Property valuation and loss settlement clauses-important considerations

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The July 1 property renewal has been presented and accepted. The Insured and Broker are satisfied with the results: broad coverage terms including flood and earthquake, blanket limits for building and contents, no coinsurance, replacement cost valuation and a modest reduction in annual cost. All is seemingly in place for the new coverage year and for the unforeseen property damage claim.

For most property insureds the test of coverage may never occur. For others these words

- "We (Insurer) will pay for direct physical loss or damage. . . ";
- "In the event of loss or damage covered by this Coverage Form, at Our (Insurer) option we will . . .";
- "We (Insurer) will determine the value of Covered Property in the event of loss or damage as follows. . .";

will be as important, if not more than, all other policy coverage terms and conditions.

While a risk management professional should be concerned about what *may* damage or destroy covered property, an equal concern should be that the Insured's settlement received post loss is appropriate in order to continue post-loss operations as if nothing had happened. An Insured's pre-loss expectations should be equal to the Insurer's post-loss policy (contractual) obligations.

A total fire loss occurs later in the coverage year at one location and the Insured learns that even a favorable renewal may result in an unexpected coverage deficiency at time of loss settlement. How could this happen?

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The policy excerpts highlighted above are taken from ISO building and personal property coverage form, CP 00 10 0402. These provisions are similar to that used in non-ISO property insurance policies so this loss scenario could happen to any risk management professional. Exposure review for property insurance starts with proper identification and determination of property and its *pre-loss value* and how the Insured *post-loss event* may have it repaired, replaced, demolished or left as is. Appropriate property risk management goes well beyond simply the identification of perils that may cause damage, destruction or interruption of operations; the pre-loss value, post-loss settlement options and policy coverage limit are also of key concern. Unless the Insured uses an appropriate "pre-loss" valuation process, coverage is flawed from policy effective date. This flaw will impact the ability of the Insured to obtain at policy inception a coverage limit needed for total loss and the limit will have a bearing on the Insured's ability to cover debris removal, a significant exposure resulting from direct physical damage.

All coverage discussion in this article is based on current ISO policy forms. The reader is advised to review actual policy language, ISO and non-ISO, to ascertain coverage impact for a real or hypothetical loss situation. Understanding and addressing coverage issues *pre-loss event* may limit *post-loss event* loss settlement issues including the need to litigate.

Values at risk
Soft insurance markets may allow a risk management professional to obtain coverage tools that can "overlook" possible deficiencies in property values by providing blanket limits to make up for inadequate limits at any one location, removal of a co-insurance requirement and providing

replacement cost valuation. Hard markets and restrictive coverage renewal terms can occur suddenly after catastrophic events as what happened to many US insureds after both September 11, 2001 and Hurricane Katrina. Can an insured suddenly create appropriate building and contents values when faced with stringent renewal terms such as limits specific per location, co-insurance and actual cash value loss settlement? For most Insureds: probably not. Establishing proper property insurance values is an ongoing risk management activity that must be viewed independently of current market conditions.

Risk management professionals should structure property insurance programs whenever possible and, when cost effective, to obtain blanket limits, removal of co-insurance and proper loss settlement valuation-replacement cost or actual cash value (replacement cost less physical depreciation). At the same time insureds need to construct the internal tools to ensure that values for buildings and contents at any location are appropriate, reasonable and in synch with post-loss settlement expectations and the Insurer's policy mandated loss settlement obligations. Such tools will become essential at time of loss in order to create timely proof of loss, serve as means to document items lost or damaged and to obtain timely and proper loss settlement from the insurer. Risk management professionals need to continually ask themselves if the pre-loss values are appropriate to not only obtain broad coverage terms at policy inception but also if the values and thereby limits post-loss will provide the Insured with timely and correct settlement from the insurer. Any hesitation in answering this question will suggest that values may be flawed and thus need to be reviewed more often than just during the renewal process. Property risk management is an ongoing process, not one that needs attention just 60 days prior to policy expiration.

The complexity of determining appropriate property values will increase with each new location when viewed as a possible unique exposure unit (building and/or contents), the geographic location of the unit (Southern Florida-demand surge such as that following catastrophic windstorm), occupancy functions within the building (many manufacturing processes under "one roof") and changing technology (buildings-increased functionality in new/smaller physical plants in relation to old mill construction and contents-computers and computer-aided equipment-getting more productivity for less cost). Simply applying a 2-3% inflation factor to an existing statement of values may not be enough, especially for dynamic organizations that frequently reinvent themselves through organic growth, acquisition and merger.

Consideration must be given to the possibility that total loss may require permanent resumption of operations at a new site (building) and permanent movement of critical machinery and equipment (contents) to new or existing location(s) thus changing values at many locations, not just one. Imagine a major loss occurrence will happen during the next year then ask during the annual valuation process: can we continue to operate at this location; will building ordinances require us to move; should operations and certain equipment be redeployed at other locations on a permanent basis; how many of these "alternate" premises costs will be subject to coverage?

<u>Valuation methodology</u>

A decision to change the valuation of buildings or contents from replacement cost to actual cash value must be reviewed carefully. The change in value will obviously decrease the insurance limit for total loss and reduce the potential for adequate loss settlement for other coverage provisions. Debris removal coverage is predicated on 25% of the sum of the deductible plus the amount paid by the insurer for the direct physical loss or damage to covered property, not to exceed the limit of insurance applicable to the covered property. A change from replacement cost to actual cash value will cause a significant reduction in debris removal coverage. While additional debris removal coverage may be provided by the insurer upon specific request using "Debris Removal Additional Insurance", CP 0415 10 00, the Insured must consider the exposure and request for the increased limit prior to loss event. Increased costs of construction, a minor coverage in ISO property policies may not be enough if local ordinances have stringent requirements regarding rebuilding damaged property. Exposure identification by way of inadequate loss settlement post loss event is not an efficient use of a property risk management process.

Loss scenario-a hypothetical look at valuation issues

Jones & Company manufactures electric motors that range in use from residential swimming pool filters to running commercial heating and ventilating systems. It has been in business for 50 years and operates out of three facilities. Building 3, fully sprinklered, was constructed ten years ago specifically for Jones manufacturing processes, utilizes state of the art machinery and is approximately 20,000 square feet of fire resistive construction. Building 2, 10,000 square feet and masonry construction, was acquired 15 years ago and was renovated several times to accommodate expansion of Jones & Company electric motor products and to extend the sprinkler system to all of the building. Building 2 and 3 are located adjacent to one another in the same industrial park. Building 1, located in an older and crowded area 2 miles from the other 2 buildings is of old mill construction (joisted masonry), dates in part to the 1890's, only 20% sprinklered and is nearly 40,000 square feet although Jones uses only half of the space with the remainder a grave yard of old machinery and odds and ends. Jones & Company is located in the US Gulf area. It did not incur any damage from Hurricane Katrina although many homes and businesses in its geographic area are still feeling the effects of severe destruction that took place only a few miles from Jones' buildings.

Jones' controller has insurance procurement responsibility, a task he inherited by promotion several years ago when the chief financial officer retired. Real and personal property values are increased an average of 3% a year although no one knows if the original base line was correct at that time or if it is current for purposes of the property policy that renewed two months ago. A few years ago it was decided to change the valuation for building 1 from replacement cost to actual cash value since senior management thought it would never replace building 1 if it was substantially damaged. A smaller and more functional building would be built. The controller estimated Building 1's actual cash value and believed the limit to be sufficient to provide adequate funds to construct a much smaller replacement building that would be perfect for current needs. The insurer responds to the change in actual cash value by stating a lower specific limit for Building 1 and changes the blanket limit to apply only to Buildings 2 and 3.

The change in valuation allowed the controller to decrease the replacement cost building limit and reduce annual premium for Building 1 by nearly 40%. The controller estimated replacement cost for a total loss of building 1 by averaging trended values for Buildings 2 and 3 since a new Building 1 would likely be constructed in the same industrial park and construction would likely be a combination of fire resistive and masonry non-combustible construction. It seemed like a logical and cost effective decision to change the valuation of loss.

Building 1 suffers a total loss from fire. Debris removal expense is significant due to being in an older commercial neighborhood where buildings essentially abut one another making demolition and debris removal for Jones both difficult and dangerous. Jones finds that its debris removal coverage is part of the overall actual cash value limit and that the coverage is not sufficient as provided in its standard ISO policy. Debris removal uses up a significant portion of the building limit. While replacement cost and actual cash value yield different building limits, the *actual cost* of debris removal is not unaffected; it remains a cost independent of whatever insurance limit or valuation applies to the building loss.

The remaining building limit is less than 75% of what Jones expected to receive as "actual cash value". The uninsured portion of debris removal requires a six figure payment out of Jones' current earnings and means the company may run in the red for the remainder of its fiscal year. There are no buildable sites that remain in the industrial park. Two buildings are for sale but upon close inspection each will require extensive renovations and cost to meet current building codes and substantial renovations to meet Jones current manufacturing needs. While the

Jones' property insurance policy includes "Increased Costs of Construction Insurance" which would cover increased costs due to building code changes it applies only when the damaged building is subject to replacement cost coverage. The need to meet current building codes will increase the amount of uninsured loss borne by Jones and led it further into the red for the current fiscal year. Demand surge from post-Katrina re-building has increased the cost of labor and materials in the local area which has increased overall construction costs and reduces the purchasing power of the actual cash value settlement. Jones is forced to use its credit lines to obtain financing for the uninsured portions of replacing Building 1.

Lessons learned

A post-loss insurance review was conducted by senior management to understand how an insurance program described as broad and competitive could be so inefficient when needed at time of loss. The board level report included the following observations.

- Major changes in insurance such as change from replacement cost coverage to actual cash value should involve facilities and manufacturing personnel. Input from these areas would have surfaced issues related to available space in the industrial park as well as cost of ordinance and renovation costs.

- A table top discussion of a possible Building 1 total loss may have resulted in concern for debris removal costs and the effect on the remaining actual cash value limit.

- A formal building appraisal every five years would have allowed Jones to better estimate values to set limits. The significant increase in local construction costs may have been identified as well and suggested use of trend factors for Buildings 1, 2 and 3 more than the national trend factors of 2-3%.

- There should be an annual review of property insurance coverage in terms of current exposure, not just a summary discussion of renewal terms, conditions and premium. This type of review may have uncovered the issues of increased costs of construction due to building codes and effect of debris removal on policy limit.

Conclusion

Understanding the current value of a critical asset is of utmost importance whether it is a building or a particular segment of contents. Determining the correct value of an insured asset pre-loss will greatly improve coverage and increase the potential for an insurance settlement that truly puts the Insured in the same position post-loss event that existed pre-loss event.

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