

### Our Legal Reality



#### Know Your Insurance Options by Scott Arquilla

*"Disaster planning is something we generally don't think about, but is necessary in any business....review your business interruption options the next time your policy comes up for renewal."*



Since the fire that destroyed our plant, I have discussed our property coverage extensively with our liability and workers compensation insurance broker. He did not actually place the property insurance but has extensive experience. He has provided a much better way to cover our business for the future. I thought I would pass on what I have learned about property coverage so all SBC readers can benefit from what I have gone through. I will address some of the requisite issues and provide the basic building blocks to constructing a properly written property insurance program.

#### REPLACEMENT COST

The most fundamental issue is establishing the accurate values of your property and contents and selecting the appropriate limits of insurance. As you will see, establishing these values is dependent upon the type of insurance you purchase. Most brokers recommend the use of the valuation method we employed—Replacement Cost (RC). Some would think this means “new for old,” but this is not necessarily the case. It actually means “like kind and quality.” In reality, replacement cost means the lesser of: (1) the limit of insurance applicable to the damaged

property; (2) the cost to replace the property with other property of comparable material and quality, used for the same purpose ("like kind and quality," if you will); or (3) the amount actually spent that is necessary to repair or replace the property. With RC coverage, depreciation does not come into play. This may or may not result in a "new or old" claim settlement but is the highest valuation basis available notwithstanding Manufacturer's Selling Price (finished "stock" only). If that clause is not available to you for your stock, make sure RC is applied to your stock as well as your other property. In this instance, the policy must read "replacement cost including stock." Again, the Manufacturer's Selling Price clause only applies to finished stock. Stock that is both finished and sold, but not yet delivered, should be automatically covered at its selling price less discounts and expenses you otherwise would have had. Make sure this is the case.

## ACTUAL CASH VALUE

Another common valuation clause is Actual Cash Value (ACV). This is actually the basic approach used in most policies (but again, not necessarily the optimal one). ACV is not book value. Book value should never be used for insurance purposes regardless of the valuation clause because substantial underinsurance will usually result. Book value is based upon the original purchase price rather than the cost to replace property. ACV, while not usually defined in the policy, generally means replacement cost minus depreciation. If a saw cost \$100,000 to replace but the actual saw you have is ten years old, an ACV valuation will depreciate the insured value by ten years. When all is said and done, you may only receive \$40,000 or \$50,000 yet you will need to spend \$100,000 to replace it. The premium paid for ACV coverage is less than RC coverage and, in certain situations, RC may not be available to you. This is sometimes the case when property is very old or in poor shape. It may also be a function of poor property protection (for example, an old frame building loaded with wood and no sprinklers) and/or general insurance market conditions as the "hard" market currently in existence. You should resist ACV and attempt to obtain RC if at all possible.

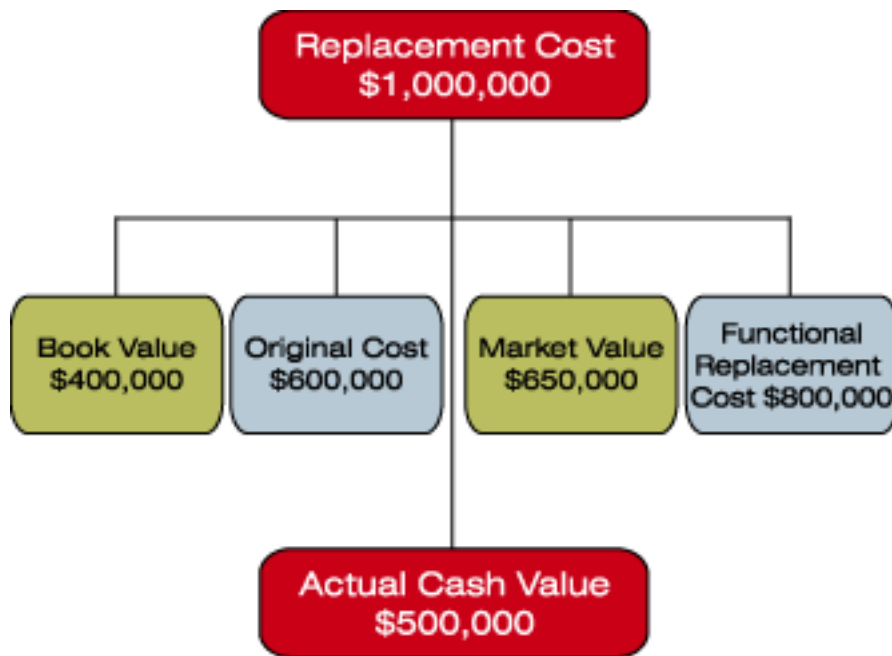
## LESS COMMON TYPES OF COVERAGE

While the above types of coverage are the most commonly used and available, there are other less used valuation clauses such as Functional Replace-ment Cost (FRC) and Market Value (MV). The FRC endorsement provides an alternative in situations where neither ACV nor RC is appropriate. This may be the case when replacement with identical property is impossible or unnecessary. It is basically RC without reference of "comparable material and quality" or the cost to replace with similar property intended to perform the same general functions. Computer equipment is probably the best example; you wouldn't want to replace 486 Intel chips when the standard has moved up to Pentiums. You want your new system to contain the faster Pentiums. We all know a computer bought today will be obsolete and replaced by something faster and cheaper very soon.

Yet another approach is Market Value which may be used to insure property whose market value is substantially different in some way than its ACV or RC value. This could apply when the MV is substantially less than its actual cash value as in the case of a building in good repair located in a blighted area. It could also apply to a building with a substantially higher market value than ACV or RC for a building that simply could not be repaired or replaced to its original condition.

An example would be a building that was built by old-world craftsmen using building materials and techniques which are no longer available. If the government didn't self-insure such things, the White House might fall into this category. There is also a MV endorsement for stock (primarily for retailers), which is used for property that is bought and sold at an established market exchange where the market prices are posted and quoted. Again, these last two valuations are not widely used and may not be available or appropriate to your needs.

In sum, an illustration of these various valuations applied to the same building might look like this:



If we were dealing with business personal property (contents) coverage, we could also have a separate box for Manufacturer's Selling Price (finished stock only) and/or Market Value-Stock. In the example above, there might also be a different value or box for the Mortgage Value, which would, most likely, be different than all other valuations, depending upon the remaining amount of the mortgage. A mortgage with a short time to maturity would probably be lower than all of these, whereas a newer mortgage could be higher as it might include the value of the land, which, of course is not a subject of insurance. This is only one example; many other valuations and a myriad of scenarios are possible.

Lastly, it is then most important to blanket all property, inventory and contents coverage together instead of purchasing individual, separate policies. My adviser has suggested that we set up coverage so co-insurance valuations are limited and the carrier agrees to coverage amounts when the policy is written. This procedure would have saved us a lot of time in dealing with our carrier. As we all know, insurance coverage can be purchased to cover just about any risk, like that big hole-in-one prize at the last golf outing you attended. My experience has always told me to rely on experts whenever an insurance issue is discussed. I'm not selling insurance, rather the idea that we understand all of the options available.

We were very fortunate to have an affiliated company next door with some vacant space. Disaster planning is something we generally don't think about, but is necessary in any business. I

also recommend that each of you review your business interruption options the next time your policy comes up for renewal. Buying insurance is always a delicate balance of risk versus reward. In evaluating every option, each of you will be better prepared if and when a disaster strikes your business.

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Scott Arquilla is Vice President of Best Homes, Inc. in Hazel Crest, IL, and the 2003 President of WTCA.

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