

# THE BULGARIAN REGULATION OF THE LOAN INSURANCE CONTRACT

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## ABSTRACT

*The article deals with the questions related to the insurance contract concluded to ensure a loan or bank loan. It designates the main features of the loan insurance contract, the legal framework of the contract according to the Bulgarian Insurance Code (2016) and outlines the legal issues that arise from the law and jurisprudence.*

**Key words:** Insurance Law, Loan, Lender, Borrower, Legal Claim.

## INTRODUCTION

A loan insurance contract is a specific type of insurance agreement as the insurable interest arises from another, separate contract between the insured and the insurer, namely a loan or credit agreement - when the loan is provided by a licensed financial institution (bank). This specificity of the loan collateral insurance gives grounds to designate the loan insurance contract as property insurance that insures the civil contractual liability of the persons. The main purpose of the contract is to ensure the risk of not covering the full loan from the borrower. When the subject of insurance agreement is precisely the non-fulfillment of the borrower's obligation to repay the amount provided by the lender, the contract is typically property in nature and its conclusion is subject to the rules of property insurance. At the same time, very often in practice the subject of insurance is the life, health or physical integrity of the borrower. In these cases, the loan collateral agreement combines elements of personal insurance and property insurance. Therefore, the rules for concluding a loan collateral agreement cover the principles of both property and personal insurance and their observance guarantees its validity and determines its specifics. The legal framework of the loan insurance contract should take into account the “dual character” (Nemeth, K. 2001) of the agreement related to the subject of insurance and provide a solution to the issues that arise in its practical application. The article analyzes as well the right of subrogation of the heirs of the borrower in case of insurance event - death and explains the weakness of the Bulgarian legislator to properly implement in the legislation the “doctrine of subrogation (...) as being an indispensable part of insurance law” (Hasson, 1985). Unfortunately, the regulation of loan collateral insurance in the Bulgarian Insurance Code (2016), introduced only in two provisions of the law, is too concise and does not affect the essential features of the contract related to both the parties and the subject of insurance.

The article outlines the main features of this type of insurance on the one hand, and on the other hand makes a critical analysis of the legal framework of the contract in the Bulgarian Insurance Code (2016). The article analyzes as well the practice of banking institutions and lenders in connection with the conclusion of loan insurance contracts and legal remedies for protection of the rights of insured persons - borrowers from illegal actions of their creditors.

## METHODOLOGY

The systematic, analytical and comparative-legal methods were used in the article. The systematic and analytical methods reveal the relationship between the existing and the repealed legal frameworks of the insurance contract concluded in connection with a loan (bank loan) contract and the typical legal consequences that follow the application of the framework. The

comparative method presents the court practice in connection with the right of subrogation against the insurer in relation to the amendments in the Insurance Code (2016).

#### Legal framework and general features of the loan insurance contract

The insurance of a loan or a bank loan has been known to the Bulgarian legislation only since 2005, when the legislator adopted a codifying law, which regulates the activities for providing insurance and reinsurance services. The first Insurance Code (2005) in the Republic of Bulgaria was adopted in December 2005 and entered into force in early 2006. Prior to the adoption of the Insurance Code (2005), now replaced by a new one, the rules for concluding insurance contracts and the principles of insurance had a brief regulation in the Commercial Act (1991) along with other types of commercial contracts. For the first time, the insurance contract, that insures the risk of default of a borrower under a loan agreement, is regulated in the Insurance Code of 2005 in the only provision of Art. 199a. Article 199a of Insurance Code (2005) provided for the possibility of concluding an insurance contract in favor of a creditor that would cover the outstanding part of a monetary obligation under a loan contract, including principal, interest and expenses. Within the meaning of the provision of Art. 199a of Insurance Code (2005) a sufficient condition for concluding the insurance contract was the presence of a monetary claim of the creditor against a specific person, regardless of the contractual basis of the claim - whether a loan agreement or other type of commercial contract. At the same time, the law required the prior consent of the debtor, in cases where the subject of insurance is his property or non-property goods.

With the adoption in 2016 of an entirely new Insurance Code (2016), the regulation of loan insurance contract has expanded to two legal norms – article 382 and 383, which claimed to further develop and improve the old regulations. However, it can be concluded that the new regulation is far from being more perfect than the previous one. On the contrary it is even vaguer and does not resolve the existing contradictions in the practice of applying the loan insurance contract.

By definition, loan insurance contract is a type of property insurance that guarantees the fulfillment of contractual obligations (Goleva, 2012). The insurance risk, which is a basic requirement for the validity of the contract, is related to the danger that the person who has borrowed a certain amount will not repay it, *i.e.* the danger that the debtor will not fulfill his main obligation under the loan contract. Therefore, whenever a valid loan agreement has been concluded between a lender and a borrower there is an insurance risk to be insured. There are two main types of loan insurance contracts that differ depending on the parties to the contract. Firstly, the loan collateral insurance can be taken out by the debtor or a third liable person in favor of the lender. With this insurance, the debtor insures his property or non-property goods in favor of his creditor under a loan agreement. Upon occurrence of the insurance event the creditor has the right to receive from the insurer the amount of the insurance indemnity, which covers the amount of his receivables under the loan contract. This first type of insurance is a typical form of insurance contract for the benefit of a third party. The third party is the creditor of the debtor, who is a party to the insurance contract and has two qualities under it - an insurer (in favor of a third party) and insured for his property or non-property benefit. At the same time, there is an insurance risk for the creditor himself of concluding an insurance contract with which to ensure the fulfillment of the obligations of the debtor under a loan agreement to repay the provided amount. The conclusion of collateral insurance by the lender is the second type of loan collateral agreement, which has essential differences with the first type. The differences stand out in several directions. In the first place, the insurance taken out by a creditor to secure a loan agreement is not insurance in favor of a third party, since the party to the contract is the creditor. As a party to the insurance contract, the creditor has all the rights deriving from it, including the right to receive the insurance indemnity or amount upon occurrence of the insured event. In addition, as a party to the insurance contract, the creditor has a contractual obligation to pay the agreed insurance premium,

just as the debtor pays it when concluding an insurance contract in favor of his creditor. Another difference between the two types of loan insurance contracts is that the creditor can take out insurance to secure a loan without insuring a specific property and non-property benefit of its debtor. In this regard, the creditor has the right to insure only the risk of default of the debtor to repay the loan amount. In these cases, the insurance contract is valid because the subject of insurance is the contractual civil liability of the debtor. Therefore, the debtor's consent to enter into the contract is not required. The debtor, in turn, has no right to insure independently the danger of non-performance of his contractual obligation without specifically insuring his property or non-property goods. This is because he is not a creditor within the meaning of the law and there is no insurance risk for him to insure. On the other hand, the creditor may insure, in addition to the contractual liability of the debtor, a specific property or non-property benefit of the debtor. The precondition of the validity of such an insurance contract is the consent of the debtor. The consent of the debtor, when the creditor under a loan agreement insures his property or non-property goods, is a condition for the validity of the insurance contract, but does not make the debtor a party to it. Therefore, even in these cases, the creditor is a party to the insurance contract and has the rights and obligations as a party.

The outlined characteristics of the two main types of loan insurance contracts are not met either in theory or in case law. Some publications on the subject indicate two types of contracts for securing a bank loan - one concluded by a creditor, the other by a debtor, but both contracts are defined as contracts in favor of a creditor. At the same time, it is pointed out that the subject of both types of loan collateral agreements is a specific property or non-property benefit of the debtor, which does not correspond to the specifics of loan insurance contracts as a type of property liability insurance. The legislator himself did not take into account the essential differences between the two main types of the contract when regulating the relations arising under the loan collateral agreement. This legislative decision leads to controversial interpretations in practice on the one hand and on the other hand to a significant restriction of the protection of the debtors from unscrupulous and unfair practices of their creditors.

### **What is the Legal Framework?**

Art. 382, paragraph 1 of the Insurance Code (2016) stipulates that in case of insurance concluded in favor of a creditor, between an insurer and an insurer who is a creditor of a third party - debtor, upon occurrence of the insured event the insurer is liable to the creditor up to the sum insured for the outstanding part of the obligation, for collateral on which the insurance contract has been concluded, including principal, interest and expenses as of the date of occurrence of the insurance event. When the due indemnity or the sum insured according to the terms of the insurance contract exceeds the amount of the outstanding part of the obligation, after payment to the creditor, the balance shall be paid to the debtor or his heirs. For the rest of the paid insurance indemnity or amount, the debtor has the status of "insured" person. Paragraph 2 of Art.382 of the Insurance Code (2016) requires the consent of the debtor, when the insurer is his creditor and the subject of insurance is debtor's property or non-property goods. It is noteworthy that in the phrasing of Art. 382, par. 1 of the Insurance Code (2016), the loan collateral agreement concluded by a creditor who is an insurer is designated as a contract in his favor. The term "insurance concluded in favor of a creditor" is used, which leads to the conclusion that the insurance is concluded in favor of a person who is not a party to the contract - a third party. The conclusion is supported by the fact that the same term "insurance concluded in favor of a creditor" is used in determining the contract that is concluded by the debtor in favor of the creditor under the second regulation of Art. 383 of the Insurance Code (2016). This means that the legislator always defines the loan insurance contract as insurance in favor of a third party, regardless of who is a party to the insurance contract - whether the party is the creditor or the debtor. This legislative solution contradicts the clarified nature of the two main types of loan

insurance contracts. The lack of legislative distinction between the typical hypothesis of insurance concluded by a creditor to secure the fulfillment of a contractual obligation of the debtor and the insurance concluded again by a creditor, but on the property or non-property benefit of the debtor, is evident from the requirements for concluding the insurance loan contract set by the legislator. It is provided, in this connection, that the loan insurance concluded by a creditor is in all cases and insurance under general conditions for which the debtor should be notified in writing in advance. The law sets obligations for the creditor to provide the debtor with all prior information in connection with the conclusion and performance of the insurance contract, including information on the subject of the insurance, the insurance sum and the terms of the contract. The legislator also states that the answers to the questions about the property status of the debtor or related to his health are given by the creditor and communicated to the debtor.

This legislative decision in practice does not regulate the main form of an insurance contract concluded by a creditor, namely the contract that ensures the debtor's civil liability arising from a loan. The law regulates only the cases where the creditor ensures profit or non-profit benefit if the debtor. When the creditor insures the civil liability of the debtor to fulfil the obligations under the loan agreement, as a party to the contract, he is not obliged to require the consent of the debtor, nor is he obliged to provide him with preliminary information on the general or individual contractual terms of the insurer. This is because the creditor is the insurer under the contract, and the subject of insurance is the civil liability of the debtor. In these cases, it is the creditor who is liable to pay insurance payments.

At the same time, neither in Art.382 of the Insurance Code (2016), which regulates the insurance concluded by a creditor, nor in Art. 383 of the Insurance Code (2016), which regulates the insurance, concluded by a debtor, gives an answer to the question - which pays the insurance premiums under the contract.

The rule in insurance contracts for the benefit of a third party is the payment of insurance premiums by the insurer. This rule is observed when the loan insurance contract is concluded by a debtor or a third party, obliged under the loan agreement, in favor of a creditor. Explicit reference to the law in these cases is not required. It should also be assumed that the rule is applicable when the insurer and a party to the insurance contract is also the creditor of the debtor. As insurance is a legal product, the influence of the legal environment on an insurance contract is very strong (Adelmann, 2008). The lack of legislation in the Bulgarian Insurance Code on the obligation of the insurance premium gives ground to application of unscrupulous insurance practices on behalf of the creditors.

### **What is the Practice?**

Insurance policies are numerous and varied in terms of length, complexity and the nature of risk insured (Merkin & Gurses, 2016). However, regardless of the type of loan insurance, the creditors in Bulgaria include the insurance premiums in the loan installments and they are paid by the debtor. This is also done in cases when the creditor concludes an insurance contract to secure a pure loan agreement without insuring a specific property or non-property benefit of its debtor. The insurance is usually concluded as a group insurance "Credit protection". The lack of legal regulation in the law as to the obligation of payment of the insurance premium leads in practice to the following - creditors under loan agreements assign in all cases to the debtors the payment of insurance premiums. In that connection the payment of the premiums appears as a discreet element of the duties under the insurance contract (Merkin, 2016). At the same time, when the insurance contract is concluded by a creditor, the debtor is not a party to it and has no right to file a claim for payment of the insurance indemnity or amount to the insurer. The debtor could not claim payment from the insurer in cases where the creditor has insured his property or non-property goods with his consent as well. For example, when the loan collateral agreement is concluded by a creditor as a group life insurance of the creditor's debtors, upon occurrence of an

insurance event related to damage to the debtor's life - death, his heirs are not entitled to claim from the insurer payment to cover the outstanding obligations of their heir under the loan contract. The heirs have the right to a direct claim against the insurer in the event of the death of a debtor in the above example only if they have paid the entire obligation under the loan contract. Only after payment the right of subrogation against the insurer comes into being. The said is settled in the court practice as well. With decision № 7149 of 20.06.2016 of the Sofia City Court, for example, a claim of heirs of a debtor against an insurer is rejected because the heirs could not prove payment of the outstanding duties of the debtor under the loan contract. It is indisputably established in the case that the bank has concluded a group contract "Credit protection" with an insurance company, to which the debtor has joined upon signing the loan agreement. During the validity of the insurance contract occurs a covered insurance risk - death of the debtor. The bank does not take action against the insurer to pay the sum insured; therefore the heirs file a claim before the court. Although the bank stated an opinion on the merits of the claim, the court rejected it because the heirs did not prove payment of the obligation under the loan agreement. Again, the question of who paid the insurer the insurance premiums under the contract is not considered, although as a rule this should be the insurance bank. The court decision is rendered under the previous regulation of the loan insurance contract, which did not explicitly state that the creditor has the quality of an insurer when insuring a specific property or non-property good of a debtor under a loan agreement. The current legal regulation of the loan insurance contract concluded by a creditor in connection with property or non-property benefit of a debtor defines explicitly the creditor as "insurer". This means that the rights under the insurance contract should arise in favor of the debtor as an insured person. In addition, the creditor as an insurer has an obligation to pay insurance premiums. In practice, however, the rights under the contract are not for the debtor, nor does the creditor pay the insurance premium. On the contrary, the insurance premiums are included in the loan installments, and the right to receive the insurance indemnity upon occurrence of the insurance event is for the creditor. Only after the debtor's obligation under the loan has been repaid, the balance, according to the new regulations, is paid to the debtor or his heirs, so nothing is changed.

Insofar as the new regulation is identical to the previous one with the difference that the creditor is explicitly defined as an insurer, it does not resolve the question of whether the heirs of the debtor or the debtor itself could claim against the insurer the insurance sum in favor of the creditor to cover the obligations under the loan contract. The novelty in the regulation of the loan insurance concluded by a creditor is related to the introduction of an obligation for the creditor in cases of covered risk - death to take with the care of a good owner the necessary actions against the insurer to pretend and collect the insurance indemnity (art. 382, par. 3 Insurance Code, 2016). However, this obligation of the creditor is not bound by a legal sanction. The legislator does not specify whether, when the creditor is inactive and does not fulfill its obligation to claim payment from the insurer, the heirs of the debtor may file a direct claim against the insurer. The answer is rather negative. The lack in the law does not allow to overcome the established case law and to assume that in cases of insurance concluded by a creditor on the property or non-property goods of a debtor; his heirs are entitled to a direct claim against the insurer for the sum insured. Such a conclusion does not follow from the definition of the creditor as "insurer" under the contract, as he is a party to the insurance contract and is also insured for the amounts due under the loan agreement, which he is entitled to receive upon occurrence of the insured event. Therefore, the rights of the debtor's heirs, who inherit his obligations to the creditor under the loan agreement, are not guaranteed by the legislation. Moreover, the emptiness of the regulation creates preconditions for unjust enrichment of insurance companies. As stated when the insurance loan contract is concluded by a creditor in connection with a non-property or property benefit of a debtor, the insurance premiums are at the expense of the debtor. In cases where the creditor fails to claim payment from the insurer, he cannot be convicted by the heirs of the debtor, as the debtor

is not a party to the insurance contract and is not insured for the amount of the loan contract. At the same time the insurer withholds the insurance payment. In addition, the Bulgarian legislator deprives persons of the right to protection on insured debt against a creditor when he intentionally fails to act and does not exercise his rights under the insurance contract.

## CONCLUSION

Unfortunately, the newly established regulation of the insurance loan contract in the Bulgarian Insurance Code (2016) does not meet the legal criteria of lucidity and justification. It does not solve the pending issues connected with the protection of the debtors on bank loans secured by insurance contract concluded by their creditors. The ambiguity of the regulation gives ground again for diverse interpretation of the rights and obligations of the parties to the insurance loan contract and thus to different solutions of the legal disputes in that connection. An amendment in the law is needed that would take into account the specifics of the relationship that arises under the loan insurance contract and the legal consequences of its effect on the parties.

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