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The Valuation Gap: Obstacle or Opportunity?

EDITOR'S NOTE

In this issue of Adjusting Today, *author Craig Gass discusses the question of who's responsible when an insured falls victim to a valuation gap. He suggests some things the broker can do to eliminate the danger, solidifying his or her relationship with the client in the process.*

—Sheila E. Salvatore, Editor

By Craig Gass

The following scenario is all too familiar. Unfortunately, so are the consequences.

For years, NMS company has been operated in a safe and efficient manner. With the exception of a minor property loss from time to time, it has had exemplary loss experience in the eyes of its property, business interruption, and boiler and machinery insurance carriers. From the broker's standpoint, the account has been non-transactional, with the bulk of activity focused on the annual renewal. The insurance carriers' rates have reflected the general rates of the industry, with occasional moderate increases and decreases in premium having nothing to do with the insured's loss experience.

Then, as so often happens in our imperfect world, this streak of good fortune comes to an end. The insured has a major property loss. It might be caused by a natural disaster like a flood, earthquake, hurricane or tornado. Or a hostile fire. Or the interruption of key services or supplies from a critical vendor or utility. Whatever the cause, the resulting damage—physical property loss, business interruption loss, or combination of the two—portends a significant financial loss. The insured studies their predicament and assumes comfortably that they have enough insurance coverage to avert a financial nightmare. They are safe.

Or are they?

During the course of filing their claim they discover these sobering realities:

- Their reported property values are substantially less than what it will cost to replace the lost property.
- There is a coinsurance clause in their policy that further reduces their potential recovery.
- Their estimate of the potential business interruption loss as described in the business interruption application worksheet is much different from what the actual loss appears to be.
- They have not considered the long-term effect that furloughing hourly employees will have on their recovery. (Will their employees still be available if they are laid off immediately after the loss and forced to remain out of work for an extended period of time?)
- Their extra-expense coverage is not sufficient to pay the extraordinary costs the company must incur to retain its business and market share.
- Their property and boiler and machinery insurers are at odds over the proximate cause of the loss and refuse to provide even partial payment to the insured until that conflict is resolved.

Sound far-fetched? It's not. It happens every day, all over the world. And it happens just when everything seems to be going so well.

Can such an unfortunate situation be avoided? **Yes!** But to determine how, let's go back to the beginning and review the circumstances that led up to it.

In this case, the insured, like so many, casually reviewed their property values from time to time, usually based on their broker's requests for updates. Frequently working against a deadline to produce the figures, the broker provided estimates—which amounted to "guesstimates"—based on prior years' values and his own knowledge of the account. (This laissez-faire approach to the insured's property exposures is probably typical of the way many commercial insurance programs are handled. It's not my intent here to accept or reject the practice or to be critical of it, but simply to recognize it as fact. Since the typical insured seldom has any measurable frequency of property claims, little concern for them is exhibited until a loss occurs.)

Where did the insured go wrong? What could they have done differently? Who is to blame, and does it really matter? Should this predicament have been foreseen by the broker? The insurance carriers? Outside counsel? The accountants?

"The most common defect in a property insurance program—usually discovered after the loss—is the insured's failure to report and maintain values that correspond to the costs they are likely to incur in replacing lost property."

Should any advisor to the insured who deals in financial matters be held responsible? Would it be right for the insured to merely shrug their shoulders and look to another party (and that party's professional liability coverage) as the answer? In this case the answer is categorically **no**! The responsibility lies first and foremost with the insured.

Let's consider what they could have done differently at the outset, and where they could have obtained help.

The most common defect in a property insurance program—usually discovered after the loss—is the insured's failure to report and maintain values that correspond to the costs they are likely to incur in replacing lost property. At the root of this problem is the fact that most insureds have no real understanding of even the most basic policy definitions. Some of the most frequently misunderstood terms—including their correct definitions and applications—are documented in the chart on page 3.

Not surprisingly, insureds' misunderstanding of these terms frequently causes them to establish incorrect values. In this context, use of the word "guesstimate" is particularly appropriate because insureds are providing values based upon mostly stale data. (How many brokers can say that all of their clients have current property appraisals or valuations? How often do brokers see their clients use acquisition costs for property values?)

As I suggested earlier, the insured's misunderstanding of terms is often exaggerated by the time constraints imposed by the renewal process. In most cases, they merely guess. There are, however, a number of things brokers can do to help their clients avoid the "valuation gap:"

1. Explain Valuation Methods

First, make sure that the client understands the various valuation methods. Once that is accomplished, they can begin to consider which method best suits their needs. Both of these steps must be taken before any decision on values is made. Then the insured should look to their available resources to assist in a correct valuation of properties.

2. Don't Forget the Coinsurance Clause

Another fundamental mistake a client can make is failing to comprehend the meaning of the coinsurance clause and penalty that can result when values are understated.

Basically, the coinsurance clause is the protection the underwriter inserts into the insurance contract penalizing the insured for deliberately underreporting values to control their premium expense. What most insureds don't understand is the fundamental relationship between policy limits and property values. The result, in effect, is that underreporting values results in inadequate limits, and therefore a coinsurance penalty. The formula is:

$$\frac{\textbf{Ins. carried}}{\textbf{Ins. required}} \textbf{ x loss = reimbursement}$$

The solution, of course, is to:

1. Report values properly;
2. Have the coinsurance clause waived;
3. Have the underwriter accept an "agreed amount" form of coverage.

3. Make Sure the Business Interruption Worksheet is Factual

A third serious mistake often occurs in the completion of the

COVERAGE	DEFINITION	WHERE USED
Actual Cash Value	The cost to repair or replace damaged property; less real depreciation.	Should be considered for buildings that will not be replaced in the event of a total loss. (Problem with partial loss.)
Replacement Cost	The cost to repair or replace damaged property with new materials of like kind and quality, or to provide a substitute unit of equivalent utility, without deduction for depreciation.	Appropriate for most properties.
Reproduction Cost	The cost to reproduce damaged property using identical or equivalent materials and techniques, to the extent available.	Should be considered for historic buildings.
Agreed Value	Fixed amount payable in the event of total loss to property.	Appropriate for difficult-to-value items such as fine arts.
Selling Price/Market Value	As in the case of finished goods inventory.	Used for valued finished materials.

business interruption worksheet. The insured must understand clearly that the information entered on the worksheet cannot be a guess, hope, wish, or projection! Rather, it must be based on substantial fact, with past performance and current forecasts the basis for the projected numbers. Significant variances from year to year must be reconciled, so that when an actual loss occurs the insurance company's settlement will be based on both actual experience and projected business.

4. Consider Employee Expenses

In the event of a loss, the insured will have to consider the disposition of hourly employees and associated ongoing expenses. This is best handled by including ordinary payroll in the business interruption application for the projected recovery period. By continuing to pay wages, the insured is less likely to lose valuable employees.

5. Where Appropriate, Make Sure the Client has a Joint Loss Agreement

When different insurers are providing various coverages, such as boiler and machinery and property, a joint loss agreement must be added to both policies to take the insured out of any dispute between the carriers over what caused the loss.

* * *

All of these points may seem rather fundamental to the experienced broker. However, they are not fundamental to the client. Just as important, there is an opportunity here that should not be missed, and its significance goes beyond the matter of resolving the "valuation gap" itself.

Whether broker, accountant, adjuster, or another type of consultant, every professional who advises in a financial capacity bears a responsibility to help his or her client address real or potential valuation problems. In so doing, he or she should always be on the lookout for opportunities to provide good management assistance, based on his or her background and experience.

Because insurance programs are inherently complex and each professional has a unique role to play, sometimes the most valuable assistance one can offer is to recommend another service provider whose area of expertise is even more closely associated with the special need at hand. With valuation cases, the professional loss adjuster has been through the process often. As a result, he or she is best positioned to help the client in areas such as establishing property values, calculating business interruption projections and understanding troublesome policy terms and conditions.

What's more, the adjuster used by the client for a preloss program review can—and certainly should—be used following a loss as well. Having already gained familiarity with the client, their business and insurance programs, the adjuster will be well-prepared to handle negotiations with the insurance company from the outset of the loss.

The valuation gap. It can be an obstacle to a client's stability and success. Or it can be an opportunity to be of even greater service to them!

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