THE CHARTERED INSTITUTE OF LOSS ADJUSTERS

Gross Profit: Fairly Under-Declared?

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Agenda

Harry Roberts – Chairman

Introduction
Background to BI cover

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Common Bases for Declaration
Routine causes for under-declaration

Jonathan Hall

Under-declaration and avoidance

Harry Roberts – Summary and Questions

Background to UK Declaration Linked Business Interruption

Basis of cover

Reasons for introduction

The ‘bargain’

Does it work ?

Bases of Declaration

Final Declaration for premium adjustment

Initial Declaration at policy inception

- Previous12 months
- Last set of Statutory Accounts
- Accounts most co-terminous with policy period
- Anticipated profit in policy period

Routine causes for under-Declaration

- Failure to appreciate that the Policy definition differs from accounts calculation
- Failure to increase for longer MIP's
- Deduction of Specified expenses beyond the policy list
- Failure to understand relevance of Declaration to cover
- Declaration of that part of GP the policyholder believes to be at risk
- Declaration based on premium affordability rather than Gross Profit as defined
- Depression of Declaration due to availability of 33% uplift

Summary

Policy Declaration Requirement

12 months pre renewal/inception

Last set of Statutory Accounts

Accounts most nearly coterminous with policy period

GP anticipated in policy period

HISTORIC FACT → FUTURE ESTIMATE

Declaration Issue

INADVERTENT

Unexpected industry upturn results in Declaration being low

Policyholder has inadvertently failed to appreciate

that the policy definition differs from the meaning in their accounts.

Policyholder understands that there is a different definition of Gross Profit in the accounts compared to the policy, but

deducts costs beyond the Specified Working expenses listed in the policy, anticipating that many costs will reduce (but leaving the policy definition unaltered

Policyholder fills out returns required by their broker without appreciating the importance or relevance of them

Broker, as the policyholder's agent passes on a calculation deducting costs significantly beyond the Specified Expenses in the policy (policyholder oblivious)

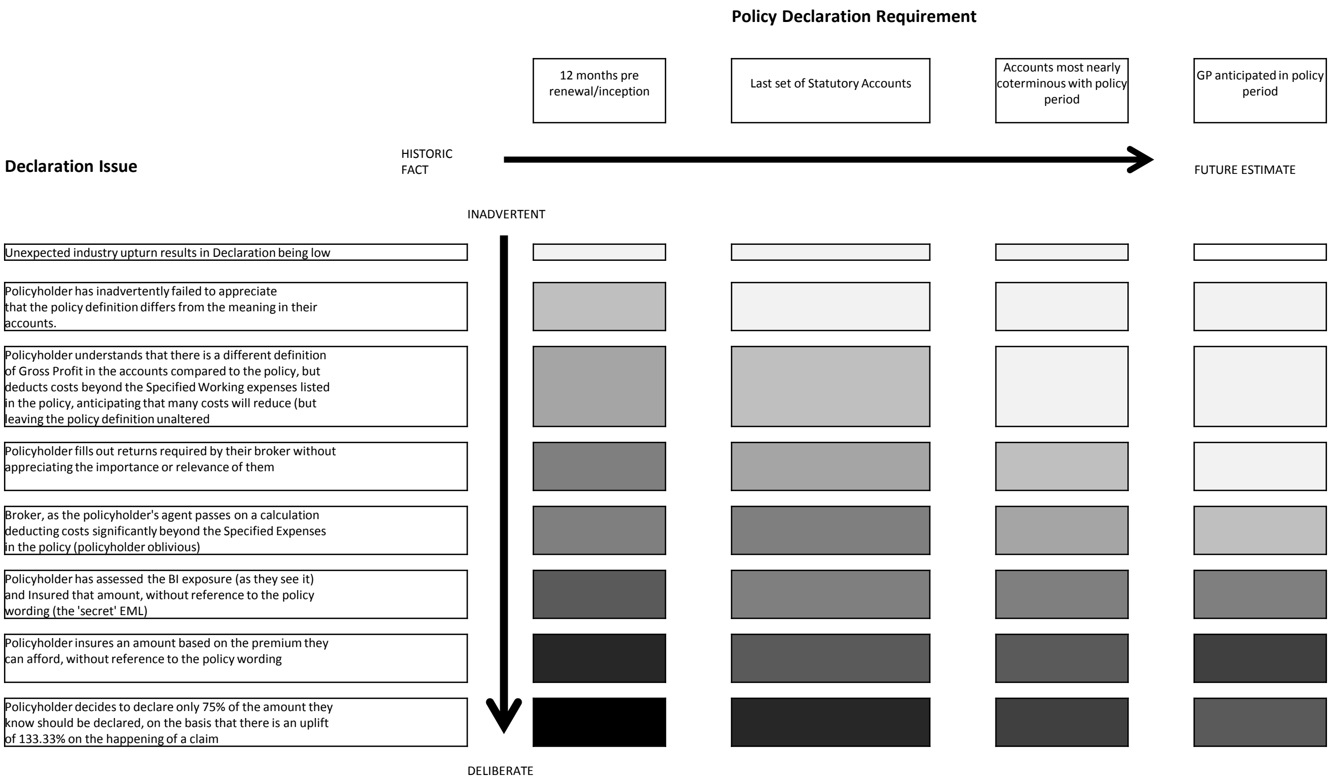
Policyholder has assessed the BI exposure (as they see it) and Insured that amount, without reference to the policy wording (the 'secret' EML)

Policyholder insures an amount based on the premium they can afford, without reference to the policy wording

Policyholder decides to declare only 75% of the amount they know should be declared, on the basis that there is an uplift of 133.33% on the happening of a claim

DELIBERATE

Fairness?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DELIBERATE

The declaration

*“**Estimated Gross Profit**…the amount declared by the Insured to the Underwriters as representing not less than the Gross Profit which it is anticipated will be earned by the Business during the financial year most nearly concurrent with the Policy period or a proportionally increased multiple thereof where the Maximum Indemnity Period exceeds twelve (12) months".*

Rescission for misrepresentation

For a representation to be a misrepresentation there must be: (1) a positive statement made by the insured to the insurer; (2) which was untrue; (3) was material; and (4) induced the insurer to give the cover for the premium that it did or on the terms or at all.(Section 20 Marine Insurance Act 1906 ('MIA 1906'), *Pan Atlantic Ins Co Ltd v Pine Top Ins Co Ltd* [1995] 1 AC 501 ('*Pan Atlantic*') and *Assicurazioni Generali v ARIG* [2002] EWCA Civ 1642 ('*Arig*').

A representation will be interpreted objectively by a tribunal: that is what would the prudent insurer have understood the representation to mean? In doing this the tribunal will look to the context in which the representation was made. *Highlands Insurance Co. v Continental Insurance Co.* [1987] 1 Lloyd's Rep 109

Statements of fact and statements of belief

Section 20 MIA 1906 makes a distinction between statements of expectation or belief and statements of fact.

If an under declaration is a statement of fact (a statement about the past or present but not the future), the remedy is avoidance, irrespective of whether the untrue statement was made innocently, negligently or fraudulently (Section 20(4) MIA 1906, *Pan Atlantic* and *Arig*).

But if an under declaration is a statement of expectation or belief, the insurer will not be able to avoid the contract unless the statement was not made in good faith; that is it was made dishonestly (Section 20(5) MIA 1906, *Economides v Commercial Union Assurance Co plc* [1997] 3 All ER 635 and *Rendall v Combined Insurance Company of America* [2005] EWHC 678 (Comm) (‘*Rendall*’)). Statements of expectation or belief include estimates (*Rendall)*.

If the declaration is dishonest either section 20 (4) or (5) or both could apply. The question is whether section 20 (4) applies if the declaration is innocent or negligent.

Is the *"Estimated Gross Profit"* purely an estimate?

Consider the components of the definition of *"Estimated Gross Profit"*:

"Estimated Gross Profit*…the amount declared by the Insured to the Underwriters as representing*

not less than

the Gross Profit (which is defined in the policy)

which it is anticipated will be earned by the Business during the financial year most nearly concurrent with the Policy period or

a proportionally increased multiple thereof where the Maximum Indemnity Period exceeds twelve (12) months".

"Anticipated gross profit" is a fact

One of the components of the "Estimated Gross Profit" is the insured's "anticipated Gross Profit".

To make the declaration of "Estimated Gross Profit" the insured must first determine its "anticipated Gross Profit", in other words, it must make a projection of its results for the coming policy period.

The process by which the insured makes that projection is a process of estimation. However, once the projection is made, its value and the way in which that value has been found are <u>facts</u>.

Typically, the projection and its composition are things that can be seen and read in a document such as a spread sheet.

The insured's declaration can be a misrepresentation of fact

What can be in issue in considering the accuracy of the insured's declaration is how the insured has used the fact of its projection.

For example, has the insured based its declaration on the correct application of the policy definition of Gross Profit to the projection it has made?

If the insured has not correctly applied the definition, its declaration will be incorrect as a matter of <u>fact</u> and thus a <u>misrepresentation of fact.</u>

As another example, has the insured based its declaration on the correct application of the indemnity period to the projection it has made?

If the insured has not correctly applied the indemnity period, its declaration will be incorrect as a matter of <u>fact</u> and thus a <u>misrepresentation of fact.</u>

Examples

An insured requires an indemnity period of 18 months, honestly estimates its anticipated gross profit for 12 months at GBP20m and declares that value. That declaration as a matter of fact is untrue because the true value of the anticipated gross profit is GBP30m.

An insured honestly estimates its anticipated gross profit at GBP5m and declares that value. In making that estimate, the insured innocently applied the rate of net profit (10%) and not the rate of gross profit defined in the policy wording (40%). That declaration as a matter of fact is untrue because the true value of the anticipated gross profit is GBP20m.

Summary and Questions