

## ***Adjusting Financial Losses***

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Speaking in Kuala Lumpur, Malaysia  
27th & 28th April 1999

### ***Introduction***

The adjuster is not a party to the contract of insurance, but is involved between the contracting parties. He is, therefore, responsible for delivering the Insurer's promise to the Insured while being alert to over-claiming from a genuine loss or even the creation of a false loss.

The aim of my paper is to discuss some of the difficulties that can be encountered when dealing with losses of a financial nature. I intend to give examples from cases that I have been personally involved with although I can assure you that none of them have occurred in Malaysia.

### ***Look Forward***

In the time available today, I would like to mention some issues and aspects related to handling financial claims, specifically, losses arising under policies covering:

- Business Interruption
- Fidelity Guarantee
- Bankers Blanket Bond

One concern that I have relating to all forms of claims handling, is the tendency for all the parties to focus on the past performance of the Insured. How the Insured grew their beans in the past is obviously important. However, it is also vital to know how they intended to grow the beans in the future. A balanced consideration of the past and the future is required. The adjuster must not let the historical data overly influence an impartial assessment of the Insured's future plans. Many organizations have faced the need to re-invent themselves in response to new markets and developments in technology.

Just because the Insured seems to have got it right in years gone by, doesn't mean their strategy for the future will lead to success.

Two classic examples help to support my point. From the world of movies, at the early part of this century, Warner, a leading film mogul said:-

"Who the hell wants to hear actors talk?"

A successful business was failing to see a fundamental change in their market. In the I.T. industry at the dawn of the P.C. age, Watson the CEO of IBM said:-

"I think there is a world market for maybe 5 computers".

Not everyone gets it right and adjusters should critically evaluate the Insured's strategy.

### ***Be Careful With Auditors***

In the current environment of litigation and down sizing, I would be extremely sceptical of reports provided by the internal and external auditors. Many cases have occurred where auditors have failed to notice a problem and it is not unusual to read of settlements being paid by auditors for professional negligence. BCI, Polly Peck and Barings are all examples showing that auditors cannot be relied on to find out the truth.

It is, therefore, important when gathering information within the Insured's company, as well as from their experts and any external sources, to adopt an approach of critical evaluation. In order to place yourself into the Insured's

position, it may be necessary to engage expert assistance to help with the evaluation exercise.

### **Back to Basics**

Just to return to basics, it is important to always bear in mind that the adjuster's role essentially involves three questions-

1. Is the claim covered under the policy wording?
2. If the claim is covered, how much should be paid?
3. If the claim is paid, can any recovery be obtained from other parties?

### **Business Interruption**

#### **Coverage**

This presentation is not a lecture on business interruption coverage. I know that you are aware of the coverage and usual extensions available under business interruption policies, and that the formula for adjusting claims under the UK form involves-

1. Loss of gross profit from lost turnover.
2. Increased costs of working to prevent a loss of turnover.

Usually the policy requires that there must have been a material damage event covered under a material damage policy.

#### **Information**

On most claims, the adjuster has to 'get up to speed' rapidly. He has to gain a rapid appreciation of the Insured's:

- Products
- Markets
- Competitors
- Internal operations
- Financial position

Decisions are often required at the early stages to keep the business operational. Information from board meeting minutes, business planning documents, maintenance schedules is often not available for sometime. In fact, if the Insured is owned by a government, it is often very difficult to ever obtain sufficient information. Armament manufacturers, nuclear programs, petrol - chemical plants are typically reluctant to disclose financial, product and strategic information, which makes reaching a settlement of the claim difficult. Multinational companies often produce their products from various different countries, usually because of the tax and production cost benefits. The system of transfer pricing that operates in such organizations, can create significant challenges, as they often have distortions relating to tax considerations rather than actual costing.

For many organizations, and particularly multinationals, a loss often provides the opportunity for a review of production and distribution strategy. A multinational glass-bottling company suffered a serious failure of a glass making furnace. The Insured quickly set in motion a transfer of production to several other of their plants within the region, ostensibly as an increase cost of working exercise. Each of the other production locations had significantly lower production costs than the location where the loss had occurred. After considerable effort, I was eventually able to obtain documents that confirmed that the Insured had, before the loss, a fairly clear intention of transferring production from the loss location due to its ever increasing costs. In effect, the Insured had not reacted rapidly to the loss, but had implemented a plan that was going to happen in any event. This information led to a significant reduction in the material damage payment and caused the increased cost of working claim to disappear.

#### **Early and Thorough Inquiries**

Insurers should expect and encourage adjusters to conduct early and extensive enquiries into the availability of alternative premises, production availability, and product suppliers.

Some years ago, I was accompanying a broker and the Insurer's risk surveyor to a major cement factory in the region. The visit was to establish a claims handling procedure. However, whilst I was actually on site, one of the major extractor fans centrifugally disintegrated. That led to the need to close down 50% of the production capacity whilst repairs were carried out. The plant director and finance manager both indicated that the costs of obtaining alternative supplies of cement from their other locations would result in an increase cost of working claim of several hundred thousand dollars. They were beginning to make contact with their other company locations to arrange for them to supply existing contracts. While they were doing that, I noticed that adjacent to the Insured's large factory site, was another cement factory, which I learnt was run by a company owned by the government. I walked around and into the other factory and asked to speak with the General Manager. He confirmed that they had sufficient stock and production capacity to provide cement to our Insured of the same quality and specification. The selling price from the government factory was less than the production costs of the Insured even taking into account some re-packaging. The outcome was that the increased cost of working claim reduced to almost nothing. I mention these two examples merely to confirm the fact that every day adjusters around the world are adopting similar approaches and that they really do need the full support of their clients if they are to be successful.

### **Recovery**

While the adjuster is still actively busy looking at the financial performance and making decisions to assist with the increased cost of working expenditure, research also needs to be conducted to establish whether there is a recovery aspect. It is not satisfactory to wait until the closing stages of the adjustment to then start pursuing a recovery. During the course of the adjustment, there will undoubtedly be areas of disagreement with the Insured over policy coverage, values and so on. Such disagreements need to be properly documented and the potential third parties should have the opportunity to make comment or at least be aware of the progress being made. Citibank NA v Lebihan, Anton Filler. TES. QBD July 1996

In 1992, I dealt with a major fire and business interruption claim at the main European headquarters of Citibank in London. Decisions within the first twenty-four hours involved significant expenditure in order to keep the global trading computer network systems operating. A recovery action was identified and several parties were placed on notice within days. However, they chose to adopt an 'ostrich' profile until legal proceedings were issued. By that time, they had lost the opportunity of participating in or at least observing the process of the adjustment. In July 1996, I gave evidence in the recovery proceedings at the High Court in London. The judgement by The Hon Mr. Justice Langley ran to many pages, but several of his comments are quoted below:-

"The consequence of the fire could hardly have been more serious and the quantum of any consequential loss claim could well have been enormous, but for the immediate emergency efforts to restore an appropriate supply and back-up. It is no surprise that considerable costs were incurred."

Justice Langley compared the close attention given to the adjustment with the lack of interest shown by the Insurer's of the third parties until proceedings had been issued. He said that:-

"The Insurers were rightly concerned to see that only legitimate claims both in principle and amount were met and not only did they keep that under careful review during the works, but they negotiated hard to limit the claims after the works were completed."

"Citibank had the adjusters breathing down its neck concerned to ensure that any enhancements or unnecessary or unreasonable expense of delay was not accepted."

In criticising the third parties Justice Langley said that:-

"A large part of the Defendant 's case, supported by their experts, involves an after the event critique of what was done and a theoretical analysis of how it might have been done differently and more cheaply. In my judgement, that needs to be examined with a measure of scepticism in a context where I have held that the Defendant 's were at fault and that fault unquestionably created very serious problems for Citibank".

In finding for the Insured, Justice Langley said that:-

"Having heard and considered all the evidence, I agree with Mr. May ".

There are several lessons from this case. If you are a liability Insurer or adjuster, you need to become involved at the earliest possible stage, obviously on a without prejudice basis. If you are the material damage / business interruption Insurer, you should consider recovery action immediately and properly document all adjustments. The adjuster's file in particular, needs to be carefully maintained, with all documentation properly recorded and indexed as it will be needed for evidence.

### ***Fidelity Guarantee.***

#### ***Staff Dishonesty***

I would now like to discuss financial losses that arise through dishonesty of the Insured's staff. The fidelity guarantee policy provides a basic protection against the effect of fraud by an Employee. This policy is generally purchased by companies where the exposure to loss from dishonesty by Employees is reasonably low.

#### ***Auditors***

It is generally an 'occurrence' wording rather than 'claims made'. Therefore, the dishonest acts must be committed during the period of the policy and discovered within a certain period after termination of the policy, often 3 months. There is, therefore, a very limited historical protection.

The adjuster must meet the internal audit personnel and also the external auditor. Whilst these people are usually relatively helpful, it must be borne in mind that they may be responsible for not discovering the problem at an earlier date. There is a need, therefore, to look beyond the reports from the internal and external auditors. If necessary, the adjuster should undertake further work especially if the size or the nature of the claim justifies the extra investigation costs.

In a similar vein, information from customers, suppliers, third parties, and even the police, should also be viewed with care and double checked. Wherever possible, facts should be verified by the process of triangulation.

#### ***Collusion***

A multi-million dollar fidelity loss that I dealt with in this region involved a major airline with several overseas offices that sold tickets. The husband of a book-keeper that worked at one of these offices was himself the managing director of a large travel agent. For several years when the external auditors sent his company a letter to confirm the outstanding balances, he signed this knowing the figures to be incorrect. Furthermore, he persuaded several other travel agents in the city to do the same. This had the result of deceiving both internal and external auditors and it was only when the book-keeper fell ill, that the loss was discovered. The national police confirmed that their enquiries had revealed that the book-keeper had 'fled the country'. However, Insurers agreed to the appointment of private detectives who found the book-keeper living at home with her mother, not far from her own house.

#### ***Prosecution of the Culprit***

There are, of course, numerous clauses in the fidelity guarantee policy, but there

is one in particular that I would like to discuss which I refer to as the 'prosecution clause'. A typical prosecution clause states:-

"The Insured shall if required by the Company forthwith prosecute the Employee or Employees for any acts insured against committed by the Employee or Employees subject to the payment by the Company, in the event of a conviction, of all expenses necessarily incurred by the Insured in such prosecution".

It is often very difficult to persuade the Insured to prosecute an Employee believed to have been responsible for dishonest misappropriation of funds. Failure to do so, is a breach of the 'prosecution clause', which is a condition precedent. The technical effect would be, therefore,

- that no claim would be payable. However, commercial considerations as between the Insured and the Employee / local community often result in a reluctance to pursue prosecution. In those circumstances, there is often a commercial settlement.

### ***Inevitability of Fraud***

It is important to recognize that no organization is free from the risk from a fidelity loss.

I have recently dealt with a theft of significant funds from the European office of one of the major firms of accountants. The theft was perpetrated over several months by the supervisor of the post room. If accountants and auditors are unable to prevent such losses occurring within their own organizations, it is clear that there is something of an inevitability which needs to be protected against.

### ***Financial Institutions***

Although fidelity guarantee losses are by no means 'small beer', they can often be significantly overshadowed by the losses that occur through dishonesty within a bank. I would like to talk about losses arising from armed robberies, obtaining funds through duress, kidnap, computer crime, use of explosives, safe cutting equipment etc. but unfortunately there is not sufficient time. I have, therefore, confined my observations to a review of the coverage available for infidelity, and some of the challenges that an adjuster faces when dealing with such claims.

### ***Confidence and Reputation***

First, I think it is important to just examine the financial sector in terms of its products and concerns. Several years ago, I rented a video for my children at a video store in a country not far from here. The video was the classic film, 'Mary Poppins'. Censorship is not uncommon, although I was very surprised to find that 'Mary Poppins' had been censored. Some of you may be familiar with the section of the film where a young boy causes a run on the bank. Well, this section had been deleted. Obviously, a loss incident at a bank may lead to customers withdrawing their funds, often in a panic. Clearly the censor felt that that section of the film presented a sufficient risk for it to be deleted. The fear is real and adjusters need to be aware of it and address it.

In Sri Lanka, after a major bomb in the city centre had affected several banking groups, I went on television to confirm that the physical damage was covered and that urgent steps were being taken to enable all banking functions and transactions to continue. It is this concern about their reputation that makes banks difficult to deal with. Their product is far more than just lending money, issuing statements and transferring funds. It is about customer confidence and reputation. These invisible aspects often make the bank's management and employees cautious in their dealings with and assistance to adjusters.

### ***Employee Fidelity***

In addition to coverage for premises and transit risks, the Bankers Blanket Bond (BBB) covers infidelity of employees. The BBB wording has been designed to meet the wide range of risks faced by banks and financial institutions and there are various wordings in use throughout the world. The adjuster must, therefore,

read carefully the wording relating to the particular loss and take nothing for granted.

### **Coverage**

Some infidelity sections will only cover losses where there is either a manifest intent of the employee committing the infidelity to obtain personal financial gain from the fraud, or where there is actual personal financial gain by the employee. Losses that arise following alleged fraud by an employee involved with loans can prove tricky. Often the employee has been seen to act outside the authority granted to him by the bank, but not fraudulently. Breaching the lending rules could have resulted in the employee receiving increased commission or even bonus payments. Technically these are not improper personal gain and the bank are required to establish whether other rewards were obtained by the employee.

Losses discovered before the retroactive date of the policy are excluded. As the policy is written on a 'claims made' basis, losses that occurred before the retroactive date are, excluded, even if they are discovered during the policy period.

The system of dual control for any transaction is of paramount importance in helping to avoid financial theft. Often the requirement for a dual control system is a condition precedent.

Trading losses are excluded, although banks quite often attempt to convince Insurers that in their view the loss was the result of alleged fraud. Often, therefore, investigation is required to establish the truth and to decide whether the claim is covered or not.

### **Recovery**

As with fidelity guarantee claims, the Insured is often reluctant to pursue recovery procedures. The delay results in the funds being transferred out of the reach of the legal system.

Relying on statements given by employees involved in fraud is fraught with difficulty. Why should the statement of a suspected thief be given any weight? However, it is not unusual to find a bank seeking to rely on the dishonest employee's statement.

Bank insurance is still one of those areas where a proposal form is quite common. The adjuster needs to obtain a copy of the proposal and check each answer.

### **Barings**

When looking at this aspect, it is worth considering some of the findings of the report of the Board of Banking Supervision inquiry into the circumstances of the collapse of Barings produced for the House of Commons in July 1995.

The report contained over 330 pages and several aspects are worth considering.

On the subject of management control and supervision, the report found that:-

"The true position was not noticed earlier by reason of a serious failure of controls and management confusion within Barings".

In relation to the need for a dual mechanism, the report considered:-

"The fact that Leeson was permitted throughout to remain in charge of both front office and back office at Baring Futures (Singapore) was a most serious failing".

To an extent, the report also confirmed the misgivings that I have mentioned earlier in this paper regarding the effectiveness of auditors. In summarising the 'lessons arising' the report found that:-

- a. "Management teams have a duty to understand fully the business they manage.
- b. Responsibility for each business activity has to be clearly established and communicated
- c. Clear segregation of duties is fundamental to any effective control system.

d Relevant internal controls, including independent risk management, have to be established for all business activities.

e. Top management and the audit committee have to ensure that significant weaknesses, identified to them by internal audit or otherwise are resolved quickly."

These are clearly points that Underwriters need to consider when evaluating a fidelity risk.

***Lack of Co-operation***

Following a loss, there is often a fear amongst employees that further investigations will either lay blame on individuals that did not deserve it, or seek to hold individuals responsible for failing to remain alert and exercise proper management supervision. The need to verify information from as many sources as possible becomes paramount.

***Concluding Remarks***

Adjusting claims under BBB policies is an extremely challenging and complex activity. The adjuster has an important role to play, not only in dealing with the claim and potential recovery, but also in providing risk management suggestions to help improve the risk.

In the time allowed, I have endeavoured to outline the challenges that adjuster's face when dealing with losses of a financial nature. There are other areas of financial loss which I have not been able to cover such as product liability, stock brokers, indemnity, other types of professional negligence etc. However, I hope that I have conveyed the message that loss adjusters are able and available to properly review and deal with financial losses around the world.