explain that it would be against the main principles of insurance theory if the policyholder were to profit from intentionally causing an insured event.¹²⁸ In theory, at least, the policyholder's intent, e.g. in setting his own house on fire, may involve some other goal. Even then, however, a policyholder who acts in bad faith as a contract action should not be 'rewarded' for his intentional unlawful actions—this also is a question of moral hazard. Article 9:101(2) states:

This provision stresses the central purpose of insurance to cover not only what Shakespeare called 'the slings and arrows of outrageous fortunes' but also the foolishness and carelessness of men and women. On this premise the main purpose of Article 9:101, however, is to establish limits on the kind of human

¹²⁴ *IS vs. SAS*, Estonian Harju County Court, Case No. 2-07-10217, 2007 // https://www.riigiteataja.ee/kohtuteave/maa_ringkonna_kohtulahendid/menetlus.html?kohtuasjaNumber=2-07-10217/6 [in Estonian].

¹²⁵ According to Art.9:101(1) of the PEICL: "Neither the policyholder nor the insured, as the case may be, shall be entitled to indemnity to the extent that the loss was caused by an act or omission on his part with intent to cause the loss, or recklessly and with knowledge that the loss would probably result. (2) Subject to a clear clause in the policy providing for reduction of the insurance money according to the degree of fault on his part, the policyholder or insured, as the case may be, shall be entitled to indemnity in respect of any loss caused by an act or omission on his part that was negligent."

¹²⁶ Martin Schauer argues that: "One may ask about the relationship between precautionary measures and the causation of loss by an intentional or reckless act of a policyholder or insured, as defined in Art. 9:101. If the insured does not take necessary precautionary measures, can Art. 9:101 be applied as well? Both problems are well known in national law. Dozens of theories have been developed in legal scholarship, especially in Germany. These problems will have to be discussed with regard to the PEICL as well, and European solutions will have to be found" (Martin Schauer, *supra* note 76: 164).

¹²⁷ For example, Art.6.1014 of the CC provides that the insurer shall indemnify the policyholder if malicious acts or infringements are deemed socially valuable (self-defence, performance of a civil duty, etc.).

¹²⁸ Kai-Jochen Neuhaus and Andreas Kloth, *supra* note 113, 672.

conduct that may be covered by insurance and, in particular, to delimit kinds of conduct that are so unacceptable that they are not normally covered.¹²⁹

One way in which the above-mentioned cases could be treated under the PEICL would be to claim that Article 9:101 should generally not be applied by the insurer to non-compliance with precautionary measures; otherwise, insurers that develop general terms and conditions could open up a 'backdoor' to restrict their obligations by applying the doctrine of *contra proferentem*. By requiring—in the general terms and conditions—that certain acts be performed (or not performed) and classifying such acts as a separate precautionary measure, the insurer is also thereby defining its potential legal remedies in case of non-compliance. However, this gives rise to the risk that, when applying the PEICL in the future, insurers will not always adequately define the quantum of precautionary measures in their general terms and conditions in order to be entitled to invoke Article 9:101, and such behavior could be seen as acting in bad faith on the part of the insurer. Another way is to analyze the goal of a precautionary measure through its causal relationship.¹³⁰ So, the Finnish legal scholar Jaana Norio-Timonen finds that causes of damage may be divided into: sufficient causes and essential causes. A sufficient cause includes circumstances that make a certain thing possible in terms of the laws of nature and society as a whole. An essential cause includes circumstances without which a certain consequence would not have occurred. The behavior described by a precautionary measure is a sufficient cause for the occurrence of an insured event but it is not an essential cause. Therefore, non-compliance with the precautionary measure and occurrence of an insured event do not solve the question of causality; rather, the specific goal of the precautionary measure should be weighed in each case.¹³¹ An essential cause or efficient proximate cause is one that sets others in motion, but it is not necessarily the last act in a chain of events. While the efficient proximate cause is said to set in motion a chain of events, it is not necessarily the triggering cause; rather, it is the predominating cause. The triggering cause may be a sufficient cause or immediate cause that is the final act leading to a particular result or event, directly producing such result without any further intervention. Article 9:101 might apply in cases where there is an immediate cause.

Returning to the above-mentioned hypothetical example (the freezing of pipes

¹²⁹ Jürgen Basedow, *et al.*, *supra* note 44, 246.

¹³⁰ The Federal Court of Arbitration of the Ural Region has ruled that the insurer was not released from liability to pay for damages from a hotel fire even though the sauna in the hotel was not planned or built correctly. These reasons were known *a priori* the insurance case, meaning that releasing the insurer from liability to provide compensation for damages would not comply with Art.963 of the Russian Civil Code (*VTB Strakhovaniye vs. Hotel Development Kompani*. Russian Ural Arbitration Court, Case No. A60-45635/2010 // <http://base.consultant.ru/cons/cgi/online.cgi?req=doc;base=AUR;n=126527> [in Russian]).

¹³¹ Jaana Norio-Timonen, *supra* note 81, 162.

in a policyholder's house during his holiday), under the PEICL the resultant consequence would be that the insurer is partly or fully released from its performance obligation only if the outdoor temperature was below zero when the policyholder left and the policyholder switched off the heating system, as, under those conditions, the loss would have been caused by the reckless non-compliance of the policyholder or the insured with knowledge that the loss would probably result. For example, in Lithuania insurance indemnity may be reduced or payment refused if the policyholder acts wrongfully.¹³² Thus, in a situation where the policyholder could not and, in view of the circumstances, was not expected to be able to foresee that the outdoor temperature would drop below zero, his non-compliance would not affect the insurer's performance obligation. In addition, under Article 89 of the Lithuanian IL, gross negligence requires that such cases must be negotiated individually. In Latvia,¹³³ the condition precedent to the insurer's partial or full release from the obligation to indemnify is that the policyholder's fault is more severe than negligent (grossly negligent). In Estonia,¹³⁴ the insurer's performance obligation is affected by the policyholder's breach of the agreement affecting the occurrence or degree of the loss and damage. Hence, similar insured events—wherein the policyholders all act in a similar manner—the legislator has made policy choices that have led to drastic differences in Estonia, Latvia and Lithuania.

CONCLUSION

Aggravation of risk and compliance with precautionary measures play an important role in relations under insurance law—in certain cases, aggravation of risk and/or non-compliance with precautionary measures may entitle the insurer to reduce the indemnity or refuse payment altogether. In both situations, the fault of the policyholder and the causal relationship between noncompliance and any damages may be weighed. Although, in home insurance, such insured risks as fire, flood, etc., or precautionary measures such as the obligation to provide heating during a cold period or emptying the heating systems of water, the obligation not to have an unsupervised open fire in a room, etc., is very similar in Estonia, Latvia and Lithuania (as the countries are neighbors, members of the EU and tied economically), there are vast differences in their domestic regulations. As a result, people who work and live in several countries must familiarize themselves with all

¹³² See, for example, Clause 66.3 of the *Lithuanian Lietuvos Draudimas Policy Wording*, *supra* note 51.

¹³³ See, for example, Clause 9.2 of the *Seesam Latvia Terms and Conditions of Individual Property Insurance*, *supra* note 52.

¹³⁴ See, for example, Clause 20.1.3 of the *Seesam Estonia Household Insurance Terms and Conditions*, *supra* note 55.

the different regulations if they wish to procure insurance coverage that would be understandable to laypeople and would pay out the indemnity in similar cases throughout EU.

We argue that the implementation of the PEICL will eventually result, first, in lower prices for policyholders and, second, in the emergence of large insurance corporations that operate in several EU countries, using optional instruments to unify their products.

Since the relevant regulations provided in the PEICL are more favorable and consumer-friendly for policyholders in the Baltic states, it would be in the interests of Baltic policyholders that the PEICL be promptly enforced as a so-called second-regime instrument in the European Union. Should the PEICL be enforced, life of consumers would undoubtedly be much easier, as consumers would be able to choose among unified insurance products. Likewise, implementation of the PEICL should result in more harmonized case law, which could help the consumers better assess the risks of operation.

At the beginning of this article we asked whether a policyholder's fault would increase as s/he travels 80 kilometers south from Helsinki, Finland, to Tallinn, Estonia. We could ask the same if s/he were to travel 840 kilometers from Milan, Italy, to Berlin, Germany. The only likely answer is 'no'; thus, in order to prevent the exceptions and differences described in this article, which hinder people from real-life problem-free use of the freedom of movement – living and working in neighboring countries – and to make the dream of a borderless EU come true, the enforcement of the PEICL as a second-regime legal act is desirable for all citizens of the EU.

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