

8 October 2015

FIRE SERVICE LEVY COMPLIANCE

COMMERCIAL PROPERTY

**Guidance notes following the Supreme Court's
decision in *Fire Service Commission v Insurance
Brokers Association of New Zealand* on 13 May 2015**

EFFECTIVE FROM 13 May 2015

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Introduction

1. The calculation of the Fire Service levy under the Fire Service Act 1975 (**Act**) (payable by all property owners who insure property in New Zealand against fire) depends on the type of property and the insurance cover arranged.
2. The Supreme Court decision of *New Zealand Fire Service Commission v Insurance Brokers Association of New Zealand* [2015] NZSC 59, dated 13 May 2015, has clarified the position on calculating Fire Service levies on both composite and multi-tiered policies. The Supreme Court has overturned earlier decisions of the High Court and Court of Appeal, and previous industry practice, ruling that:
 - (a) if a fire insurance policy provides for settlement on a more favourable basis to the insured than the indemnity value of the property insured, the levy must be calculated on the sum insured (comprising both the indemnity sum and any excess of indemnity), capped at the true indemnity value of the property insured; and
 - (b) composite policies with multiple insureds will be treated as multiple policies with multiple levies attaching, unless the terms of the contract clearly treat those insureds collectively as one 'insured'.
3. This note provides general guidance to members of the Insurance Council of New Zealand as to the impact of the Supreme Court's decision, and to provide guidance on how the levy should now be calculated with respect to the Supreme Court's interpretation of section 48 of the Act.

Not legal advice

4. This document is not legal advice. Insurers and brokers should obtain independent legal advice where they have any doubts about their own compliance with the Act and how the levy should be calculated. Legal advice passed on by third parties should not be relied on without independent verification.
5. While this guidance note sets out general principles in relation to the Supreme Court decision, the basis of calculation of a levy on fire insurance policies will depend on the wording of the particular policy.

Universality of the levy

6. At the heart of the Supreme Court's decision was the focus on an outcome that would enhance the universality of the levy and on the purpose of section 48 of the Act, "to calculate a fair contribution to the costs of the fire service". The Fire Service is funded almost entirely by levies under s 48, but must provide a universal service to the uninsured, as well as the underinsured who do not pay for their 'fair share' of the services they are provided. The Supreme Court considered the importance of giving effect to the purpose of the section by saying that:
 - (a) although the Act does not contain an anti-avoidance provision, the significance of that should not be overstated; and that:

- (b) ‘...we think the nature of the levy as a charge for a universally available service is an important feature of s 48. The interpretation of the words of the section must be undertaken having regard to the fact that this section imposes a levy, in the nature of a tax, for the purpose of funding a public service. This is a strong indication that to the extent s 48 can be interpreted to enhance the universality of the levy, that interpretation should be adopted.’

7. The Supreme Court has taken a strong view that section 48 should be interpreted, insofar as possible, in such a way as to ‘enhance the universality of the levy’. This signals that a generous approach in favour of the Commission is likely in any future legal proceedings.

Beware of levy avoidance

8. While properties (truly) insured for less than their indemnity value¹ can continue to attract a smaller levy than properties insured at full indemnity value, the Courts will be critical of arrangements that appear to be structured in a way to minimise the levy.
9. Since the Supreme Court’s decision, in a letter from the Fire Service to ICNZ & IBANZ dated 2 July 2015 the Fire Service said:

The Commission is supportive of our view that any new arrangements that looks (*sic*) artificial in nature and are designed to minimise levy will be immediately investigated, and if concerns still remain, will result in immediate legal challenge.

10. Policies which appear to be structured to reduce the levy will be scrutinised by the Fire Service Commission and the courts. While there may be commercial reasons for structures that incidentally reduce the levy, ICNZ’s view is that members should treat such structures with extreme care, ensure the commercial reasons are genuine, and seek independent legal advice for compliance with the Act.
11. Because of the court’s statements as to the universality of the levy, we take the view that policy structures that minimise levy are ineffective. The only way to minimise levy is to underinsure – a decision which should not be made lightly.
12. There is a real threat of a legal challenge if the Commission discovers incorrect levy calculations. The financial risk of corrective levy payments, fines and punitive interest charges is potentially very large so it is important that the correct levies are paid.

How is the levy calculated?

13. The levy is calculated differently, depending on the nature of property, the wording of the policy and the value for which property is insured. Accordingly, it is recommended that all property is assessed individually. The basis of calculation depends on a combination of:

¹ i.e. where the maximum payable under the policy in relation to a property is less than the property’s indemnity value

- (a) the type of property (motor vehicle, residential building, personal property or all other property);
 - (b) basis of settlement (an insured sum, indemnity value or replacement value);
 - (c) whether the indemnity value has been established in accordance with the Act (declaration or valuation); and
 - (d) the sum insured.
14. The Supreme Court judgment sets out how to calculate levies for commonly available policies on commercial property described in section 48 of the Act:
- (a) Where the property is insured only under an indemnity policy that specifies a sum insured, the levy will be computed on the sum insured in the policy, even if that is below the true indemnity value of the insured property;
 - (b) Where the property is insured only under a policy that does not specify a sum insured, the levy will be computed on the indemnity value of the property determined under s 48(6)(c) (or s 48(6B) if the Commission disputes a declaration of value given under s 48(6)(c)(i));
 - (c) Where the property is insured under a policy that provides for cover greater than the indemnity value, such as a replacement policy, the levy will be computed on the indemnity value determined under s 48(6)(c) (and s 48(6B), if there is a disputed declaration);
 - (d) However, if the insured person under a policy of the kind described in (c) does not provide a declaration or valuation certificate under s 48(6)(c), the levy will be computed on the sum insured in the policy, if there is one, or otherwise in a manner determined by the Commission. That creates an obvious incentive for the insured to activate the mechanism in s 48(6)(c) by providing a suitable declaration or valuation to avoid having to pay the levy at too high a level;
 - (e) Where a property is insured under a combined indemnity policy and excess of indemnity policy no greater than the indemnity value, s 48(6)(d)(i) will apply and the levy will be computed on the basis of the combined sum (or sums). Where the combined sum is greater than the indemnity value, s 48(6)(c) will apply and s 48(7) will relieve the insured of the obligation to pay more than the indemnity value (and the combined sum is therefore 'capped' at the indemnity value of the property).

Split-tier policies

- 15. The example given in (e) above is the situation the Supreme Court considered with split-tier policies. More detail of this example is provided below.
- 16. The Court used the following hypothetical example of an insurance contract of a commercial property with the following features:

Replacement value	\$1 billion
Indemnity value	\$600 million

Indemnity sum on the policy	\$300 million
Excess of indemnity sum	\$400 million

17. IBANZ & Vero argued that the levy attached to the \$300m sum insured only. The Commission argued that the levy attached to the indemnity value of the property at \$600m. The Supreme Court agreed with the Commission.
18. The levy in this example had to be determined under s 48(6)(c), because the indemnity cover and excess of indemnity cover provide for the settlement of the claim for damage or destruction of a property on a more favourable basis than its indemnity value (in this example, the indemnity sum and excess of indemnity total \$700,000). Section 48(7) relieves the insured of the obligation to pay a levy on the combined cover to the extent that it is greater than the indemnity value of the property.
19. The indemnity value as determined by s 48(6)(c) is \$600m, so that is what the levy is calculated on.

Indemnity value lower than the sum insured

20. The calculation of the levy is capped, in most cases, on the indemnity value of the property. Where a property is insured at an amount greater than the indemnity value (such as replacement value), the levy attaches to the indemnity value, rather than the higher insured value. However, where the insured does not provide evidence of the indemnity value (either by way of declaration or valuation), the levy is payable on the full sum insured. As the Supreme Court said in its judgment, this creates an obvious incentive for the insured to provide a declaration or valuation as to the indemnity value of the property to pay the lower levy.
21. For example, if the policy sum insured is \$10m and the declared indemnity value is \$5m, then the levy is only payable on the \$5m value. The indemnity value must be supported by either (1) a declaration signed by the owner that the indemnity value declared by the owner is a fair and reasonable indemnity value in relation to the replacement value of the property, or (2) a suitable professional valuation certificate which establishes clearly the indemnity value of the property for the purposes of the levy.

By way of example, the basis of the levy calculation with a valid signed declaration or valuation certificate for various sums insured would be as follows:

Sum Insured	Indemnity value	Amount on which levy is calculated
\$10m	\$5m	\$5m
\$7m	\$5m	\$5m
\$5m	\$5m	\$5m
\$4m	\$5m	\$4m
\$1m	\$5m	\$1m

22. If the declared indemnity value is not supported by a suitable professional valuation or the property owner does not provide a signed declaration confirming the indemnity value then the levy must be charged on the policy sum insured.

Policies with multiple risks

23. Referring to the Act (and using the criteria established by the Supreme Court ruling) the Fire Service levy calculations can be made given the following examples below:

Property Insured	RV Sum Insured	IV Sum Insured	Declaration or Valuation	Fire Service Act reference	FSL	Notes
Residential House	\$500,000	n/a	n/a	48(6)(a)	\$100,000 x .076%	A cap of \$100,000 applies for residential property (Earthquake Commission Act 1993, s 18)
Personal Contents	\$50,000	n/a	n/a	48(6)(b)	\$20,000 x .076%	A cap of \$20,000 applies for personal contents (Earthquake Commission Act 1993, s 20)
Commercial contents and/or Building	Full RV	\$500,000	Yes*	48(6)(c)	\$500,000 x 0.76%	
Commercial contents and/or Building	IV only	\$500,000	n/a	48(6)(d)(i)	\$500,000 x .076%	
Commercial contents and/or Building	\$1,000,000	\$500,000	Yes*	48(6)(c)	\$500,000 x .076%	
Commercial contents and/or Building	\$1,000,000	\$500,000	No	48(6)(d)(i)	\$1,000,000 x .076%	
Commercial contents and/or Building	IV only	No sum insured	Yes, declared at \$500,000	48 (6) (c)	\$500,000 x 0.76%	

* This is made on the assumption that the declaration or value is equal to the indemnity value written on the policy.

Would applying fire-only sum insured or a loss limit change the fire service levy calculation?

24. The levy applies to contracts of fire insurance. The fact that other risks are insured under the same policy for different amounts should not affect the levy. For example, if a property is insured for “fire only” at a sum of \$500,000, but the property is insured for other damage at the indemnity value of \$1,000,000, the fire service levy is only payable on the lesser sum of \$500,000.

25. This is justifiable because the current legal framework allows for the levy to be paid on the sum insured, even where that sum is less than the indemnity value of the property. The levy payable is proportionate to the level of fire insurance taken out on the property (subject to the qualification that the indemnity value acts as a maximum) and the insured bears the risk of being underinsured.
26. Whether a loss limit (such as a monetary cap on the amount of loss that can be claimed in any one event) affects the fire service levy calculation will depend on the terms of the particular policy. The Supreme Court has taken a purposive approach to interpretation, and put more emphasis on the substance of the basis of settlement (the true amount the property is insured for), rather than its form (i.e. the way the insurance payments are structured).
27. The Fire Service Commission has recently stated its view as to the meaning of “sum insured” under the Act. In a letter to ICNZ dated 18 September 2015, the Commission says:

““sum insured” should be interpreted to mean the amount of cover available in the event of fire (or fires) during the period of insurance. Note that cover may be available for more than one event and in this regard the sum insured is not the same as a “per loss limit”.”

...

“In giving effect to this approach, the Commission will look to substance over form. Regardless of the specific wording used, if an insurance policy contains a clause that genuinely limits the cover available in the event of loss caused by fire throughout the entire insurance period to an amount beneath the indemnity value of the insured property, levy will be payable on that amount.”

These comments reinforce the view that the only way to minimise exposure to the levy is to underinsure.

28. A loss limit in a fire insurance policy may have following effects:
- (a) For commercial property insured on a replacement value basis (cover greater than indemnity value), the basis of calculation is the indemnity value (s.48(c)). Therefore any loss limit applied on the policy does not affect the calculation so long as the loss limit is higher than the indemnity value.
 - (b) For commercial property insured on an indemnity basis, the levy is calculated on the sum insured (s.48(d)). So a loss limit on a policy would not affect the levy calculation if the loss limit is at least as high as the sum insured declared for the property.
 - (c) The Supreme Court’s judgment does not directly answer the question whether a loss limit which is lower than:
 - (i) the indemnity value of the property, in a replacement value policy; or
 - (ii) the sum insured declared for the property, in an indemnity policyshould be regarded as ‘the amount for which the property is insured’. We note the Commission’s comments at paragraph 28 above.

Composite policies

29. Composite policies with multiple insureds will be treated as multiple policies with multiple levies attaching, unless the terms of the contract clearly treat those insureds collectively as one 'insured' (that is, with joint liability for the premium and cancellation rights, etc.).
30. The Supreme Court found that a contract insuring eight individual companies under one policy wording, with one premium and one joint sum insured, was to be treated as eight separate contracts for the purposes of calculating the levy.
31. The following factors persuaded the court:
 - (a) The insured ports had a commercial association with one another but no interest in each other's insured property.
 - (b) There was no evidence of joint responsibility to pay the premium as the premium was calculated separately for each insured and then aggregated (with a group discount); the ports were invoiced separately; and there was a term in the policy requiring it to be interpreted as though issued separately to each insured.
 - (c) It was unclear whether cancellation rights applied to each port individually or whether cancellation could only happen if all eight ports (as the collective 'Insured') gave notice.
32. The Courts' findings meant that eight separate levies were payable. Each insured's levy would be calculated on the indemnity value of their property insured.
33. Composite policies will not always be treated as separate policies and it will be a matter of analysis in each case to determine whether the levy needs to be assessed individually for each separate interest, or whether the levy can be paid on the composite policy as a whole.

Residential & commercial mixed property requires separate calculation

34. Levies applicable to residential property are separately calculated under the Act. Any calculation of an aggregate levy on commercial property will not apply to residential property.

The Supreme Court decision will not be enforced retrospectively

35. The Fire Service Commission has confirmed that it will not be seeking to apply the Supreme Court's decision retrospectively.
36. Levy calculations in relation to any policies arranged after 13 May 2015 will need to conform to the Act as interpreted in the Supreme Court's decision of 13 May 2015.