



Reinstatement Basis of Settlement

Practical Problems in Adjusting Losses

by the CIL A Property Special Interest Group

This Guide is intended to assist experienced adjusters in considering the issues that arise when dealing with commercial property claims where, as is most often the case these days, the basis of settlement is reinstatement. There are various versions of wordings in existence and it is not proposed to go into the finite details and subtleties of these, but to give some help on the basic principles and problems. It is anticipated this will give the industry an opportunity for a more consistent approach, although of course at all times any specific instructions or requirements from the relevant insurers will prevail. Nevertheless, it is important the issues are understood, even if the answers are not always so clear.

It is not intended to set out a typical wording in detail in this document. Most adjusters will be more than familiar with the typical forms of words and their variances. Almost universally, however, the wordings allow for repair or replacement of the damaged or destroyed insured item(s) to a condition equal to, but no better than, when new, provided the reinstatement is actually carried out. What we are seeking to do is highlight the key aspects and particularly those that may be problematical. For the purposes of this guidance document such cover will be referred to simply as “reinstatement” and should be construed as covering all the various wordings out there.

It is worth making the point at this stage that there is little in the way of case law to refer to. There are various opinions and views, and the adjuster and insurer will need to weigh the merits and logic of the arguments. This paper provides a reasoned and logical interpretation of how the cover might be considered to apply but the true test is what can fairly and equitably be agreed between the insurer and their policyholder, in any given circumstances.



The Essential Principles

The first point to have clear is a policy providing reinstatement cover is still a contract of indemnity. The addition of the reinstatement basis of settlement simply provides a means by which an indemnity will be calculated. It is important to understand this point - and to remember an insurance policy covers the insured's *financial interest* in the subject matter of the cover, not the item itself. So, if the damage to the item in question causes the insured no financial loss, there is no indemnity to consider and reinstatement is an irrelevance.

It is important to understand this concept of *financial interest* as it has wider implications and helps in appreciating the reasoning behind some of the later comments in this paper. Specifically, it is generally accepted that the starting point for determining the amount the insured may have to spend on reinstatement is the “notional reinstatement value” (NRV) but this may not be as simple as it seems.

The Notional Reinstatement Value

- *Buildings*

Taking buildings losses first, there is a definite difference between repairs and rebuilding. Clearly for repairs, the materials used need to be compatible with the rest of the building, so if the building is old and has traditional materials (slate roof, stone walls, etc.) then it is only reasonable matching or sympathetic materials are used for repairs. This is entirely consistent with protecting the insured's financial interest as a “hotchpotch” repair will reduce the value of the building, and thus reduce the insured's financial interest. We will come back to the requirement to actually reinstate.

For a complete rebuild, it is more complicated. The NRV of an old industrial building of traditional construction is not necessarily, and is in fact unlikely to be, its exact replication in terms of materials and construction. If we take a warehouse as an example, which is likely to be the more practical and valuable - a building of modern construction (steel frame, block/brick walls and cladding roof, etc.) or one of massive solid brick walls, slate roof, internal columns, etc.? The clear answer is



the former and it will also cost far less to construct. By reinstating using modern methods, the insured's financial interest is protected as the final result is an asset at least as valuable, and probably more so, than that which was lost.

Conversely, there might be a good reason to want to replicate some or all of the original building - where the building is "listed" or of particular architectural interest, for example - if however there is no good reason, other than to extract a higher figure from insurers, this should be resisted unless reinstatement takes place on a like for like basis, for good and valid reasons. The efficacy of the approach to the NRV can and should be considered with reference to the actual reinstatement intended and carried out - as will be explained further below.

There are many variations on this theme and each case must be seen on its merits. Full height brick walls, for example, as the original building, might well be a reasonable thing to want for security and lower maintenance, but the cost of building those walls using modern methods and materials is the measure. So block inner skin, cavity construction and facing bricks is the correct cost, not some solid 9" thick brick, or as has been argued in the past, rubble filled, 3 feet thick stone walls.

The important thing to bear in mind is that, if the insured has no intent to replicate obsolete features, there is no reason to include those as a part of the NRV calculation. It should be stressed, this is not an imposition of a modern materials basis of settlement - if the original building had stone walls, then stone walls can be allowed in the NRV - but it could be argued that they should be built in a modern manner, with cavity construction, insulation (to meet building regulations) and a stone outer skin. Indeed actual replication of a solid, rubble-filled stone wall would not be compliant with thermal requirements, or indeed likely to be within the skills of most contractors. So to try and build as was and then introduce thermal properties thereafter, would be much more expensive, may well be impractical and would produce no tangible benefit. As commented on below relative to the actual reinstatement carried out, such issues might well turn out to be academic in any event, if elements of the building are reinstated in a different manner.



Whilst the guidance in this paper has been split into sections to assist in understanding the main aspects, it should be understood that, in reality, an holistic approach is really needed - so the NRV and the actual reinstatement are inextricably linked. If the insured has no intention to replicate costly, obsolete elements of the original building (such as the rubble-filled walls referred to above by way of example) then such costs should not form part of the NRV consideration.

- *Contents*

This same principle applies to machinery and contents - the insured's financial interest in an item is whatever it does, not the machine itself. Computers are an excellent analogy, given the pace of change and the fact new equipment is generally better and cheaper than the original. It would seem incongruous to spend money on replicating an out of date specification of computer when, for far less, a more efficient and faster computer can be obtained today. It is the functionality that is important, but that can of course include reliability, quality and the like as all these things are relevant. The basic principle remains however that the "notional reinstatement" of a machine is the current equivalent in terms of its functionality - same capacity, output, quality of product, etc. as the original. If only an improved replacement can be obtained (the computer being a typical example) then the NRV is the current nearest equivalent, with arguably a deduction made to reflect the inherent improvements.

The Actual Reinstatement

General Considerations

Having established the "notional reinstatement value" we then get into the problems of carrying out the actual reinstatement work, as is required under all such wordings.

Most wordings require reinstatement to be done in a reasonable time frame and some define that time frame. If it is defined, it is clear. If it is not then there could be a problem that does not seem to have an easy answer. What may or may not be a reasonable period to commence reinstatement is subjective and it is unusual for an insurer to be prepared to take issue on this, except in extreme cases. This is very much something



to use to apply pressure to get progress but its use as something with which to impose a basic indemnity settlement instead of reinstatement is dubious, as long as the insured do genuinely have an intention to reinstate. Where it can be shown the insurer's position has been prejudiced by delays, this is an issue that can be taken up, but equally if the insured can provide good reason for not having commenced reinstatement, it is unlikely there is any remedy under the standard, open-ended wording.

Most wordings are quite clear in distinguishing between repair and reinstatement. If the basis of costing the notional reinstatement is repairs, then the repair must be carried out. Where this can be more controversial is with a significantly damaged building, and an insured would like to put the money toward a new build elsewhere. This would not be compliant with the terms of most clauses. You cannot carry out a repair elsewhere, as there is no damage there to repair and therefore an indemnity settlement would be appropriate. Using that money to put towards a complete replacement is not therefore reinstating in a strict interpretation of most wordings - although in some cases insurers will accept this as a reasonable option and their agreement can be obtained. This may well therefore be part of a negotiation with all parties.

Usually the controversy in this area arises with total losses (which would include constructive total losses) and the option to reinstate in a different form and in a different location. Of course the art of loss adjusting relies on excellent communication. Understanding the policyholder, the Insurer and the desired outcome will assist considerably.

- *Contents*

Let's look at machinery and contents first, as that is easier. Having established the NRV as above, the insured can replace with a different item and it can go in a different location. So, a different manufacturer, a different model, etc. are all fine but it is only a valid reinstatement if it has the same purpose as the original. A plastic injection moulding machine must be replaced with a plastic injection moulding machine - buying a lathe instead would not be a reinstatement. The replacement can be bigger, faster or better in other ways, but the insured will have to contribute in proportion to the level of betterment. This is where it can get problematic- even more so for buildings as will be expanded on later - but



upholding the principle of financial interest detailed above, will ensure it makes sense. It is not the amount spent on the reinstatement that is important, it is what is obtained for the amount spent.

In the example above of an injection moulding machine, if £100,000 is the agreed replacement cost of a similar machine of the same make but the insured then spend that same £100,000 on a machine of a different make which has 25 % additional production capacity (for example the replacement makes 10,000 units per hour compared with 7,500 for the original), then the correct level of payment is arguably £75,000. There may be other factors that mitigate or affect the contribution but this example sets out the principle. In reality, the correct NRV is £75,000 as it is the insured's decision to replace with a better model - they just originally advanced a different proposition for the purpose of the claim. It is not therefore a simple matter of making sure the NRV is a cap, it is important to examine what the insured actually do and any other factors which may be relevant.

- ***Buildings***

With a building it can be more complex, as of course a building is made up of many parts and components, with lots of options to vary those to suit. Dealing firstly with the “reinstatement elsewhere” option, it does appear this is pretty limitless. Certainly a different location of the insured's is fine but there really is no sound reason to preclude a new site (although the insured would have to buy the land) and it can be in a different town and even potentially a different country. The wording will need to be verified but it will have to be clear from the wording why any option put forward is not acceptable.

As with the machinery above, the first point is the building should have the same functionality as the destroyed one. Rebuilding a block of flats instead of a factory is not a reinstatement. Taking the warehouse example mentioned earlier, however, rebuilding an originally multi-story old building as a high-bay single storey modern building is fine, as is building two warehouses instead of one, provided the overall result is not “better”. As with everything stressed in this paper, “better” needs to be construed in terms of the insured's financial interest. For our warehouse “better” would generally mean bigger, as the use of a warehouse is its capacity for



storage - it is also the size that drives the value. Arguably, a single storey building may be more attractive than a multi-storey one but provided the overall size remains the same, it would be acceptable. It is worth remembering that size is a function of more than floor area - the height of the rebuild is also relevant. A warehouse that is 15m to eaves as opposed to an original that was 10m to eaves has a greater storage capacity for the same floor area and will have greater value.

Applying the same reasoning as with the injection moulder, the Insured should not automatically expect to spend up to the agreed NRV and recover this figure, nor is the betterment judged against the NRV. If the original building was 50,000 sq. ft. and the insured build 100,000 sq. ft. (same height) the Insured would arguably be entitled to 50% of the amount spent on reinstatement - not 50% of the NRV. This larger floor area for the same price can be achieved by reducing the specification of the building from the original to a more basic level so it costs less per sq. ft. (or sq m) but that does not entitle the Insured to have a bigger building as a result. It is what they reinstate that counts (which is in reality reinstating in another manner) and the overriding issue is then the betterment.

This issue is something that can be reasonably extended to elements of the building. If a building had a slated roof and that is agreed as appropriate in the calculation of the NRV, if the insured then actually put back a roof of metal cladding, they should not automatically assume that they can use the saving from that to enhance something else. The reinstatement carried out is the metal clad roof, so that is the cost they are entitled to for the roof. The same applies to the walls (refer back to the rubble-filled stone walls mentioned earlier), the internal finishes et al - although there is a point perhaps where reality should prevail in terms of the relevance and significance. For major elements of the building, this is however valid. Equally money spent on enhanced car parking, landscaping and the like is not reinstatement expenditure so amounts saved on a reduced building specification would not normally be used to pay for other, undamaged aspects.



Under insurance

Under insurance on the buildings is relatively straightforward in that Average will apply, although care needs to be taken as to whether the policy is on a sum insured or Day One basis, to ensure the correct figures are used. The value at risk will be the agreed NRV and the insured can then have the net of Average figure once they have spent it, or more, on an acceptable reinstatement project - not forgetting to account for any “betterment” in whatever project it is. As the nature of the calculation in the event of a total loss is likely to produce the same figure on indemnity as the after - Average reinstatement calculation (as the VAR is reduced by the same amount as the deduction for depreciation) then the same figure is going to be payable as an indemnity, leaving the insured to do as they wish. For partial losses, however, consideration needs to be given to the levels of depreciation applicable to the affected elements, as compared to the whole.

The same considerations will apply to contents where single items are concerned but for partial losses (involving several items but not all the contents at risk), the indemnity based VAR might well be different from the indemnity based loss, in terms of deductions for depreciation for the items in the claim, compared with the undamaged items that form the balance of the VAR.

Beware also of suggestions to “mix and match” indemnity and reinstatement: it is not correct to allow any of the claim on reinstatement unless the overall VAR is calculated on full reinstatement and average applied to the whole claim on reinstatement. That produces a net of Average sum the insured can then use to reinstate those items they want to replace, with indemnity allowances on other items. The actual settlement paid can therefore be a mix of indemnity and reinstatement in terms of expenditure of the after Average figure, but the Average calculation must assume overall reinstatement of all items at risk if any item is to be included in the pre-Average settlement on a reinstatement basis.



Conclusion

Hopefully property adjusters will find this guidance a useful reference for the main issues and the principles of reinstatement settlements but it must be stressed that there are many variations on the theme, all with different merits. Pragmatism and commerciality may well also come into play and must not be lost sight of. Of course by engaging with all parties and understanding the issues, loss adjusters are usually able to agree an outcome which is favourable and acceptable to all parties.

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