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FROM THE EDITOR

Paying a lower premium than they would for full replacement cost insurance while believing they will still be able to restore original functionality to their property after a loss can make functional replacement cost coverage an attractive alternative to many insureds.

It's not that simple, however. As author Joseph Harrington explains in this issue of Adjusting Today, *an understanding of insurers' different obligations under — and interpretations of — this coverage is essential to projecting how it would restore a given property that is damaged or destroyed.*

In his discussion, he reviews the evolution of functional replacement cost coverage and looks at its application in the homeowners, commercial building and personal property arenas. It makes for interesting and informative reading.

Sheila E. Salvatore
Editor

Functional Replacement Cost: Its Origin, Evolution and Application

By Joseph S. Harrington, CPCU, ARP

At first glance, functional replacement cost (FRC) coverage can seem very attractive.

Unless the implications of FRC are fully explained to them, however, all that most insureds are likely to comprehend is that they will be able to replace damaged property for a lower premium than with "full" replacement cost coverage. The fact that the insurer can insist on repairing or replacing property with less appealing but "functionally equivalent" materials and workmanship can seem remote and inconsequential.

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Homeowners may not understand what is at stake until they incur damage to unique brickwork or ornamental features that accounted for a substantial part of a home's value. Is an "engineered" hardwood floor, let alone a linoleum floor, really equivalent to a genuine hardwood floor, simply because it's a surface?

Similarly, commercial property owners, especially those seeking to generate "walk in" trade, may be surprised to learn that an FRC policy may not pay to repair or replace features that are distinctive and attractive in their appearance but serve no unique "function."

Valuable Alternative

Make no mistake, functional replacement cost valuation is a valuable alternative for insurance buyers, especially those seeking to insure older structures whose replacement cost exceeds their market value. But when a loss occurs, an FRC loss settlement can put the insured at a disadvantage. Under full replacement cost coverage, the insurer clearly has an obligation to pay for replacing damaged property as it was, subject to a coinsurance requirement, and the requirement that the property actually be replaced.

With FRC coverage, an insurer can identify the least costly and minimally sufficient options for replacing and/or repairing damaged property. The burden then shifts to the insured to make the case that functional equivalence may require greater quality materials, design and workmanship than the carrier has considered.

While trying to make this case, an insured can also be constrained by a coinsurance requirement whose penalty can eliminate the benefit of having chosen FRC coverage in the first place.

"Depreciation Insurance"

To clarify what's at issue when insuring property on a replacement cost basis — full or functional — it helps to know that the two dimensions of coverage used to be provided under two different forms of insurance, sometimes by different carriers.

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... estimating depreciation is still an inexact science – and the amount of depreciation can vary from one feature to another in the same structure.

In the early 20th century, most buildings, fixtures and equipment were insured only for their actual cash value (ACV), which reflected the depreciation in value of materials and components over time.

Underwriters were reluctant to offer coverage for the full replacement of property, and did so quite selectively, usually requiring a full appraisal of the property to be insured. To provide the coverage, insurers used what was initially known as "depreciation insurance," which applied over the ACV coverage and covered the difference between the property's depreciated ACV and the cost to repair or replace it.

To illustrate, consider a building that would cost $100,000 to build new, but had depreciated 30 percent; the ACV would be 70 percent of the construction cost ($70,000) and the depreciation would be 30 percent ($30,000). In the event of a total loss, the ACV coverage would immediately pay $70,000 — and the depreciation insurance would pay $30,000 when reconstruction was completed.

It's never been that simple, of course. Even today, with extensive data available on the resilience and durability of building materials and techniques, estimating depreciation is still an inexact science — and the amount of depreciation can vary from one feature to another in the same structure.

Furthermore, the factors for defining actual cash value vary from state to state. According to the law firm Timoney Knox, states look to one of three different factors to determine actual cash value: a property's fair market value; its replacement cost less depreciation; or the "broad evidence rule" which incorporates consideration of a structure's condition and marketability, among other factors.[1]

When two different insurers wrote ACV and depreciation coverage separately on the same risk, disputes often arose regarding the extent of depreciation and each carrier's resulting share of a loss.

Over time, insurance buyers came to see the value of coverage for replacing damaged property beyond its cash value — and insurers responded by combining ACV and depreciation coverage into a single form of loss settlement known as replacement cost coverage. This simplified the coverage and avoided disputes among carriers.

Problems Emerge
As the market for insurance grew in both volume and breadth of coverage, insurers incorporated replacement cost coverage into homeowners and commercial property policies, usually with a coinsurance requirement stipulating that the amount of insurance be at least 80 percent of the replacement cost.

The spread of replacement cost insurance led to some problems, however.

For one thing, in the eyes of insurers, replacement cost coverage gave rise to an inordinate number of claims for roof replacements. As roofs age, they show wear and become discolored. Even minor damage can require complete replacement of a roof as new roofing for a damaged section would not match the older, weathered sections. In recent years insurers have introduced endorsements providing for ACV coverage on roofing for structures that are otherwise covered on a replacement cost basis. Nonetheless, roofing losses remain at high levels in areas of the country prone to wind and hail storms.

Another problem with replacement cost coverage came with older structures that have features which are obsolete, such as lath and plaster walls, or clay roofing, as well as decorative features such as hand-carved woodwork or masonry ornaments. Such features are very expensive to repair and replace — and to insure given the 80 percent coinsurance requirement.

Functional replacement cost coverage emerged as a cost-effective alternative for the owners of older structures with unique or obsolete features. Typically provided by endorsement to property policies, FRC coverage stipulates that the insurer will pay to replace damaged property with less expensive and more current materials and workmanship, provided they fulfill the same functions as the original property.

Under FRC building coverage, lath and plaster walls are replaced with wallboard or plywood; roofing tiles are replaced with shingles; and elaborate woodwork and ornamental fixtures may be removed. As for personal property, outmoded or unusual furnishings and equipment are replaced by more common modern equivalents.

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> *ISO has developed three functional replacement cost endorsements – one for homeowners insurance, one for commercial building property and one for commercial personal property.*

ISO Endorsements

As coverage features are adopted by more and more insurers, they are often standardized by insurance advisory organizations or bureaus, the most prominent of which is the Insurance Services Office (ISO), now part of Verisk Analytics.

ISO has developed three functional replacement cost endorsements — one for homeowners insurance, one for commercial building property and one for commercial personal property.

The ISO homeowners endorsement (HO 53 05) replaces the full replacement cost coverage under Coverage A (for the principal dwelling) and Coverage B (for related private structures) provided in three of its owner-occupied homeowners policy forms (HO 00 02, HO 00 03 and HO 00 05).

The endorsement defines functional replacement cost to mean the amount it would cost to repair or replace a damaged structure using materials and methods that are less costly but "functionally equivalent" to "obsolete, antique, or custom" methods or materials used originally.

Coverage is subject to a coinsurance requirement of 80 percent of the functional replacement cost; however, foundations and other building supports below the ground or basement undersurface are not considered in the coinsurance calculation.

If the ACV of the damage is less than the estimated FRC, the insurer will pay no more than the ACV until repairs and/or replacement are complete. (This provision was modified in the late 1990s to allow immediate and full payment of small FRC losses. Under recent versions of the endorsement, if the cost to repair damage is less than $2,500 *and* 5 percent of the applicable limit, the insurer will simply pay the functional replacement cost recovery whether or not the property has been repaired or replaced.)

Under the ISO homeowners endorsement an insured may initially disregard the functional replacement cost feature and submit a claim for the ACV of the loss, then make an additional claim for full FRC recovery, provided the insurer is notified of the intent to do so within 180 days of the loss.

The ISO homeowners FRC endorsement makes no reference to personal property of the insured, which will be covered under the base form for ACV or full replacement cost, as the policyholder chooses.

Commercial Endorsement

Things are considerably more complicated when it comes to functional replacement cost coverage for commercial property.

ISO's endorsement for commercial buildings (CP 04 38) is more detailed than its homeowners counterpart and includes a schedule for listing insured locations and limits of insurance. This approach eliminates coinsurance by establishing the functional replacement cost for each building and, in effect, adjusting losses in advance.

In the event of loss or damage to a scheduled building — and the insured contracts within 180 days to restore it to the same occupancy and use — the insurer will pay the *least* of:

- The scheduled limit for the damaged building;
- The cost to replace a building after a <u>total</u> loss with a less costly but functionally equivalent structure (on the same site or a different site if required by ordinance or law);
- The cost to repair or replace damaged property after a <u>partial</u> loss with less costly materials in the same architectural style, plus costs to demolish and clear undamaged parts of a structure; or
- The amount actually spent to repair the building with less costly materials, and to demolish and clear undamaged parts.

If the insured does not contract within 180 days to rebuild the property, recovery is limited to the *least* of the following:

- The scheduled limit for the damaged building;
- The market value of the damaged building, excluding the value of the land; or
- The cost to repair or replace damaged property with less costly materials in the same architectural style, less an allowance for physical deterioration and depreciation.

Note that this endorsement's requirement to *contract* for repairs within 180 days is more stringent than the customary requirement under full replacement cost coverage to simply *notify* the insurer of one's intent to rebuild.

Other Features

ISO's endorsement for establishing FRC coverage on commercial buildings has two other distinct features.

One is a dual application of the "other insurance" provision. With respect to any other insurance on the property with the same terms and conditions, coverage under the ISO endorsement will apply on a pro rata basis. As for insurance not on the same terms and conditions, coverage under the ISO endorsement will apply as excess, up to the scheduled limit.

The other distinct feature of the ISO endorsement is its inclusion of coverage for increased replacement costs due to building ordinances or laws. This coverage is provided within the scheduled FRC limit and is subject to exclusions for costs in excess of legal requirements, pollutant testing and cleanup, or costs for failing to comply with requirements before the loss occurred.

This coverage replaces an ordinance or law exclusion in ISO commercial property forms and reflects the fact that older structures insured for FRC must often be upgraded to comply with building codes enacted and revised after those structures were first built.

Personal Property

For business personal property (other than stock), ISO offers a separate FRC endorsement (CP 04 39) with its own schedule of insured locations, described personal property and limit of insurance. That limit is the only limit applicable to the described property and there is no coinsurance requirement. So, in essence, the insured and insurer estimate at the policy's inception what it will cost to replace older furnishings, equipment, and supplies with newer ones.

As with the building FRC endorsement, the personal property endorsement gives the insured 180 days (unless there is an agreement otherwise) to contract for the repair or replacement of damaged property. If the insured does so, the insurer will pay the least of the following:

- The scheduled limit for the lost or damaged item;
- The cost to replace the lost or damaged item (at the same location) with the most closely equivalent alternative; or
- The amount actually spent that is necessary to repair or replace the item.

If the insured does not contract to repair or replace the damaged property within a stipulated time period, the insurer will pay the smallest of the following:

- The scheduled limit for the lost or damaged item;
- The market value of the lost or damaged item (the price it would realize in a fair market); or
- The amount it would cost to repair or replace the damaged item(s) with materials of like, kind, and quality, less allowance for physical deterioration and depreciation.

While the ISO endorsements serve as standard models followed by most companies, be aware that there are many independent FRC forms that deviate from the ISO specifications, especially in commercial lines.

What is the "Function?"

With their coinsurance requirements, FRC coverage provisions are designed to prevent policyholders from trying to take advantage of the system. Without coinsurance, insureds could contract for the lower premium available for FRC coverage, then contest the insurer's estimation for what constitutes functional equivalence. With a coinsurance requirement in place, the greater an insured's demands regarding functionality, the greater the cost will be, and the more likely a coinsurance penalty will result.

This still leaves a rather large gray area for establishing functionality, especially for repurposed structures. Consider this example:

In a Pennsylvania case, a woman had purchased a small former church as her home. When it was damaged by fire, she sought recovery under an FRC policy for the full replacement of some stained-glass windows and an old pipe organ. Under the terms of the policy, the company offered only to replace the windows with thermal glass, and to provide a new electric organ. The policyholder challenged that offer, but a state court upheld the company's position.[2]

That's an unusual case, but an illustration of the questions that arise when the features of a building no longer relate to its function. How would the insurer in the case above have responded to the claim if the building was still used as a church? Presuming that a comparable loss settlement provision was in place, it seems that a case could certainly be made for replacing the stained glass windows, if not the organ.

This situation comes up more often when antique farm structures sustain severe damage. In the 18th and 19th centuries, farm buildings were commonly constructed with large supporting beams and no load-bearing walls. Today, following a loss, it can be more cost-effective to use smaller supports and shift some of the building weight onto the walls.

As often as not, the latter type of construction is functionally equivalent for the current use of such buildings, many of which have become residences, small shops, or bed & breakfast facilities. Yet to forgo restoration of large beams seems to some to be a step too far in violating the architectural integrity of the building. It becomes a matter for negotiation.

In light of the limits of functional cost replacement, agents, insureds and adjusters should strive to see that policyholders are credited for the maximum amount of actual cash value they can legitimately claim for damaged property before considering what it would take to replace it with functionally equivalent features.

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[1] Timoney Knox, LLP, "Being In The Minority – The Broad Evidence Rule," accessed at http://www.timoneyknox.com/blog-posts/being-in-the-minority-the-broad-evidence-rule.
[2] June 2011 memorandum of opinion in the case of Ingrassia v. Erie Insurance Exchange, case no. 08-1758, Court of Common Pleas of Carbon County, Pa.

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