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EDITOR'S NOTE

In an industry driven by details, can less ever be more? It can when it means using fewer specifics in defining coverages. An interesting discussion of how employing broader language in a policy can ultimately serve the insured's best interest leads off this issue of Adjusting Today*.*

Our second article examines claims involving replacement cost coverage, including the special considerations that must be applied in these situations if the coverage is to work as intended.

It's reading you will find to be interesting, informative and practical!

Sheila E. Salvatore
Editor

Sometimes It's What the Policy *Doesn't* Say That Counts!

As insurance professionals, ours is a business in which being specific is desirable. Usually it is in everyone's best interest to make sure that a property insurance policy is specific as to the insureds and to the type of property being insured. Sometimes, though, being too specific in these areas can actually remove coverage.

A Case Study

A case in point happened several years ago when an insured corporation was unable to recover a substantial portion of lost property because they could not prove that they had an insurable interest in the property. Their inability to provide proof was directly related to the way in which the insured was named and described in the policy. They were further hampered because the property description was not broad enough to indicate a relationship between the insured and the lost property.

The insured firm was enjoying a period of rapid growth. At some point in time, its shareholders (using an associated company) purchased another corporation and stored part of its property in the insured's warehouse. This information was not transmitted to their agent/broker for insurance purposes, nor was any other coverage in force on the property.

When the loss occurred, the insured included the stored property on their claim. Unfortunately, the property was quite clearly owned by an uninsured separate legal entity (notwithstanding the common shareholding) not named on the policy and which could not prove insurable interest under the policy, even though the property fell within the description on the policy schedule. There was no qualification of ownership or responsibility included in the description that could have created a link to the named insured!

> **"Their inability to provide proof was directly related to the way in which the insured was named and described in the policy."**

Ultimately, the missing coverage was caused by the fact that the named insured was limited to a specific entity and the property description in the policy did not include any coverage for property not owned by that entity.

Insurable Interest

The relevance of insurable interest in property insurance policies is usually described in the policy with wording such as *"We will not pay you more than your financial interest in the Covered Property."*[1] The insured must have some form of recognizable interest in the property. In the benchmark case of Lucena V. Craufurd (1806), legal precedent for insurable interest was set and explained, in part, as follows:

"A man is interested in a thing to whom advantage may arise or prejudice happen from circumstances which may attend it. Interest does not necessarily imply a right to the whole or part of a thing, nor necessarily and exclusively that part which may be the subject of privation, but having some relation to or concern in the subject of the insurance which relation or concern may be so affected as to produce a damage, detriment or prejudice to the person insuring."

Even though the precedent is in archaic language, it is still relevant and does allow some latitude to interests in property other than just pure 100 percent ownership. This permits insurers, agents and brokers to use definitions and interpretations that are as wide as possible to accommodate the variations of interest that occur between ownership and property owned.

> "Unfortunately, it is too often only after a loss occurs that the agent/broker learns what he or she should have known previously!"

Business Factors

Definitions and interpretations that are very broad in connecting insurable interest are particularly applicable in providing insurance for corporations for several reasons:

1. By its very nature, a corporation is in business to do business, not to buy insurance. Consequently, business decisions are not normally based on insurability. Operations call for a wide range of activities, some of which change daily, and this depth and diversity can have a dramatic effect on insurable interests. The interest of the corporation in some of the property in its possession will not always be clear and straightforward.

2. The period of insurance — normally 12 months — provides more than enough time for changes to occur between the policy's inception and expiration dates. New insurable interests will emerge; old ones will disappear; and still others will become hard to distinguish, falling into "gray areas."

3. Complicating these changes in insurable interests is the matter of communicating them to the insurance agent/broker. Too many of them will confirm that they are usually the last to know of potentially significant changes in a company's operations. The firm's attorney will know; so will its financiers (they always know!) along with, it seems, everyone else. Unfortunately, it is too often only after a loss occurs that the agent/broker learns of what he or she should have known previously!

What Can Be Done?

The claim failure in the case study noted at the beginning of this article was influenced by a combination of the business factors and by the fact that the property insurance policy was not properly constructed. Of course, even the most professional agent/broker cannot predict or hope to deal with all of the possibilities or eventualities that can affect a corporation's insurable interests. But he or she can prepare to circumvent potential problems, and therefore greatly reduce the client's exposure to rejection of claims by defining the named insured and describing the property covered in ways that are as broad as the insurer will accept.

Broadening the Named Insured

The following language is representative and has been seen often as an endorsement in property policies to broaden the named insured. It avoids the problem of having to continually add new entities during the policy period for an active corporation. It would have provided coverage for claims which would have been denied if more precise or specific language (such as an outdated list of entities) had been used.

"XYZ Corp. Ltd., and/or Subsidiary Companies and/or Associated Companies and/or Affiliated Companies and/or Directors/Shareholders acting on behalf of the aforementioned for their respective rights and interests."

This definition is particularly useful for corporate groups where there is movement of property by what are essentially bookkeeping entries between the various companies and/or shareholders; or where a client creates new subsidiaries and divests existing insured property to them during the current insurance year.

The Challenges of a Broad Named Insured

As is usually the case, while this language may solve a host of insurable interest problems, it may also open up other challenges that must be addressed.

The agent/broker and insurer must know what could potentially be covered by such a broad grant of coverage. Is the corporation one which will stay primarily in one area of expertise or will it branch out to all kinds of businesses? For example, the coverage and underwriting considerations faced by a manufacturer of plastic spoons who buys other plastic cutlery makers would differ from those the firm would face if it bought shoe manufacturers. Additionally, the corporation would have to be a trusted client to be sure there is no moral hazard in potentially shuffling and/or not disclosing property.

"The agent/broker and insurer must know what could potentially be covered by such a broad grant of coverage."

Perhaps the biggest challenge on a policy with this broad named insured would be getting the total property valuations correct. As entities are added, the policy valuations could easily become inadequate. This, in turn, would create major coinsurance problems at the time of a loss; or in the worst case scenario, it could mean inadequate limits to cover losses the same as if all the entities were not covered. Ideally, this broad named insured wording should be coupled with some mechanics to be sure the property limits started and stayed adequate. For one, the limit could be selected at the maximum potential loss with a reporting provision allowing the insured to report actual values (and be charged for them) as they went along during the year. Agreed value provisions and tailored value provisions could also be used.

Broadening the Property Definition

While not as common as changing the named insured, there are still a few policies that may need broadening in the definition of covered property. One that has been seen is:

"Property of the insured or held by them in trust or on commission or in their custody or control or for which they are responsible as described under…"

This effectively widens the scope of the relationship between the policyholder and the property insured, and attempts to provide coverage on any property that comes into the possession of the insured.

Challenges of a Broadened Property Definition

In the case of policies issued in the United States, this type of definition would rarely be used because the standard commercial Building and Personal Property Coverage Form (CP 00 10 06 07) includes personal property of others that is in the named insured's care, custody or control and located on their premises. Additionally, there is some limited additional coverage for newly acquired property built into the policy. Therefore, a broadened definition of property would probably be relegated to something very exotic, which normally should be covered in a marine or special form.

In other countries this definition may still be useful based on the local policy language. But as with the broadened named insured, accurate valuation may become a major headache for the policy constructors.

Being Proactive

Suffice to say that these definitions or similarly general definitions can play an important role in helping a corporation avoid the predicament in the case study — inadequate reimbursement due to coverage that was too narrowly defined. On the other hand, they bring their own significant challenges. The benefit is that they will allow all parties to think about the possibilities and provide an opportunity to address the insurable interest dilemma proactively initially or at renewal, rather than after a claim.

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[1]This is the language incorporated in the standard U.S. ISO Building and Personal Property Coverage Form (CP 00 10 06 07) but would be common in some related form in most property contracts in all countries.

"… these definitions or similarly general definitions can play an important role in helping a corporation avoid the predicament in the case study — inadequate reimbursement due to coverage that was too narrowly defined."

The Replacement Cost Claim: It's Just Like Any Other, or Is It?

Replacement cost coverage is designed to protect a policyholder who has an insured loss from having a reduced financial recovery due to depreciation of the damaged property. Replacement cost coverage will pay the costs to repair or replace damaged property by a covered cause of loss without a deduction for depreciation.

For a number of years, replacement cost was provided on a guaranteed basis — meaning that if the replacement costs exceeded the limits, the company would pay. Today there are a few companies that still offer homeowners policies and business owners policies with replacement cost on a guaranteed basis. The majority offer replacement costs on an extended basis that restricts the amount the company will pay to 25 percent to 50 percent above the policy limit.

While the coverage seems to contradict the principle of indemnity — by enriching rather than restoring — most professionals in our business understand that correctly administered replacement cost coverage works to the advantage of both the insured and the insurer. Less established, however, is understanding how to handle replacement cost adjustments. Some of this lack of understanding is due to the fact that the coverage is relatively vague.

The term "replacement cost" is not defined under the definitions of standard commercial property and homeowners insurance policies.[1] Words not defined within the policy are interpreted by their ordinary, plain and usual meaning. Courts have ruled that policy language should be interpreted in the manner that an average person would understand it.[2]

Misconceptions and ambiguities exist. The intent of this article is to clarify some of them — by discussing replacement cost coverage from a claims perspective!

Enrichment vs. Restoration

The principle of indemnity as applied to insurance holds "the policy should not confer a benefit greater in value than the loss suffered by the insured."[3] It is to restore the insured to the conditions they were in prior to the loss. Since damaged property can most often only be replaced with new, one might feel that an insured actually benefits by getting new property in place of old. It was out of this concern — to be consistent with the indemnity requirement — that the concept of depreciation was established.[4]

Replacement cost coverage does not unjustly enrich the policyholder for three important reasons. First, the loss is fortuitous to the insured, thus neither foreseen by nor deliberately caused by the insured. Second, prior to the loss the property was providing a functional service for the insured and by replacing the item, the insured is being returned to the same position. Third, the insurer is compensated for the additional coverage granted because premiums are based on the higher replacement cost values rather than the lower actual cash values.

Please bear in mind that in the examples cited, the policy's limit of liability is always the maximum level of recovery for the insured. Also note that we have not considered "guaranteed replacement value," which may permit a recovery that exceeds the stated limit of liability.

180 Day Requirement

A common misconception involving replacement cost coverage is that the insured has 180 days to make repairs. This is not the case! When a loss occurs the insured can request a payment based on the actual cash value (ACV) and still retain the option of replacement cost. To keep the replacement cost option open, the insured merely needs to notify the insurer within 180 days of the loss date that the property will be repaired or replaced. The policy language does not specify the method, manner or format of the notification. To eliminate the possibility of misunderstandings and/or a missed deadline, a best practice is to notify the insurer in writing of the insured's intent to exercise the replacement cost option upon being retained to perform the adjustment of the loss.

As for the time limit actually allowed for making repairs, courts in several states have ruled that the insured has a reasonable time in which to repair or replace the property. What is reasonable is based on the individual characteristics and circumstances surrounding the specific loss.

It should be noted that some policies, such as older editions of the ISO Homeowners 5, do contain a condition in the replacement cost provision to make repairs within one year from the date of loss. There is also at least one carrier that has other specific time limitations, e.g., 180 days after receipt of the ACV payment.

The Holdback

One of the basic principles of replacement cost insurance requires that the insured not receive the replacement cost amount until the property is actually repaired or replaced and done so within a reasonable time frame.

"Courts have ruled that policy language should be interpreted in the manner that an average person would understand it."

Generally, the insured is not in the financial position to begin the repairs or replacement. As a result, the insured first collects the depreciated or actual cash value amount. When the property is repaired or replaced, the insured can collect an additional amount that is equal to the difference between the repair/replacement cost and the depreciated or actual cash value amount. This amount of money withheld is customarily referred to as a "holdback" or "retainage."

A common solution, at the time of settlement, is for the insured to sign — in addition to the proof of loss — a statement as to full cost of repair or replacement, spelling out the amount that may be collected later as the replacement cost claim.

Replacing Elsewhere

Policies normally state "… we will pay the cost to repair or replace, after application of any deductible and without deduction for depreciation, but not more than the least of the following amounts:

1) The limit of liability under this policy applying to the lost or damaged property
2) The cost to replace the lost or damaged property with other property
   a) of comparable material and quality; and
   b) used for the same purpose
3) The necessary amount actually spent to repair or replace the lost or damaged property"[5]

Item 2 is often misunderstood to mean that the insured has to replace property with an identical building at the same site. This clause only serves to establish the theoretical cost to repair or replace the damaged property with like kind and quality at the insured premise. It establishes the limit of liability for the replacement value at the insured site, not the replacement values at another site.

For example, the costs used in determining replacement cost for a loss in Albuquerque, New Mexico, would be the cost of rebuilding or repairing that property in Albuquerque — not Honolulu, Hawaii, if the insured elected to rebuild there. The insured may replace the property in Honolulu, but their recovery cannot exceed the theoretical cost to repair or replace the property in Albuquerque.

The courts have long supported an insured's option to rebuild elsewhere. In Blanchette v. York Mutual Insurance Company, 455A2d 426 (Me. 1982), where the insured was not able to rebuild on the property and the insurer tried to hold that the insured could not recover replacement cost dollars, the court ruled that building elsewhere did constitute replacement under the insurance policy. Current ISO policy forms incorporate the option to build elsewhere by stating, "If a building is rebuilt at a new premises, the cost described in (2) above is limited to the cost which would have been incurred if the building had been rebuilt at the original premises."[6]

Buying Rather than Rebuilding

Does the insured have to rebuild to collect replacement cost — or can they buy an existing building somewhere else? The ISO policy forms provide "… The amount actually spent that is necessary to repair or replace the lost or damaged property."[7] A key phrase is "amount actually spent." It is the responsibility of the insured to provide the documentation establishing the historical cost and the capital improvements and/or repairs/upgrades made to the property. Another key phrase is "repair or replace." It does not say specifically "rebuild." Replace can be to rebuild or to purchase another existing property. The choice belongs to the insured. The courts have ruled that the insured does not have to build or repair, but may purchase an existing property and still qualify for replacement cost.

It is important to keep in mind, however, that not all costs associated with the acquisition of the new property may be eligible for coverage. As the policy refers to "the lost or damaged property," insurers do not generally include the land value in a replacement cost transaction. There is debate if the closing costs can be included or not. One can reason that the property cannot be purchased without incurring closing costs. Therefore, the insured can elect not to repair or replace (rebuild) the existing lost or damaged building.

What if Replacement is Less than the Available Limits?

The insured is limited in recovering the theoretical cost of what it would take to repair or replace the lost or damaged property with property "(a) of comparable material and quality; and (b) used for the same purpose"[8] on the same premises. Of course, this assumes that the amount does not exceed the applicable limit of insurance. Remember — the amount actually spent to replace the property does not always become the threshold for recovery.

Sometimes, if the cost of the replacement property is less than that which was lost, the insured may elect to add improvements or enhancements to the replacement building. The insured must actually incur the costs for these additions and they must be permanently attached to and part of the building structure.

For example, the insured's original building consisting of 4,000 square feet had a replacement cost of $100,000. The ACV was agreed to be $75,000. If the insured decides to rebuild only 3,000 square feet for a cost of $75,000, the insured could add a large front porch, handicap accessible ramps, and expanded bathroom facilities that were not part of the damaged building, and receive an additional payment up to $25,000. It is important to remember that the dollars must actually be incurred on the physical upgrades.

An interesting option related to this is whether the insured is limited to purchasing one building only. There are several losses in which the insureds acquired several buildings to replace the one lost — to qualify for all available replacement cost dollars.

Be Careful of Values and Coinsurance Requirements!

One of the most important things to watch when purchasing the policy for replacement cost coverage is to have an adequate amount of insurance. If the policy contains an 80 percent coinsurance clause to qualify for full replacement cost benefits, then the insurance requirement is based upon 80 percent of replacement cost of the property of like kind and quality.

Newer ISO forms make the valuation method used (replacement cost vs. actual cash value) the option of the insured and the coinsurance application would follow accordingly. In the example above, the actual cash value claim yields a larger recovery than the replacement cost claim; consequently, the insured should not elect replacement cost in this case.

EXAMPLE:

Insurable Replacement Cost Value:	$2,000,000
Insurable Actual Cash Value:	$1,700,000
Replacement Cost Loss:	$ 100,000
Actual Cash Value Loss:	$ 90,000
Insurance Amount:	$1,000,000
Coinsurance:	80%

Actual Cash Value Settlement with Coinsurance

$$\frac{1{,}000{,}000}{80\% \text{ of } 1{,}700{,}000} \times 90{,}000 = \$66{,}176$$

Replacement Cost Settlement with Coinsurance

$$\frac{1{,}000{,}000}{80\% \text{ of } 2{,}000{,}000} \times 100{,}000 = \$62{,}500$$

The insured must remember, however, that simply endorsing the policy for replacement cost coverage is not sufficient to keep it in line with actual replacement costs; the limits must be increased as well.

How is Replacement Calculated when there are Many Items?

As stated previously, the definition of what constitutes replacement is very vague in most insurance policies. Therefore, it is what a reasonable person would expect. In other words, if the insured can reasonably expect recovery, they are entitled to it.

In the majority of today's policies, it is the insured's option to select replacement cost or actual cash value. In a building claim, it is best to use an itemized estimate and not a lump sum estimate. This would allow the insured to replace the carpet with hardwood flooring and collect that portion of the hardwood that equals the cost to replace with carpet. Experience has shown that a larger payout is achieved when each item is identified and separate calculations are made.

When making claim for contents, the insured retains the option to make the replacement cost claim decision on an item-by-item basis. An example involved a contents loss for a school district that carried replacement cost coverage on its contents. Not all of the items lost were replaced, and the amount actually spent by the insured replacing those that were was less than the total actual cash value of all items lost. It was requested that the insurers pay the full replacement cost on those items that were replaced on an item-by-item basis.

At first, the insurer resisted because the insured had not spent the total amount of the actual cash value claim. In other words, each item stands on its own. Those that are replaced qualify for replacement cost. Those that are not replaced are paid on an actual cash value basis. As items are replaced individually, the line-by-line depreciation holdback should be paid to the insured, even if the dollars are spent on items different than those lost. The insurers resisted, so the question was posed to the editors of *FC&S Bulletins,* who provided the following response — which helped convince the insurer to accept the approach:

"An insured who has coverage for replacement is not required to replace each and every damaged item in order to receive replacement cost. … The insured is not required to replace every item that was involved in the original statement. Nor is the insured required to use any part of the ACV recovery on any one part of insured property to pay for all or part of the replacement cost of another item of insured property." *FC&S Bulletins Q & A 811.*

What Constitutes Replacement?

Nowhere in the policy is the insured required to replace with identical kind and quality. In some policies, the wording used is "like kind and quality and for like use"[9] and in others, "comparable material and quality; and used for the same purpose."[10] The words "like" and "comparable" do not mean "identical."

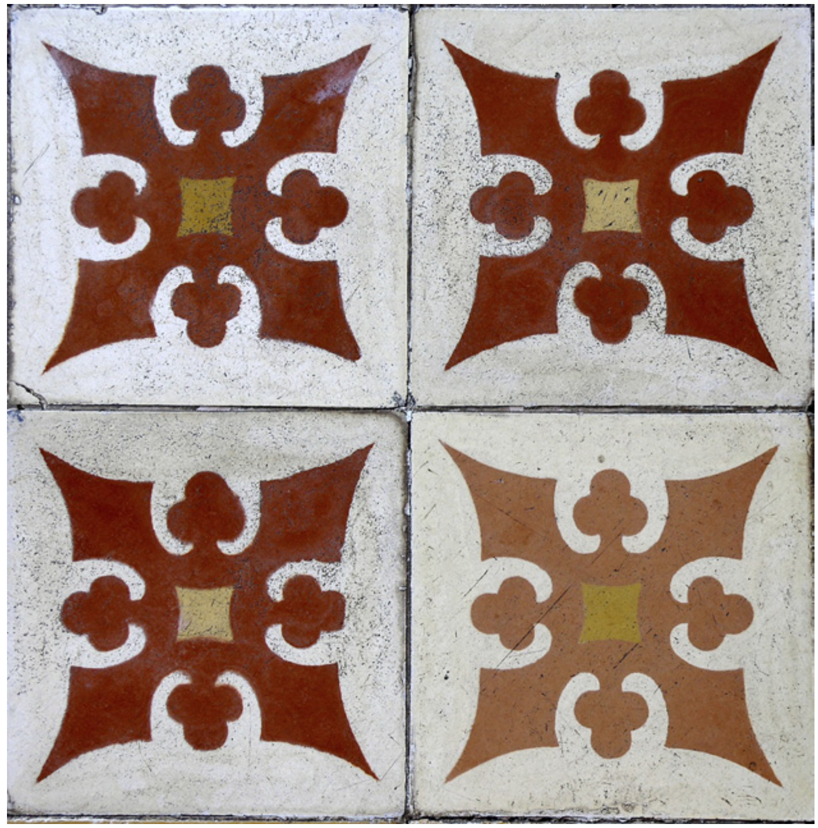
An insured who lost a milk pasteurizing plant bought an orange juice plant to replace it. The insurers agreed that this met the requirement of the insurance policy and paid the claim based on the cost to replace the milk plant. Both types of plants had the purpose/use of processing products; just different products — milk vs. orange juice.

Limit the Holdback

In prudent claim handling, the amount of depreciation withheld should always be kept to a minimum. Doing so leaves fewer points open for discussion and/or reduces the problems later on. Just as important, when funds are withheld, the insured does not have use of them until and unless they meet the policy requirements. As a result, they must fund the actual replacement themselves before they can make claim for the holdback amount.

The Issue of Functional Replacement Cost

On one claim, the homeowner suffered a costly water loss when the refrigerator ice maker malfunctioned with a slow leak over time. The kitchen and adjoining dining room flooring had hand-painted imported tiles installed when the home was built in 1926. Amazingly, it was still possible to order similar tiles, but at considerable cost. The insurance company adjuster suggested that the homeowner accept a functional replacement flooring tile which, while of high quality, was not hand painted nor imported, each tile being unique. The tile suggested by the insurance company would have cost substantially less. Here the insurance company wanted to substitute the higher replacement cost value with the lesser functional cost value.



The concept of functional replacement is to replace the damaged property with property that performs the same function. One of the most common examples is replacing a damaged wall with drywall instead of with plaster. Unless there is a specific statute or policy provision, the insured is entitled to replacement cost value under a replacement cost policy.

There are policies that contain a provision for functional replacement cost. Most often, one finds this provision on older buildings with very ornate and/or obsolete features (i.e., lathe and plaster walls). The building can be repaired using today's common construction materials and methods, while retaining the same functionality for the owner. Another example is when a business occupies a building but no longer uses the top floor or back extension. If a fire destroyed the building, it could be rebuilt without the top floor and back extension, giving the business owner the same functionality.

Personal computers, televisions and other electronic devices may be replaced on a functional basis. For instance, an insured's damaged personal computer is three years old and still very functional, but the model is no longer available and current models have additional features with enhanced storage capabilities at less cost than what the insured originally paid.

Walk-Away

Sometimes the insurer and insured will entertain what is commonly known as a "walk-away" or negotiated settlement. This means both have agreed to a settlement figure that is somewhere between actual cash value and replacement cost. In accepting the figure, the insured agrees not to make a supplemental claim for replacement cost at a later date. This can be a win-win situation: the insured wins because they have use of the money up-front and do not have to buy items that they choose not to replace. For the insurer, besides saving money, this arrangement also saves a lot of time, accounting, and adjusting red tape.

In the final analysis, replacement cost coverage is both a desirable and necessary part of today's property insurance programs. The replacement cost provision will not live up to its potential, however, unless all conditions of the policy are met by both the insured and insurer. Good underwriting and well-established values that are kept current are essential.

Just as important, knowing what you can and cannot expect from the policy's coverage before a loss occurs is critical to helping the insured manage their risk. It's also extremely valuable during a property loss adjustment in maximizing recovery.

Replacement cost coverage was developed to serve both insureds and insurers. But like all of the provisions in the policy, the degree to which it benefits each depends on how well it is understood and then applied when the insurance is called to deliver!

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[1] For example, Insurance Services Office (ISO) Commercial Property Form CP 00 10 06 07 and Homeowners HO 00 03 10 00 and American Association of Insurance Services (AAIS) Commercial Property Coverage CP-1 ED 1.0 Building and Personal Property Coverage Part CP-12 Ed. 1.0.

[2] "The language of the policy is to be interpreted in accordance with the way it would be understood by the average person, rather than in a technical sense." Weyerhaeuser Co. v. Aetna Casualty and Surety Co. 123 Wash. 2d 891, 874 P., 2d 142 (Wash. 1994).

[3] Black's Law Dictionary, 7th Edition, p. 773.

[4] It should be pointed out that many courts have ruled that depreciation should not be taken when there is a partial loss. "Under the policy language, the cost of (repair, replacement) that you may consider is the cost of (repair, replacement) with material of like kind and quality within a reasonable time after such loss. In that calculation, you are concerned only with the cost of restoring the building to its condition prior to the fire, and depreciation plays no part." Pattern Jury Instruction PJI 4:49.

[5] ISO Building and Personal Property Coverage Form; CP 00 10 06 07; p. 14 of 14.

[6] ISO Building and Personal Property Coverage Form; CP 00 10 06 07; p. 14 of 14.

[7] ISO Building and Personal Property Coverage Form; CP 00 10 06 07; p. 14 of 14.

[8] ISO Building and Personal Property Coverage Form; CP 00 10 06 07; p. 14 of 14.

[9] ISO Homeowners 3 – Special Form HO 00 03 10 00; p.13 of 22.

[10] ISO Building and Personal Property Coverage Form; CP 00 10 06 07; p. 14 of 14.

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