

insurance INSIDER

INSURANCE & FINANCIAL PLANNING REVIEW



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Underinsurance and General Average term

Many times for various reasons either legitimate or unfair one may make one of the most frequent mistakes in the case of insurance, i.e. he may underinsure his property subjecting himself to the General Average clause.

To understand what underinsurance and the General Average clause is, let us consider a simple example:

When you originally purchased your property and you've insured same, the latter had a certain value. In all probability your property's values is worth more or less for several reasons:

- Because of generally increased construction costs
- Because you have made additions or repairs
- Because you have enriched your household
- Due to economic crisis
- Due to upgrading / downgrading the area etc.

If the insured amount is still the same, then in all probability your insurance does not cover you completely. To find out if the above applies to your case, simply compare your insured amount with the current value of your home and your household furniture, to see if there is any difference.

In addition, underinsurance is very commonly found in the case when the property's insurance is prescribed by the bank on account of the granting of a loan. If the borrower already has part of the capital required to purchase the property, and only wants to borrow the rest of the total value, then the bank will most probably ask him to insure the property only for the loan amount. But this value will not correspond to the actual value of the property being just part of the total actual value. Hence, in most such cases, the property will be underinsured.

But why is underinsurance wrong and how is the general average term implemented?

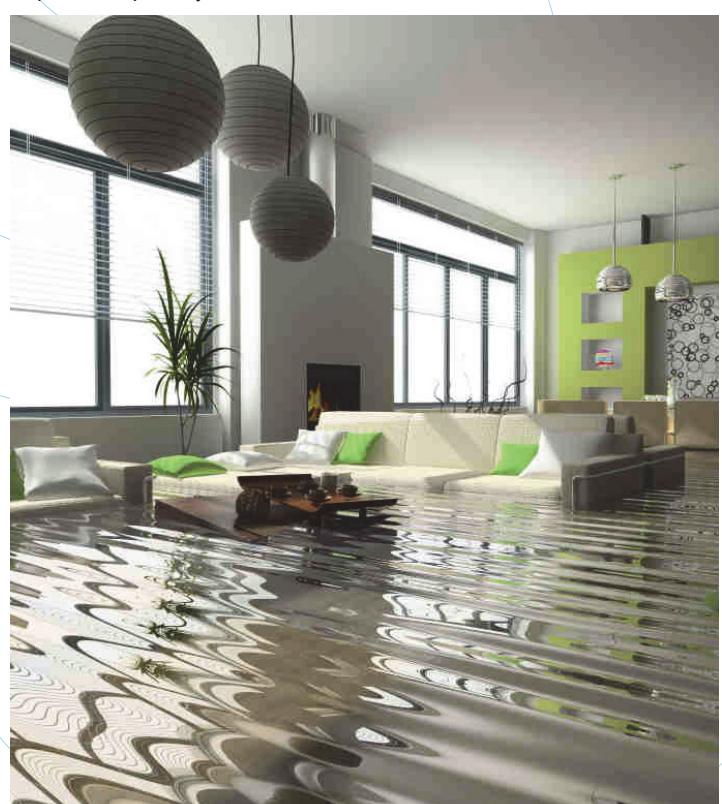
Underinsurance essentially means partial insurance and this in turn means partial compensation.

For example, if a house with its household equipment is worth € 60,000 but is only insured for €30,000, then the compensation in case of the occurrence of the insured risk will be limited to half. So if your loss value is estimated to € 20,000, then the amount that will be paid by the insurer under the insurance contract will be limited to € 10,000.

So it is worth to assume such a risk just to save a little bit on your premium? Certainly not!

Furthermore, it is worth mentioning the usual definition of underinsurance used by the Insurance Companies, as same was reviewed by the Supreme Court in the case Stylianos Michalakis and People's Insurance Co Ltd (2012):

Average: *If the property hereby insured shall, at the breaking out of any fire, be collectively of greater value than the sum insured thereon, then the insured shall be considered as being his own insurer for the difference, and shall bear a rateable proportion of the loss accordingly. Every item, if more than one of the policy shall be separately subject to this Condition».*



That is, when the insured amount of a property (e.g. a building) is kept below its real value (as will be assessed at the time of loss) then the Insured shall be considered as insurer of himself and he will bear the loss for the amount not covered by the insurance policy as same will be computed on the basis of the application of the General Average Clause or similar term, provided such clause is included in the policy. In as far as the insurance company is concerned its liability for damages will be limited to symmetrical proportions as analysed below.

For the subject matter reference may be made to the Textbook MacGillivray & Parkington on Insurance Law, 6th edition, para.2000, pp. 835 referring to the subject of under-insurance and the existence of conditions in the insurance policy known as «subject to average», or «condition of average» or «average clause». The relevant passage is quoted below:

«2000. It has therefore become the almost invariable practice for insurers to declare that the policy is «subject to average» or «subject to the undermentioned condition of average» which means that, if the sum insured does not represent the value of the property insured at the time of the loss or damage, the insured is to be his own insurer for the requisite proportion of the insurance and must therefore bear a part of the loss accordingly. In Carreras Ltd. v. Cunard Steamship Co. where the plaintiff company warehoused goods with



the defendant company at a fixed rental to include insurance against loss or damage by fire, Bailhache J. held that the so-called pro-rata condition of average was so common in fire insurances on merchandise that it must be implied as a term of the warehouse agreement. The average clause now occurs in almost all policies, except those relating to private dwelling-houses and household goods, and to a building and its contents used wholly or mainly for religious worship ».

A similar clause was examined by the Cyprus Courts in the case EAC N. American Home Assurance Co. Ltd. etc. (2003) 1 AAD 1570, the clause was as follows:

«17. If the property hereby insured shall, at the breaking out of any fire be collectively of greater value than the sum insured thereon, then the insured shall be considered as being his own insurer for the difference and shall bear a reasonable proportion of the loss accordingly. Every item, if more than one, of the policy shall be separately subject to this condition».

The Supreme Court considering the above term in light of the facts of the case stated, *inter alia*, the following:

«.... where it is demonstrated that the insured property is a total of more value than the sum insured, then the insured shall be considered as a self-insurer in relation to the difference and will bear a proportionate share of the loss.

The Court, referring to textbook ER Hardy Ivamy «General Principles of Insurance Law», 4th ed., Para. 538, identified the agreement as Average Policy and therefore in case of partial loss of insured objects, the insured may not recover the full amount of the loss within the Agreement, only such proportion as the sum insured represents the full value of the object at that time. Relative was the reference in the book MacGillivray & Parkington on Insurance Law, 6th ed., Para. 2001. The conclusion reached by the judge of first instance in this regard is that in such cases, the insurer does not pay





the full amount of the contract but part of it. The determination of the amount payable is obtained after multiplying the sum insured to the amount of value loss and divided by the sum of the actual value of the goods at the time of the accident according to the following formula:

$$\frac{\text{sum insured} \times \text{amount of loss}}{\text{real value of goods at the time of the accident.}}$$

Example:

Full value of the building (estimated) at the time of damage: € 200,000. Insured amount of the property: €100,000. Damage repair costs: €50,000

The applied formula is:

$$\frac{\text{Sum insured at the time of loss} \times \text{Cost of repairs}}{\text{Full value at the time of loss}}$$

That is:

$$\frac{100.000 \times 50.000}{200.000} = 25.000 \text{ euro}$$

Amount to be paid by the Insurance Company (Indemnification): euro 25,000

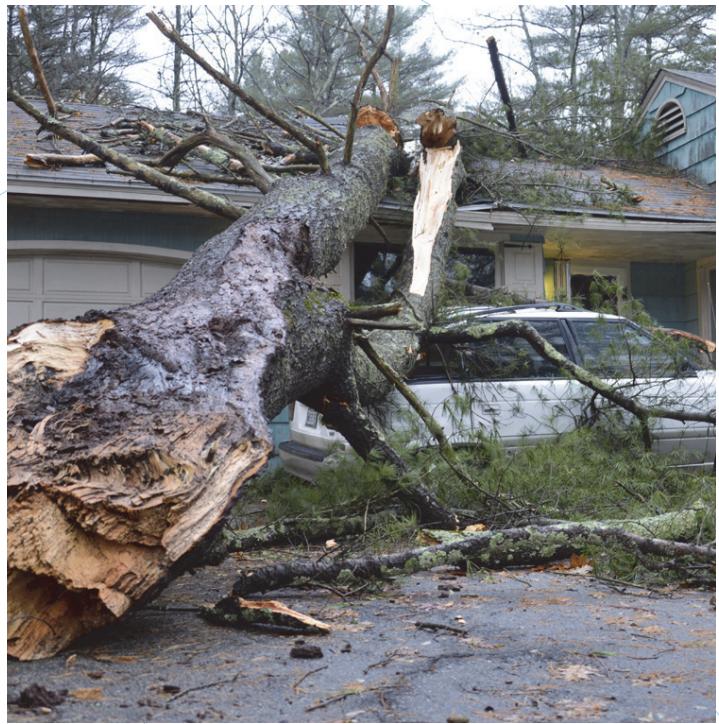
Amount to be paid by the insured: 25,000 Euro

In the example, the insured had the amount of the insured amount to 50% of the actual value of the asset, as assessed at the time of the damage. As a result, the compensation from the insurance company was limited to 50% of the cost that caused the damage and, consequently, the remaining 50% will fall on the same insurer as the insured himself.

Having regard to this very essential term of the policy means that the sum assured should always be located in the current real value to insure asset.

In the case where somebody voluntary, most probably in order to save on the premium or on account of negligence or ignorance or failure to take proper professional advice, he sub-insures an asset, either by not revising the asset's value in the insurance policy for many years although the value has increased, or by stating less value from the start then he

should be aware that he will not be fully covered and in the event of a contingency he will find **himself liable to pay** although he has insurance....



QUICK TIPS:

1. Seek the advice of an experienced estimator for proper estimation of value of your property for the purposes of your insurance.
2. Make frequent re-evaluations of the insured property and revise accordingly your insurance policy
3. Read very carefully the terms of your insurance policy. For any clarification please contact your personal insurer.

If you want any clarification or have any questions , please feel free to contact me at 22 26 96 46 or drop me an e-mail at savvas@insurancelinkcyprus.com, or fill out the enquiry form below and I will be more than happy to answer you and give you a quotation if you are interested.

Savvas P. Christoforou is a Chartered Insurer and managing director of Insurancelink Cyprus.

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