

Indemnity Basis of Settlement.

Practical Problems in Adjusting Losses.

By the CILA Property Special Interest Group

INTRODUCTION

All insurance policies are based on providing the policyholder with an indemnity, but just how that indemnity should be calculated is not always obvious. We have provided a separate guidance note on how one possible indemnity might be calculated – under the Reinstatement Memorandum – but where that is not applicable, or its conditions are not met, then consideration has to be given as to the basis of arriving at an alternative, equitable indemnity settlement.

This paper concerns indemnity as a whole rather than being restricted to specific methods of arriving at an indemnity settlement – such as deductions for wear and tear, or second hand values. Both of these may well be components of an indemnity settlement in appropriate situations but there may well be other methods of settlement provided by the policy. Loss adjusters must understand the need to treat customers fairly, taking into account the requirements of the Financial Conduct Authority and, as appropriate, decisions taken by the Financial Ombudsman Service.

Firstly, it is worth restating that an insurance policy covers the insured's financial interest in the subject matter of the policy, not the thing itself. It is a fundamental principle of insurance that an insured must have a financial interest in the item that has been lost or damaged, to be able to make a claim, so it follows that any claim can only relate to the financial loss suffered by the insured. Therefore if something was of no value to an insured before it was lost or damaged, then the insured can suffer no loss as a result of any such loss or damage. Equally, if an insured had only limited interest – for example shared ownership of something – then they can only suffer a loss to the extent of their share of the financial loss/ value of any item. This may be something that can be ascertained by considering any contractual arrangement that is in place.

Keeping this fundamental point in mind at all times, we can then give more specific consideration to how it can be applied to the different aspects of property losses. As always, the policy wording applicable to the loss should be referred to in the first instance, to see if that makes any reference to the means of calculating the indemnity in the particular circumstances under consideration.

BUILDINGS

It is probably in relation to buildings losses where there is the most potential for dispute, especially when dealing with total losses. Before tackling that, it is however worth looking at partial losses, where repairs are carried out. In such cases it is well established that the basis of an indemnity settlement is to reflect the pre-damage age and condition and this should be approached on an elemental basis. Different parts of a building have different expected lives and the approach is to consider the age and condition, pre-damage, and reflect the remaining expected lifespan in the indemnity calculation.

For example in a house fire, typically there will be damage to plasterwork, decorations, electrical services and the like, and possibly also damage to some structural elements, such as the roof. It is necessary to consider each element separately; if the decorations were in poor condition prior to the fire, then significant deductions are appropriate. Indeed if decorations were in very poor condition (for example spoiled by graffiti) then there is an argument there is no loss – based on the principle above. At best, it might be appropriate to accept there are some additional costs associated with removal or sealing in of smoke, prior to redecoration, which is an additional cost the insured would not have had to meet if redecorating before the fire. The same process therefore needs going through for each element – gauge the expected life of the element; how much of that expected life had it already had before the fire and thus what life it had left, in percentage terms, applied to the cost of replacement. Some elements will last the life of the building; some may have an expectancy of 50 years, and so on. At the opposite end of the scale, if a damaged building element had only been renewed shortly before the fire, then indemnity would be the full replacement cost.

Where damage is extensive but a building remains repairable, the potential for the cost of the repairs to exceed the diminution in market value (DMV) should not be overlooked: if repairs are not going to be carried out, then the same considerations apply as below in terms of valuing the insured's loss. There are valid reasons why repairs which exceed DMV might be appropriate – the building may be of special interest to the insured, or there may be tenant issues to address. As long as there is a clear intention to repair, and DMV is not an acceptable alternative to the insured for good reason, then indemnity based on repairs is realistic.

Where the greater problem arises is in relation to a total loss and whether settlement should be based on rebuilding less depreciation or diminution in market value. It has been suggested this depends on the insured's interest and use of the building in question before the loss, and that is certainly relevant. Also of importance, however, is the insured's intention after the loss, and that is probably the more relevant aspect.

If, before a loss, a property was for sale than it seems quite clear the correct measure of the loss is the DMV. The residual value of the land needs to be taken into account, although if that is based on a cleared site, then the cost of demolition and clearance needs to be allowed for. Unless the building can be rebuilt (with due allowance for age and condition) for less than the diminution in market value, then in such cases DMV is the correct measure of indemnity as that will reflect the pre-loss condition of the building. If it was in poor repair, then its value is reduced accordingly. If in excellent condition, that is also reflected.

Where the property was not for sale, then the strict legal position remains that the starting point is DMV, as the financial interest of an insured in a building is, in the first instance, limited to that building's value. If therefore the insured have no intention of rebuilding, then irrespective of what they intended before the loss, the correct measure of indemnity is the DMV. This was confirmed in the cases of *Reynolds v Phoenix (1978)* and *Pleasurama v Sun Alliance (1979)* as being the correct approach, albeit that in *Reynolds* the judge felt rebuilding was the starting point, but only because he was convinced the insured did intend to rebuild: in *Pleasurama* the decision was also different but only because it was not felt there was a realistic method of establishing any market value for the particular building affected. Both cases did however affirm that, generally speaking, loss of market

value would be the correct measure of indemnity in circumstances where rebuilding was not intended.

There are however many reasons why an insured might wish to rebuild, even if that cost exceeds the market value of the building. In the case of a house, it is unlikely to be possible to directly replace the house by buying another. If the insured particularly like the location, the specific piece of land or have other valid reasons and wish to rebuild, then the correct measure of the indemnity is the rebuilding cost, but with appropriate deductions for age and condition, pre loss. In most cases this means the insured have to contribute to the rebuild costs, in some cases significantly, and that may affect the decision. DMV might therefore still be a realistic alternative, as might an enhanced value, reflecting the particular insured's use and circumstances.

For commercial losses, there are also many reasons why rebuilding might be the preferred option. The destroyed building might be only one of several on site and required for the business – so rebuilding is the only viable option. Again, pre-loss age and condition need to be reflected although of course the insured can then take the funds available and build to a lesser specification or reduced size if no additional funding is to be made to supplement the insurance payment. The important point is that the measure of indemnity is influenced by the insured's intention post incident, as it is what they do that establishes their level of financial loss as a result of the destruction of the building in question. If the business can readily operate from alternative premises and comparable facilities are available on the market, then it may be the correct measure of indemnity is the cost of buying such alternative premises, reflecting of course any residual site value.

Commercial landlords are primarily interested in a rental return on their investments. If a building is destroyed and it is readily replaceable on the market as a realistic alternative, there will need to be good reasons to go down the rebuilding route. Tenant interest may be such a good reason, or a building forming part of an estate. Generally, however, if DMV differs significantly as against rebuild less indemnity considerations, DMV is the way to go, and probably the preference of a property investor in any event. Partly funding a rebuilding project to achieve the same level of return as can be obtained by buying an alternative building at no additional cost to the insured is clearly not going to make good business sense.

In summary, for total losses of buildings, the prima facie measure of the loss is DMV. The insured's intentions and interest pre-loss may well reinforce the view that DMV is the correct measure but equally relevant will be the insured's intentions after the loss. If they buy another building or intend to take a cash settlement and do nothing, then that will not change the prima facie position. Only if they have a clear intention to rebuild, in some form or another, does the rebuild cost (with due allowance for depreciation) become a realistic measure of the insured's loss. It is important that the adjuster discusses the intended approach to the indemnity in these situations with the insurers concerned before beginning negotiations – the insurer may have other considerations to take into account that affect the situation.

MACHINERY, PLANT & GENERAL CONTENTS

It is an easy and often made mistake to assume that the repair costs for a damaged machine are payable as an indemnity and only if an item is completely replaced are deductions required for wear and tear. On the contrary, many repairs involve the replacement of components that have limited

operating lives or significant maintenance costs - motors, bearings, etc – and it is therefore quite correct to expect an insured to contribute towards repair costs that involve such items being replaced. The same principles apply as outlined above for a damaged building – reflect the usage or proportion of expected life already enjoyed before the damage and allow a pro-rata amount of the repairs. It should not be overlooked that labour is an integral part the cost of replacing a damaged component so that should be apportioned as well.

For significant repairs, the question of economic viability has to be considered. It is perfectly reasonable to look at the second hand replacement cost of items when dealing with a claim on an indemnity basis and such replacements can be significantly cheaper than repairs. Any proposed second hand replacement does need to be a comparable item in terms of age and condition but there can be some degree of flexibility in this respect, and also exact model comparison. It is far better to find a slightly better second hand replacement than the damaged item, and still make significant savings against the alternative of repair costs. The value of any salvage should not be forgotten when making such comparisons.

For total losses, again the second hand alternative is realistic and especially so if the insured bought the original item second hand in the first place, as it often the case with, for example, machine tools and other substantial items. If no second hand option can be found, then the measure will be current equivalent replacement less deductions for depreciation. Delivery and installation costs should also, of course, be included (in the overall cost calculation *before* deductions are made for depreciation), which may be significant in the case of heavy items of machinery.

All of the above assumes, as is generally the case, the insured use and wish to replace the item in question. Just as with the buildings above, there is however a possibility the loss of selling value might be the correct measure of the loss. This might be the case where an insured had surplus equipment for disposal and either a history of selling, or an intention to sell off unwanted items. That being the case, their loss is the likely realisable value, had the item been sold. Equally if the insured show no intention to replace an item at all, it can be inferred it was not needed in any event and again the loss of disposal value might well be the correct measure of indemnity.

Where an item is hired or on loan, provided the definition of “Machinery, Plant, etc.” includes such items, the insurable interest is limited to the extent of the insured’s financial responsibility under any contract. In the absence of any contract, 2nd hand replacement (or indemnity for repairs) would be appropriate. If a contract should commit the insured to replacement cost, that may not be fully covered by an indemnity based policy – the cover requires deductions for wear and tear to be made, either specifically in some wordings or by reference to the word “value”, which refers to the actual value of the loss or damage. The insured could therefore find themselves with cover that falls short of their responsibility under some contracts (leased photocopiers are a common example) as the liability for any loss beyond the “value” is a contractual liability.

STOCK

Generally the establishment of an indemnity for lost or damaged stock is more straightforward but there are a number of specific problems that can be encountered.

For stock purchased for resale, the cost of replacement immediately after the loss, or as soon as realistic after the loss, is the measure. If foreign currency is involved, then the exchange rate at the time of earliest possible replacement should be taken, or the actual cost if replacement is delayed, if that is a lower figure. Any obsolescence identified for slow moving items should be taken into account, unless it can be shown that such items are generally sold off at greater than cost. Even then, as a negotiating point, it may be appropriate to maintain there is still some deduction required as the replacement stock has an enhanced ability to derive profit, which would not have been forthcoming from the older items. Alternatively, this might be a consideration if there is also a BI loss. It is of course quite possible that the replacement stock costs more than the original but that is entirely consistent with the principle of indemnity, provided the stock is to be replaced.

There can be cases where the selling price may well be an appropriate measure of indemnity. Rare or irreplaceable items (parts for rare cars as an example) might fall in this category as does scrap or by-products from a production process. Some commodities can also be valued in this way as of course the reality is, being commodities, the current replacement value is the same as the current selling price; traders generally make their profits on speculation in these markets.

Manufactured goods and work in progress (WIP) are more complicated. The insured are entitled to the cost of replacing such items to the point reached when damaged. So, if finished, it is the cost to the insured of remaking: if WIP it is the cost of remanufacture to that point. The question is what should be included in that valuation.

Clearly, the insured will have to purchase or use further raw material. That should be included at replacement cost on the date of the loss. To that will be added labour, variable overheads and fixed overheads, plus a profit margin. Traditionally, labour was seen as a directly variable cost and an integral part of the remanufacturing cost but in reality most labour forces are relatively fixed costs these days with little variance in terms of volumes of goods produced. Directly variable production costs, such as electricity or gas used in heating or cooling processes, will be incurred again; although there could well be a fixed element (standing charges) which will not be re-incurred. Fixed costs will not increase – rates, rent, head office costs, etc. - and they should not be included as the normal contribution to those will be derived from the sale of the replacement stock, or the BI claim if sales are lost. The same applies to any profit element.

Given the fixed nature of wages many companies now value stock at raw material content only. If they do that and insure stock on that basis then it is fair and equitable that their claim for stock is valued on the same basis.

If an insured also includes direct wages and variable overheads, then again it is acceptable to value a loss on the same basis. There may be elements (wages in particular) that then have to be reflected as a saving in any BI loss, but it is acceptable that they are allowed in the stock loss as of course there may be no BI claim, or the insured may have chosen not to insure BI. Reflecting the principle of indemnity, however, it may be appropriate to test whether the insured are able to remanufacture the lost or destroyed items from spare production capacity, which may well be dependent on the quantities involved. Any fixed overheads should however be disallowed as those costs will not be incurred again, or increase as a result of re-manufacturing the destroyed items. Profit should also be excluded.

In general for manufactured stock, the principle of indemnity is observed by ensuring that the amount payable reflects the direct, re-incurred costs of remanufacture, and accords with the basis of the insured's valuation when fixing their stock sum insured. The value at risk should also be considered on the same basis.

Goods in trust are not an uncommon aspect of stock losses, especially where a manufacturer processes other companies' goods – dyers and fabric finishers being typical examples. Stock cover indemnifies the insured and there is no set means of valuing stock under the policy. If the insured have therefore agreed to insure a customer's stock on selling price, then the insured's loss may well be that amount. In the absence of any specific contract terms setting out the basis of such liability, then the same factors are applicable in determining the owner's loss – the direct cost of remanufacture or replacement, or actual loss if lower. This assumes all issues of liability and cover are clear – goods in trust are a whole topic of their own. The stock sum insured does however need to be adequate to reflect the value at risk – so if the risk is based on a customer's selling price, the sum insured needs to reflect that, or Average will apply.

SUMMARY

By following the basic principle of compensating the insured for the financial loss they have sustained for loss or damage to insured property, as well as observing fairness and equity in terms of the insured's intentions when arranging the cover and deciding on the sums insured, an appropriate indemnity should be arrived at. As will be understood from the above, deciding on the basis for the indemnity will in part be determined by the insured's position pre loss, but also very much by their intentions post loss. Pre loss, the insured may have had no plans or intentions at all with regard to an item, which reinforces the view that it is what they intend after the damage has occurred that makes the correct basis of indemnity clearer in any given set of circumstances.

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