THE LOSS ADVISOR

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LOSS ADVISORS
Summer 2007 Issue

AKLA

Actual Cash Value and Replacement Cost Value: How To Get the Most from Your Property Insurance

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Your property insurance policy says it covers the cost "to repair or replace damaged property with property of like kind and quality," and you assume that if a fire destroys your company's property, then the insurance company will pay the cost to replace it. Depending on what else your property insurance policy says, this may not the case. Read on to find out how to make sure that your insurance gives you the coverage you expect and how to get the most out of what you have.

Actual Cash Value vs. Replacement Cost Value

Insurance generally is based on the principle of indemnity—a promise by the insurance company to return its policyholder to the position it was in prior to a loss. Since lost property often only can be replaced with new, one might feel that a policyholder actually comes out better than it was prior to the loss by getting new property in place of old. It was out of this concern—to be consistent with the indemnity principle—that the concept of depreciation was incorporated into the adjustment of property insurance losses via Actual Cash Value ("ACV") insurance coverage.

Many policyholders, however, preferred to have insurance that completely protected against the cost of recovering from a loss. Thus, many years ago, insurance companies seeking to develop insurance products that appealed to such customers began to offer Replacement Cost Value ("RCV") insurance coverage. This innovation expanded the basic ACV coverage beyond the indemnification principle and meant that the policyholder who had a loss did not need to bear any cost in replacing depreciated property. Although RCV coverage might seem to contradict the principle of indemnity—by enriching rather than restoring—it does not unjustly enrich the policyholder for two important reasons, namely: (i) the loss is neither foreseen nor deliberately caused by the policyholder; and (ii) the insurance company is compensated for the additional coverage because premiums are based on replacement cost values rather than the lower actual cash value.

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ACV Holdback

Although RCV coverage compensates the policyholder for the difference between the depreciated cost and the actual cost of making the replacement or repairs, most claims under RCV policies are adjusted by requiring that the affected property be repaired or replaced before the depreciation actually is paid. Thus, the insurance company typically will first pay only the ACV loss and it will pay the depreciation after the damaged property is actually replaced. The money withheld is customarily referred to as a "holdback."

Unfortunately, insurance companies sometimes used this "holdback" as a loss adjustment trap, telling the policyholder: "Don't worry about the amount of depreciation taken, you'll recover those dollars once the property is replaced and you spend the money." In response, policyholders or the public adjuster representing them on the claim should ask (rhetorically): "If it's not an item of concern, then why doesn't the insurance company pay all the replacement cost dollars now?"

The amount of depreciation "held back" 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 policyholder does not have use of them during the critical time of its recovery from the loss. As a result, the policyholder is forced to fund the replacement itself.

Sometimes the insurance company and policyholder will entertain what is commonly known as a "walk-away" settlement. This means both have agreed to a settlement figure that is somewhere between ACV and RCV. In accepting the figure, the policyholder agrees not to make a supplemental claim for RCV at a later date. This can be a win-win situation, with the insurance company paying less than the full replacement cost owed under the policy, and the policyholder getting most (if not all) of its money up-front, as well as the choice not to replace certain property. Needless to say, this arrangement also saves a lot of time, accounting, and adjusting red tape.

Replacing Elsewhere or with Non-Identical Property

Many policyholders believe—incorrectly—that they must restore the property to its exact condition prior to the loss or replace the property with exactly the same property. Contrary to this misapprehension, courts have been liberal as to what constitutes actual replacement. Moreover, many RCV policies specifically state that the policyholder can use its insurance proceeds on "any expenditures related to the insured's operations." Generally, as long as the replacement dollars are spent, the depreciation will be recoverable, but the amount of the claim will be determined based on the cost to replace the property that actually suffered the loss. For example, the RCV coverage for a loss in Albuquerque would be the cost of rebuilding or repairing that property in Albuquerque – not Honolulu, even if the policyholder elected to rebuild in Hawaii. The policyholder may replace the lost property by rebuilding in Honolulu, but the recovery cannot exceed the theoretical cost to repair or replace the property in Albuquerque.

Nowhere in most policies is the policyholder required to replace with identical kind or quality. The policy wording merely establishes a limit for what it would cost to repair or replace lost property with property of identical kind and quality. Thus, policyholders may purchase an existing property rather than engage a contractor to physically rebuild, and still quality for RCV coverage. Indeed, one of the authors has handled a claim

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where a policyholder who lost a milk pasteurizing plant bought an orange juice plant to replace it, and the insurance companies agreed that this met the requirement of the insurance policy and paid the claim based on the cost to replace the milk plant.

Coverage Extensions That Can Pick Up the ACV Slack

Your company's policy probably includes additional coverages that supplement the ACV or RCV coverage and may, among other things, fill in any gap between the depreciated ACV and the true cost of replacing the damaged property. For example, many policies include coverage for: (i) "Soft Costs" such as attorneys' fees, other professionals' fees, real estate commissions or interest expense incurred to restore the damaged property; and (ii) "Expediting Costs" such as deposits or premiums paid to secure contractors in order "to expedite the permanent repair or replacement of damaged property." Talk to your broker or insurance consultant to get a better understanding of the extent to which your company has the benefit of these or other type of coverage extensions.

Conclusion

In the final analysis, RCV coverage is both a desirable and necessary part of a contemporary property insurance program. RCV coverage was developed to serve both policyholders and insurance companies, but the degree to which it benefits those parties depends on how well it is understood and then applied when the insurance is called to deliver. For policyholders, knowing what coverage can be expected, before a loss occurs, is critical to effective risk management. Be sure to conduct a thorough review of your insurance portfolio before a loss occurs—or have an independent professional review it with you. ■

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