

# Governmental Risk Management Manual

## **SUPPLEMENT NO. 117**

This supplemental relates to the use of the replacement cost endorsement on a fire insurance policy. Place in your Manual following P. 10-205.

# THE REPLACEMENT COST CLAIM: IT'S JUST LIKE ANY OTHER. OR IS IT? \*

## INTRODUCTION

It has been a number of years since the introduction of replacement cost coverage. An innovation in property insurance, it was designed so the policyholder who has an insured loss does not suffer financial loss due to depreciation.

While the coverage might seem to contradict the principle of indemnity – by enriching rather than restoring - most professionals in the insurance business understand that correctly administered replacement cost coverage works to the advantage of both the insured and the insurer. Less established, however, is the understanding of how to handle replacement cost claims.

Some of this lack of understanding is due to the fact that the coverage is still relatively new and vague (*see footnote 1*).

Misconceptions and ambiguities exist. It is the intent of this supplement to clarify some of them - by discussing **replacement cost coverage from a claims perspective!**

## ENRICHMENT VS. RESTORATION

The principle of indemnity is to return the insured to the position they were in prior to the loss. Since lost 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 (*see footnote 2*).

Replacement cost coverage does not unjustly enrich the policyholder for two important reasons, namely: first, the loss is neither foreseen nor deliberately caused by the insured; and second, the insurer is compensated for the additional coverage because premiums are based on replacement cost values rather than the lower actual cash value!

Bear in mind that in the examples cited, the policy's limit of liability is always the highest level of recovery. Also note that the "guaranteed replacement value" concept has not been considered, 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! Under most policies, the insured has 180 days merely to notify the insurer of their intent to exercise the replacement cost clause. Basically, the insured must inform the insurer within this period of time that they intend to make claim under the replacement cost coverage. Many astute loss consultants for the policyholder routinely exercise the replacement cost option on behalf of their client the moment they are retained on the loss. In most cases this is a good practice to follow since it eliminates the possibility of a missed deadline.

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.

## THE HOLDBACK

One of the basic principles of replacement cost insurance requires that the insured not receive the expanded indemnification until the property is actually repaired and/or replaced. As a result, the insured first collects their depreciated or actual cash value loss, and when the property is repaired or replaced in accordance with the conditions of the policy, is paid the difference between the actual cash value loss and the replacement cost loss. The money withheld is customarily referred to as a "holdback."

At the time of settlement it is also common for the insured to sign – in addition to the proof of loss – a *Statement as to Full Cost for Repair or Replacement* spelling out the amount that may

be collected later under the supplemental replacement cost claim.

### **REPLACING ELSEWHERE**

Policies normally state "...we will pay the cost of repair or replacement without deduction for depreciation, but not exceeding the smallest of the following amounts:

- A. The limit of liability under this policy applying to the building;
- B. The replacement cost of that part of the building damage for equivalent construction and use on the same premises; or
- C. The amount actually and necessarily spent to repair or replace the damaged building."

Item B 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 premises. It establishes the limit of liability to be replacement value at the insured site, *not* the replacement value at another site.

For example, the costs used in determining replacement cost liability 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!

If there was an intent to limit the repair or replacement of a damaged building to the same premises, it is safe to assume that the authors of item C would have included wording such as "for use on the same premises."

Note: The courts have supported an insured's option to rebuild elsewhere. In *Blanchette v. York Mutual Insurance Company*, 4554 A2d 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. Also, *Johnson v. Colonial Penn Insurance Company*, 127 mis2d 749 487 NYS2d 285 (Supreme Court 1985), reinforces the interpretation of the courts regarding *Blanchette v. York Mutual*.

### **BUYING RATHER THAN REBUILDING**

Does the insured have to rebuild to collect replacement cost - or can they buy an existing building somewhere else? 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 recovery. It's important to keep in mind, however, that closing costs are not generally included in the amount actually spent to repair or replace damaged property; they are considered part of land acquisition costs. Furthermore, as a matter of procedure, many insurers will exclude the land value from any replacement cost transaction.

### **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 property for identical use on the same premises. Remember - the amount actually spent to replace the property does not always become the threshold for recovery. Sometimes, if the cost of replacement property is less than that lost, the insured may elect to add improvements and/or enhancements to the replacement building to make up the difference.

An interesting option related to this is whether the insured is limited to purchasing one building only. The author has handled several losses in which the insureds, to qualify for all available replacement cost dollars, acquired several buildings to replace the one lost. Not finding anything in the policy to exclude such a recovery, the insurers paid the claims.

### **BE CAREFUL OF VALUES AND COINSURANCE REQUIREMENTS!**

One of the most important things to watch when insuring for replacement cost is to have an

adequate amount of insurance. If a policy contains an 80% coinsurance clause, the insurance requirement is based on 80% of replacement cost instead of 80% of actual cash value.

In the example that follows, 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.

Under the older ISO forms, even if the insured chose not to make a claim on a replacement cost basis, some interpretations would still base the coinsurance requirement on replacement cost. This results in a worse situation when the insured does not have replacement cost coverage. Newer ISO forms make the basement valuation (replacement cost vs. A.C.V.) the option of the insured, and the coinsurance application would follow accordingly. The insured must remember, however, that simply endorsing the policy for replacement cost is not sufficient to keep it in line with actual replacement costs; the values must be increased as well.

**Example:**

Insurable Replacement Cost Value	\$2,000,000
Insurable A.C.V.	\$1,700,000
Replacement Cost Loss	\$100,000
A. C. V. Loss	\$90,000
Insurance Amount	\$1,000,000
Coinsurance	80%

A. C. V. Settlement w/coinsurance  

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

Replacement Cost Settlement w/ coinsurance  

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

**HOW IS REPLACEMENT CALCULATED WHEN THERE ARE MANY ITEMS?**

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.

The author’s adjusting firm recently handled a 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 the items lost. We requested that the insurers pay the full replacement cost on those items that were replaced on an item-by-item basis. The insurers resisted, so we posed the question to the editors of the “FC&S Bulletins.” We were pleased with the following response, which helped convince the insurer to accept our 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 A.C.V. recovery on any one item 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 (January 1991).*

*This is a very important point because the insured does not have to spend more than the total actual cash value of the loss to qualify for replacement cost recovery. 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.*

**WHAT CONSTITUTES REPLACEMENT?**

Nowhere in the policy is the insured required to replace with identical kind or quality. This wording merely establishes a limit for what it would cost to repair or replace lost property with property of identical kind and quality.

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.

### **LIMIT THE HOLDBACK**

Many times insurers create an adjustment trap! Their position is: “Don’t worry about the amount of depreciation taken, you’ll recover those dollars once the property is replaced and you spend the money.” To that stance, the adjuster, as the insured’s advocate, would ask the question – If it’s not an item of concern, why, then, doesn’t the insurer pay all the replacement cost dollars **now**?

In prudent claim handling, the amount of depreciation withheld should always be kept to a minimum. Doing so leaves fewer points open for discussion or to develop into 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 replacement themselves.

### **WALK AWAY**

Sometimes, the insurer and insured will entertain what is commonly known as a “walk-away” settlement. This means both have agreed to a settlement figure that is somewhere between actual cash value and replacement cost. In accepting this 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 insurer wins because it pays less than full replacement cost, and 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. Needless to say, 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 a contemporary property insurance program. The replacement cost provision will not live up to its potential, however, unless all conditions of the policy are in order. Good underwriting and well-established values 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.

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!

### **FOOTNOTES**

*1. In the absence of actually limiting language in the insurance policy, a broad interpretation of such coverages must be made in favor of the insured. “It is fundamental that any ambiguity in an insurance policy will be construed against the insurer and in favor of the insured, and this is particularly so when the ambiguity is found in an exclusionary clause.” **Breed v. Insurance Company of North America**, 46 NY2d 351.*

*2. 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 p.11 4:29.***