

## VOLATILITY & VALUATIONS

<http://www.youtube.com/watch?v=bOKYYsH49pk>

### 1 A BIT OF HISTORY

#### 1.1 Marine Policies

Section 81 of the Marine Insurance Act 1906

“Where the assured is insured for an amount less than the insurable value or, in the case of a valued policy, for an amount less than the policy valuation, he is deemed to be his own insurer in respect of the uninsured balance.

#### 1.2 Non-Marine Policies

Such an Average or Co-Insurance condition, however, is not implied into any other policy and, most pertinently for this talk certainly not into non-marine property policies.

The result of this was that it became “invariable practice<sup>1</sup>” for insurers to declare positively in their policies that the insurance they were providing would be “subject to average”.

This move was recognised by the Courts in the 1918 case of *Carreras Ltd v Cunard Steamship Co*<sup>2</sup> where the plaintiff stored goods with the Defendant in a warehouse at a fixed rent to include insurance against loss or damage by fire. The Court held that the so-called pro rata condition of average was so common in fire insurance on goods that it must be implied as a term of the warehouse agreement.

### 2 THE PRESENT

The reality nowadays is that on large commercial property and energy risks a very significant proportion of brokers and/or risk managers are pushing hard (generally successfully) for the inclusion of Average or Co-Insurance clauses to be done away with. Clearly their view is that it is in their clients’ best interests to have these clauses written out of their policies.

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<sup>1</sup> MacGillivray on Insurance Law p 675

<sup>2</sup> [1918] 1 K.B.118

The motivation behind this approach by brokers and risk managers is fairly obvious; wanting to protect themselves or their clients in the event that the valuations provided to their insurer were either wrong at the outset or have become wrong between inception and the time that a loss has occurred.

This is understandable. No broker or risk manager is going to want to have to explain to their client or board of directors that because of the operation of an Average clause they are only going to receive a percentage of their claim.

This is particularly so if the shortfall in valuation is the result of volatility in the markets beyond the Insured's control that adversely effects the valuations that an Insured &/or his broker placed on its portfolio of property when it purchased its insurance.

On the other hand when the shortfall in the valuation is not caused by market volatility but rather simply by straightforward undervaluation of their property by the Insured sympathy and understanding for their position lessens considerably. Why should they not share some of the pain, given that they have already received the benefit of lower premiums based on their undervaluation?

Clearly there are market forces at work here that are outside our control and so the next question, once the business has been placed, becomes what can insurers do to protect themselves?

### **3 WHAT CAN INSURERS DO?**

#### **3.1 Avoidance**

Given English Insurance law, if there is no Average Clause in the policy, the only option available to the Insurer if there has been a significant undervaluation is to consider avoiding the policy on the basis of misrepresentation. This is clearly a drastic step.

Even if an insurer is happy to go down this route it remains fraught with difficulties because of the tests that the insurer has to satisfy to allow him the option to avoid the policy for Misrepresentation<sup>3</sup>.

- (i) the statement of opinion or belief as to the valuation has to be untrue;
- (ii) if made to the insurer, it has to be material to the insurer's appraisal of the risk, and in other cases material in the wider sense;
- (iii) it has to be a statement as to a present or past fact not one of the future (i.e. post inception volatility effecting the value will not assist the insurer);

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<sup>3</sup>Applied in *Randall v Combined In Co of America* [2006] Lloyd's Rep IR 732; *Limit No 2 Ltd v Axa Versicherungs AG* [2008] Lloyd's Rep IR 330,338.

- (iv) the insurer personally has to have been induced to enter into the contract by the misrepresentation.

There are two particular difficulties that the Insurer faces in meeting these tests.

The first arises out of the fact that a valuation is not a statement of fact but of opinion or belief. An important issue here is whether such an opinion given by a proposer for insurance could give rise to an implied representation of the facts accompanying it that the proposer possesses reasonable grounds for his opinion. However, the Courts have held that no such representation could be implied so long as the statement of opinion or belief is honestly held<sup>4</sup>.

Secondly, there is no hard and fast rule as to the extent by which the valuation has to be wrong before it will be deemed material. This to an extent can be tied in to the first point as the greater the disparity in the valuation from the true position the less likely it is that the opinion was honestly held. I would certainly expect it to be considerable, e.g. underinsurance of at least 50%.

### **3.2 Practical difficulties**

Avoidance as a remedy for misrepresentation whilst available in England is not an option in many other jurisdictions around the world.

In such jurisdictions the remedy is likely to be limited to being one in damages where the question of proportionality could well come in to play. The upside that Insurers may well find in these jurisdictions is that unlike in England average will be implied to all insurance policies and not just Marine policies.

### **3.3 Defences for the Insured**

One of the most difficult clauses for an insurer to overcome in this sort of situation is the Errors & Omissions Clause or the Non-Vitiating Clause.

These essentially provide the Insured with the ability to run the defence that so long as the undervaluation was not deliberate or reckless then the Insurer is not entitled to avoid the policy. This takes a similar line to that set out above with regard to “honestly held belief” save that by having the clause in writing in the policy is likely to add a further deterrent to the Insurer.

As you will all no doubt appreciate seeking to prove that an Insured has deliberately or recklessly undervalued its property is going to be exceptionally difficult as to do so you are moving in the realms of fraud.

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<sup>4</sup> Economides v Commercial Union Ass Co Plc [1998] QB 587.

What these clauses also provide is protection for the brokers or valuers who are likely to have assisted the Insured in providing the valuation to the Insurer. If the Insurer has been stripped of his remedy against the Insured then the Insured will not need to seek recourse against the negligent broker or valuer.

## **4 POSSIBLE SOLUTIONS**

### **4.1 Additional Premium Provisions**

One possible way to deal with the problem of undervaluation whether caused by volatility in the market place or otherwise would be to include an AP provisions based on a declared value at the end of the policy period, much in the way as they are sometimes used in BI covers. An average could then be applied over the policy period and the appropriate AP applied. There are obvious practical difficulties with this option mirroring those that exist at the inception of policies.

### **4.2 Warranty of valuations**

Another option would be for underwriters to seek to make the valuations provided the subject of a warranty. However, given the draconian implications under English law for breach of warranty I would be very surprised if any broker would agree to this - however, proposing it might persuade brokers and their clients to look again at reintroducing average clauses.

### **4.3 Insurers could potentially seek their own valuations**

Again, I am not at all convinced that this would in fact be a practical solution, albeit it might be one that could provide an additional source of income to loss adjusting houses. It would certainly cut into insurers' bottom lines and would increase their workload in having to re-price the business once their valuation had been received.

Perhaps the alternative to this would be for Insurers to use their own systems or databases so that they could 'sense check' the basis of the valuations they are provided with, e.g. on the basis of rebuilding costs per square foot in a particular area or the replacement cost of plant & machinery.

### **4.4 Insist on Average or Co-Insurance clauses**

As mentioned above this is unlikely to be a workable option given the current market conditions and brokers' and risk managers' aversion to them, but it remains in my view probably the simplest and the fairest solution. This is particularly so if you have built in to the clause some leeway for the Insured

such as is provided by the 80%/120% provisions that can be included to soften the blow for an Insured.

We shall have to wait and see how this issue progresses and what solutions the market manages to find to address what remains a significant and ongoing issue.

**Tony Hannon**