



## **Selected Property Damage Insurance Concepts (Replacement Cost, Coinsurance, Agreed Value, and Improvements and Betterments)**

**Spring 2001**

Written By:

Janet Johnson  
t 312.258.5658  
jjohnson@schiffhardin.com

### **SCHIFF HARDIN LLP**

6600 Sears Tower  
Chicago, Illinois 60606

t 312.258.5500  
f 312.258.5600

**[www.schiffhardin.com](http://www.schiffhardin.com)**

When reviewing or advising clients on property damage insurance requirements for themselves or for their tenants or other parties to a transaction, the attorney must understand what typical property damage insurance policy terms mean and how those terms operate together. Sometimes the coverages, exclusions or endorsements will work together to enhance the coverage available in the event of an insured loss, and sometimes they will work at cross purposes and result in less coverage than what was expected or intended. Replacement cost coverage, coupled with the coinsurance language or agreed value coverage provisions are a few examples addressed in this paper. When the policy also is used to cover the named insured's tenant improvements and betterments, other coverage issues arise, some of which may be outside of the control of the insured.

This paper will summarize these concepts as addressed in the most recent (2000 Edition) Insurance Service Organization (ISO) form commercial property insurance policy (CP 00 10) issued in October 2000 (the "ISO Policy").<sup>1</sup> As of November 2000, the ISO Policy had been approved for use in all but 13 states (Alaska, California, Hawaii, Idaho, Louisiana, Minnesota, Mississippi, Oregon, South Carolina, Texas, Vermont, Virginia and Washington), and was awaiting approval in those states and in the District of Columbia and Puerto Rico. Many other forms are available, and risk pools often use manuscript policies which can be quite different, but the ISO Policy is the form most frequently used.

## Property Insured

Before considering replacement cost and agreed value coverages, a brief description of the property insured in the ISO Policy is necessary. The Declarations page added to the pre-printed form ISO Policy discloses what property is covered, the election of various optional or additional coverages, and what coinsurance percentage applies. The Declarations page also notes any other special endorsements that are made a part of the policy. Thus, if one has access to the form ISO Policy issued and the Declarations page or pages, one can determine exactly what coverages apply, even without a copy of the entire policy.

In the ISO Policy both buildings and business personal property can be covered (if so noted on the Declarations page). The definition of "Building" includes buildings and other structures, completed additions, fixtures and permanently installed machinery and equipment, as well as personal property owned by the insured that is used to maintain or service the building or structure or its premises

(e.g., fire extinguishing equipment, outdoor furniture, floor coverings and appliances used for refrigerating, ventilating, cooking, dishwashing, or laundering). As long as other insurance is not in place to cover them, additions under construction,<sup>2</sup> as well as alterations and repairs to the covered buildings and structures are also included, as are materials, equipment, supplies, and temporary structures on or within 100 feet of the premises that are used for making additions, alterations, or repairs to the covered buildings or structures. (See "Covered Property" portions of the ISO Policy.)

Business personal property includes furniture and fixtures, machinery and equipment, "stock,"<sup>3</sup> and all other personal property owned by the insured and used in its business, if located in or on the building insured under the policy, in the open, or in a vehicle within 100 feet of the insured premises. It also includes labor, materials or services furnished or arranged by the insured on the personal property of others, and leased personal property if the insured has a contractual responsibility to insure it, unless it is otherwise provided for in the portion of the policy called "Personal Property of Others."

The ISO Policy also insures the insured's interest as a tenant in improvements and betterments. What constitutes improvements and betterments is described elsewhere in this paper.

Beyond the scope of this paper are the lists of property not covered under the ISO Policy, although one should keep in mind the most important exclusions from the ISO Policy. These exclusions include foundations of buildings below the lowest basement floor (or the surface of the ground, if there is no basement), and the cost of excavations, grading, backfilling or filling, retaining walls that are not part of a building, as well as bridges, roadways, walks, patios and other paved surfaces. Generally these are excluded because they are relatively unsusceptible to damage by the perils insured against in the ISO Policy, although they are not completely invulnerable to such damage. Particularly in suburban office or high tech industrial campuses, these amenities may be expensive to replace if damaged. Additional coverage for these items is beyond the scope of this paper.

## Replacement Cost Valuation

Prior to the issuance of the 1986 ISO form policy, replacement cost valuation was provided by endorsement only. Since 1986, replacement cost valuation is an "Optional Coverage" in the printed form ISO Policy, which must be elected on the Declarations page of the policy. If elected, it replaces the typical "actual cash value" language

in the Loss Condition portions of the ISO Policy. The actual policy language itself reads: “If shown as applicable in the Declarations, the following Optional Coverages apply separately to each item...Replacement Cost (without deduction for depreciation) replaces Actual Cash Value in the Loss Condition, Valuation, of this Coverage Form.” Replacement cost is the “cost to replace, on the same premises, the lost or damaged property with other property: (a) [o]f comparable material and quality; and (b) [u]sed for the same purpose...” (See “Optional Coverages” portions of the ISO Policy.)

The policy does not define or explain Actual Cash Value. It is subject to interpretation by courts, which is beyond the scope of this paper. According to the IRMI Manual, some courts have interpreted it to mean “fair market value” (meaning the amount a willing buyer would pay a willing seller if neither were under undue time constraints), but most courts have upheld the insurance industry’s traditional definition, which is the cost to replace the damaged property with property of like kind and quality, less depreciation. Because courts often differ on whether depreciation includes obsolescence, as well as actual physical depreciation, most insureds today opt to select replacement cost as an Optional Coverage, because it does not include a deduction for depreciation. However, there are other limitations included in the ISO Policy standard replacement cost Optional Coverage language that must be considered, as they will affect the ultimate recovery.

First, replacement cost coverage does not apply to the personal property of others, contents of a residence, manuscripts, works of art, antiques or rare articles or “stock.”<sup>4</sup> The insured’s tenant improvements and betterments are not considered to be the personal property of others for purposes of the replacement cost coverage provisions. (Replacement cost coverage as it applies to tenants’ improvements and betterments is discussed later in this paper.)

Second, in the event of a loss or damage, replacement cost basis payments will not be made under the ISO Policy until the lost or damaged property is actually repaired or replaced, and then only if the repairs or replacements are made as soon as reasonably possible after the loss or damage. The IRMI Manual suggests insureds sometimes make a claim for the actual cash value of an insured loss and later submit a claim for the difference between the actual cash value settlement amount and the replacement cost to speed up the claims process and the receipt of at least some proceeds to begin rebuilding. This may be advisable particularly where the building damaged is

occupied by tenants with leases allowing them to terminate their leases if the damage is not repaired within a specified time period, but it may result in the insured having to advance a large portion of the costs to rebuild. The insured must notify the insurer of the insured’s intent to replace the lost or damaged property within 180 days from the date of the loss. If the insured’s mortgage lender requires sufficient proceeds be on deposit with it before the repairs or rebuilding commences, the insured may be hard pressed, in the event of a major loss, to provide the necessary funds.

Regardless of whether the insured selects replacement cost coverage, the ISO Policy provides that it will not pay more for the loss or damage than the least of (1) the Limit of Insurance applicable to the property (also found on the Declarations page); (2) the cost to replace the lost or damaged property on the same premises with other property used for the same purpose and of comparable material and quality; or (3) the amount actually spent to repair or replace the lost or damaged property. Although recovery of the policy proceeds is not prohibited if the insured rebuilds at a new location, the coverage amount is limited to the cost that would have been incurred if the building had been rebuilt at the original premises. It is important to note that the ISO Policy language specifically excludes from the cost of repair or replacement any “increased costs attributable to enforcement of any ordinance or law regulating the construction, use or repair of any property.”<sup>5</sup>

## Coinsurance

The ISO Policy contains a Coinsurance provision that applies in accordance with the applicable coinsurance percentage shown in the Declarations page. The operation of this provision effectively requires the insured to purchase a limit of insurance equal to the specified percentage of its full value. If, at the time of the loss, the Limit of Insurance specified in the Declarations page is less than the amount required under the coinsurance provision, the loss recovery will be limited to a coinsurance percentage of the loss that is determined by using a ratio equal to the insurance amount carried to the insurance amount required. However, if the application of the coinsurance formula results in a figure that exceeds the applicable Limit of Insurance for the loss, the Limit of Insurance is the maximum amount that will be paid.

According to the IRMI Manual, ISO does not specify a minimum coinsurance percentage that must be specified in the Declarations, although most rates are set contemplating an 80% coinsurance provision. Rate credits

are applicable for 90% or 100% coinsurance provisions, and rate surcharges apply when the insured selects less than an 80% coinsurance percentage.

The purpose of the coinsurance provision is to protect the insurer against deliberate underinsurance by the insured. However, by selecting less than 100% coinsurance, the insured is protected against the risk of small underinsured losses. This is important, particularly where property values are increasing rapidly in the geographic area where the insured property is located or when the insured obtains a multiple year policy. The application of the coinsurance provision is more easily explained through formulas and examples. [Appendix A](#) attached to this paper has reproduced some of the examples contained in the IRMI Manual.

## Agreed Value

Another Optional Coverage provided for in the ISO Policy, which is available to the insured by electing to add it to the Declarations page, is the Agreed Value coverage option. Election of this option suspends the application of the coinsurance provisions of the ISO Policy and is made by inserting an agreed value amount and expiration date for that agreed value amount under the Agreed Value heading in the Declarations page. An Agreed Value must be specified for each location and type of covered property to which the election applies. As a condition to issuing an ISO Policy with agreed value coverage, the insurer may require a recent appraisal of the property or properties or an explanation of how the values were determined. At a minimum, it will normally require a signed statement as to the property values.

Electing Agreed Value coverage suspends the coinsurance provisions only until the expiration date shown in the Declarations page, upon which the coinsurance provision is automatically reinstated. Usually the expiration date is one year from its effective date or the policy anniversary date, which provides the insured with an incentive to submit an updated schedule of property values annually to the insurer. If the insured fails to submit the updated statement of values, coinsurance will be reinstated.

If a loss occurs during a period of time when the agreed value coverage is in place, the insurer will pay no more for the loss or damage to the property than the proportion that the Limit of Insurance for the damaged or lost property bears to the Agreed Value shown for it in the Declarations page. Thus, agreed value coverage does not provide complete protection against underinsurance, since the most the insurer will pay, regardless of the agreed value stated, is the Limit of Insurance applicable to the covered

property. Although a discussion of choosing the appropriate Limit of Insurance for any property is beyond the scope of this paper, limits can be arranged on a scheduled basis, with a separate limit for each type of property at each location, or on a blanket basis, which generally provides for a single limit of liability for all types of properties at all locations covered by the policy. A single blanket limit that applies to all property at all locations is ideal, particularly where the properties are located in different states or far enough apart that it is unlikely that the same loss event will occur to all properties at the same time. It can also provide a hedge against inaccurate property value estimates at any one location, and if set high enough, will offset any underinsured risk as long as the agreed value amount is sufficiently high to cover a total loss for the particular property to which it applies.

## Tenant Improvements and Betterments

As indicated above, the ISO Policy includes coverage for improvements and betterments made by a tenant insured under the policy to a building or structure occupied by that insured but not owned by that insured. Under the ISO Policy, improvements and betterments are "fixtures, alterations, installations or additions" that are made a part of the non-owned building or structure occupied by the insured, and that were acquired or made at the insured's expense, but which cannot be legally removed. Thus, if the insured tenant has the right to remove any of those improvements and betterments at the end of the term, they will not be covered under the definition of improvements and betterments in the Policy. Theoretically, these items would need to be covered as part of the other included business personal property, but if they truly are alterations to the building itself and not trade fixtures, a separate type of insurance coverage would need to be procured.

If the insured selects replacement cost coverage, it will also apply to tenant improvements and betterments, but slightly different provisions apply in the case of a loss. In addition to waiting until the lost or damaged property is actually repaired or replaced, and the condition that the repairs or replacements be made as soon as reasonably possible, the replacement cost coverage provisions applicable to improvements and betterments in the ISO Policy go on to provide that if the previous two requirements are not met, the value of the tenant improvements and betterments will be determined as a proportion of the insured's original cost. Furthermore, the insurer will not pay for any loss or damage covered by the landlord's or any other person's insurance.

Where the proportion of the insured's original cost provision applies, the actual cash value provisions of the ISO Policy (not replacement cost) will be used to determine the amount the insurer will pay for the lost or damaged property. The proportion of the original cost that will be paid is determined by multiplying the original cost by the number of days from the loss or damage to the expiration of the lease, and dividing that amount by the number of days from the installation of the improvements to the expiration of the lease. If the lease contains a renewal option, the number of days to the expiration of the renewal option period will replace the number of days to the expiration of the lease in the formula. The application of these provisions is illustrated by the examples from the IRMI Manual in the attached [Appendix B](#). The rationale for the formula applied in the ISO Policy is that because the tenant is not permitted to remove the improvements, the value of those improvements declines with the running of the lease period, and once the lease expires, the tenant's interest in the improvements is completely extinguished. Thus, it is critical for a tenant to replace its tenant improvements and betterments as quickly as possible, or it will risk a significant decrease in its insurance coverage. Unfortunately, the timing of a tenant's rebuilding may be outside of the ability of the tenant to control, particularly if the landlord must first rebuild all or a portion of the structure.

## Conclusion

Finding one's way through an ISO Policy, or any other insurance policy for that matter, is sometimes an exercise as difficult as interpreting the Internal Revenue Code. Working with a qualified insurance broker or agent experienced in handling claims under the form of policy that is being proposed is an invaluable resource, as the nuances of each coverage can be difficult to interpret.

## Appendix A — Coinsurance Examples<sup>6</sup>

### a. If one Limit of Insurance applies to one item:

#### Example No. 1 (Underinsurance):

When:	The value of the property is	\$250,000
	The Coinsurance percentage for it is	80 %
	The Limit of Insurance for it is	\$100,000
	The Deductible is	\$250
	The amount of loss is	\$40,000

Step (1):  $\$250,000 \times 80\% = \$200,000$  (the minimum amount of insurance to meet your Coinsurance requirements)

Step (2):  $\$100,000 / \$200,000 = .50$

Step (3):  $\$40,000 \times .50 = \$20,000$

Step (4):  $\$20,000 - \$250 = \$19,750$

We will pay no more than \$19,750. The remaining \$20,250 is not covered.

#### Example No. 2 (Adequate Insurance):

When:	The value of the property is	\$250,000
	The Coinsurance percentage for it is	80 %
	The Limit of Insurance for it is	\$200,000
	The Deductible is	\$250
	The amount of loss is	\$40,000

The minimum amount of insurance to meet your Coinsurance requirement is \$200,000 ( $\$250,000 \times 80\%$ ). Therefore, the Limit of Insurance in this Example is adequate and no penalty applies. We will pay no more than \$39,750 (\$40,000 amount of loss minus the deductible of \$250).

**b. If one Limit of Insurance applies to two or more separate items, this condition will apply to the total of all property to which the limit applies.**

Example No. 3:

When the value of the property is	Building at Location No. 1	\$75,000
	Building at Location No. 2	\$100,000
	Personal Property at Location No. 2	<u>\$75,000</u>
		\$250,000
	The Coinsurance percentage for it is	90%
The Limit of Insurance for Buildings and Personal Property at Location No.s 1 and 2 is		\$180,000
	The Deductible is	\$1,000
The Amount of Loss is	Building at Location No. 2	\$30,000
	Personal Property at Location No. 2	<u>\$20,000</u>
		\$50,000

Step (1):  $\$250,000 \times 90\% = \$225,000$  (the minimum amount of insurance to meet your Coinsurance requirements and to avoid the penalty shown below)

Step (2):  $\$180,000 / \$225,000 = .80$

Step (3):  $\$50,000 \times .80 = \$40,000$

Step (4):  $\$40,000 - \$1,000 = \$39,000$

We will pay no more than \$39,000. The remaining \$11,000 is not covered.

**Coinsurance in the Event of a Total Loss<sup>7</sup>**

(Amount of loss x (Limit of Insurance ÷ Limits of Insurance Required)) - Deductible = Loss Recovery

When:	Property Value	\$250,000
	Coinsurance Applicable	80%
	Limit of Insurance Required (80% x 250,000)	\$200,000
	Limit of Insurance	\$100,000
	Amount of Loss	\$250,000
	Deductible	\$250

Then:  $\$250,000 \times \frac{\$100,000}{\$200,000} = (\$250,000 \times .50) = \$125,000 - \$250 = \$124,750$

Loss Recovery:	\$100,000	(the limit of insurance)
	\$125,000	(from the coinsurance formula)
	<u>- \$250</u>	(the deductible)
	\$124,750	<i>But Recovery is limited by the limit of insurance to \$100,000</i>

## Appendix B — Loss of Tenant Improvements and Betterments

### Valuation of Improvements and Betterments<sup>8</sup>

If repairs are made promptly valuation is: actual cash value at time of loss.<sup>9</sup>

If repairs are not made promptly valuation is:

$$\frac{\text{Original cost} \times \text{Number of days from loss date to expiration of lease}}{\text{Number of days from installation to expiration of lease}}$$

Original Cost of Improvements            \$10,000

Number of days in Lease (5 years H 365 days)    1,825

#### Example No. 1:

Number of days from loss date to expiration of the lease (loss 180 days into lease)	1,645
Number of days from installation to expiration of the lease (installation complete at inception of lease)	1,825
Valuation of improvements ( $\$10,000 \times 1,645 \div 1,825$ )	\$9,000

#### Example No. 2:

Number of days from loss date to expiration of the lease (loss 2 years into lease)	1,095
Number of days from installation to expiration of the lease (installation 1 year into the lease)	1,460
Valuation of improvements ( $\$10,000 \times 1,095 \div 1,460$ )	\$7,500

---

<sup>1</sup> The primary resource used for this paper was the International Risk Management Institute, Inc.'s reference guide to Commercial Property Insurance, a three-volume set (also available on CD-ROM) that is updated frequently. It is referred to as the "IRMI Manual" elsewhere in this paper.

<sup>2</sup> When builders risk coverage is advisable or required to cover additions or improvements rather than relying on the ISO Policy language is beyond the scope of this paper.

<sup>3</sup> Defined elsewhere in the ISO Policy as "merchandise held in storage or for sale, raw materials and in-process or finished goods, including supplies used in their packing or shipping."

<sup>4</sup> See the definition of "stock" in footnote 3 above.

<sup>5</sup> Where the insured has elected replacement cost coverage, the ISO Policy automatically includes, as one of the Additional Coverages, coverage for Increased Cost of Construction. However, this coverage is limited to the lesser of \$10,000 or 5% of the Limit of Insurance applicable to the insured building (which can be further reduced by the coinsurance provisions), and it does not cover the cost to demolish undamaged portions of the building or the extra costs to upgrade the reconstruction or undamaged portions to meet current code requirements. This requires an Ordinance or Law Coverage Endorsement (ISO form CP 04 05), a discussion of which is beyond the scope of this paper.

<sup>6</sup> Source: Commercial Property Insurance, International Risk Management Institute, Inc. (2000 Edition), p. V.K.3 (4th Reprint November 2000).

<sup>7</sup> Source: Commercial Property Insurance, International Risk Management Institute, Inc. (2000 Edition), p. V.K. 5 (4th Reprint November 2000).

<sup>8</sup> Source: Commercial Property Insurance, International Risk Management Institute, Inc. (2000 Edition), p. JV.J.14 (4th Reprint November 2000).

<sup>9</sup> Or the cost to replace, if replacement cost coverages applies.