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EDITOR'S NOTE

For all policyholders, avoiding coinsurance penalties is of paramount importance. However, keeping up with current values, and adjusting your insurance routinely can overwhelm most property owners. The use of the Agreed Value Option is an excellent tool for insureds to avoid the possible penalty effects of the coinsurance clause in both property and business income insurance. While it provides the benefit of removing coinsurance, it can also create problems if not properly exercised. The following article by Adjusters International's insurance expert Paul O. Dudey details the origins, benefits and potential pitfalls of this alternative to coinsurance.

Stephen J. Van Pelt, Editor

Agreed Value Clause

FRIEND? OR SOMETIMES FOE?

Paul O. Dudey, *CPCU*

One of the major disappointments a firm may discover following a severe disaster: While the limit of insurance is higher than the total amount of the loss, the insured did not have a high enough limit of insurance to satisfy the coinsurance clause of the policy, so that insurance recovery of the loss is dramatically reduced.

Because most property losses are partial rather than total, it was commonplace for insureds to gamble and buy and pay for only enough insurance to cover what they believed would be the highest loss likely to be incurred, even though well below the total value at risk. In most loss scenarios, this gave the cost advantage to that insured as compared to the prudent insurance buyer who insured the property at risk for its full value. Only in the unlikely case of a loss that exceeded their expectations did the "gamblers" lose out.

To combat this practice of deliberate underinsurance, property insurers devised the "coinsurance clause," which requires the insured to carry at least a stated percent (80, 90, or 100% are common) of insurance to the value of the property insured, for which a substantial reduction in rate is offered. Failing to carry at least the required percentage of insurance to value, the insured becomes a "coinsurer," with recovery of any loss reduced in proportion to the deficiency.

For example: Assume total insurable value of $100,000 with an 80% coinsurance clause and the insured buys $40,000 of insurance. A loss of $30,000 occurs. Because the insured bought only half of what the coinsurance clause required — $40,000,

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instead of 80% of the $100,000 value at risk, or $80,000 — recovery will be limited to half of the amount of loss or $15,000, even though the amount of insurance carried, $40,000, substantially exceeds the amount of loss, $30,000.

A major problem with coinsurance, of course, is that coinsurance applies to values at the time of loss, not at policy inception when the amount of insurance is usually established based on the values at risk at that time. Or often, if values are not reviewed and the limit of insurance adjusted at policy renewal, they may already be inadequate to satisfy the coinsurance requirement, and can become even more out of line as time passes.

In times of rapid price inflation, or at any time for a growing business, values at risk can quickly outgrow the insurance, leaving the insured subject to a coinsurance penalty at the time of loss, unless values are reviewed and adjusted frequently, which few insureds have the time or patience to do.

To minimize this problem, insurers came up with a provision which they initially called the Agreed Amount clause, but now call the Agreed Value Optional Coverage. This option can be included with the property insurance, usually for a period of one year, by noting on the property coverage declaration page that it applies. It suspends the operation of the coinsurance clause until the expiration date of the Agreed Value Option or of the policy, whichever comes first.

To obtain this Option, the insured must submit a statement of values to the underwriters showing the insurable value — actual cash value (ACV) or, if replacement cost insurance is carried, the cost to replace new for old with no deduction for depreciation — of all property to be insured. The underwriters can review this report, and perhaps even order an inspection of the premises and appraisal to determine the report's accuracy, and if satisfied with it, can authorize use of the Agreed Value Optional Coverage for a period of up to one year from the date of acceptance. This report does not become a part of the policy.

Prior to the expiration date of the Agreed Value Option, a new statement of values must be submitted to the underwriters and the Option extended for another year. Failing that, the Option will lapse and coinsurance will again apply. Note that most insurers apply a small additional charge (5% is common) for the use of the Option.

Allowing the Agreed Value Option to lapse can be quite harmful for the insured. If values have increased substantially in the year since the limit of insurance was established and a loss occurs, applying the coinsurance provision to the increased values can, of course, produce a coinsurance penalty in the loss recovery.

Notice also that if the expiration of the Agreed Value Option is beyond the policy expiration, the Agreed Value Option will end with the expiration of the policy, and unless the policy renewal or extension shows that the Agreed Value Option again applies, coinsurance will again apply, again with the possibility of a coinsurance penalty in the event of loss.

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Use with Fluctuating Values

One possible use of the Agreed Value Option is to replace a reporting form, eliminating the need under the reporting form for monthly or quarterly reports of values. The average of the annual values can be shown on the annual report. This eliminates coinsurance as well as the possibility of penalty for underreporting of values under a reporting form policy, and it is necessary to review values and extend the Agreed Value Option only once a year. This works quite well as long as the Agreed Value is high enough to cover the maximum possible loss, including the cost of debris removal.

Use with Blanket Coverage

For example, with blanket coverage over two or more separate locations far enough apart that they would not be totally involved in the same loss, the entire blanket amount is available for a single loss.

A further advantage of the Agreed Value Option with blanket coverage is that, unlike with coinsurance, it is unnecessary after a loss to prove the values at all locations other than the loss at the involved location.

Failure to Carry Enough Insurance

A word of caution: The Agreed Value Option requires the amount of insurance carried to be not less than the agreed value stated in the Option. Failing this, the insurers will pay only that proportion of the loss that the amount of insurance carried bears to the amount that should have been carried, as stated in the Agreed Value Option.

What occasionally happens is that the insured's values drop substantially for whatever reason, so that less insurance is required. A case in point might be an insured with substantial values in the World Trade Center insured blanket with property at other locations, as well. If the insured reduces the amount of insurance to reflect the World Trade Center destruction, if the Agreed Value is not also reduced to reflect this change, a reduction in recovery of any future loss can result.

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Change in Language

When the Agreed Value Option was introduced by the Insurance Services Office (ISO) in 1986, replacing the Agreed Amount clause, changes were made in the language with (according to the Bulletin from ISO announcing the changes) no important change in the meaning of the provision. Note that for the purposes of this article, reference is to the ISO forms and endorsements, but insurers not following ISO also usually use the equivalent Agreed Value provisions to the same general effect.

The Agreed Amount Endorsement CF 12 10 was replaced by Optional Coverage G.1. Agreed Value, which is activated by appropriate entry on the property coverage declarations of the limits of insurance to be carried and the expiration date of the Agreed Value Option.

Added under the new provision is an expanded explanation of the expiration provision, which the ISO Bulletin states is "for clarity." The Waiver of Inventory and Appraisement clause of the Agreed Amount Endorsement is eliminated on the Agreed Value Option because, as the ISO Bulletin states, "all inventories are optional with the company in the simplified form."

Use with Business Income Insurance

The effects of coinsurance (or "contribution clause" as it is sometimes called with time element insurance) can be even more devastating with this coverage than with property insurance.

Earnings, income, and expenses can fluctuate greatly over time, and limits of insurance established at a low period can become woefully inadequate at time of loss, even if only a short time later.

ISO did make one improvement in this provision a few years ago. It made the coinsurance clause apply to the values for the 12 months immediately following the inception date of the policy term in which the property damage giving rise to the time element claim loss occurred. Previously, the clause applied to the values for the 12 month period immediately following the date of loss. In a time of rising insurable values, this change can make quite a difference in the effect of coinsurance. There may be some independent insurers still using the older clause. Insureds would be well advised to check their policies for this provision, and if the older provision is still in use, ask that it be changed.

To combat coinsurance problems, underwriters offer the Business Income Agreed Value Coverage Option, which is included as an optional coverage under the ISO Business Income Forms CP 00 30 and 00 32. To obtain this option, the insured must submit an annual business income report/work sheet

(ISO Form 15 15) listing the gross sales (Gross sales value of production for manufacturing risks) less outgoing prepaid freight, returns and allowances, discounts, bad debts, and collection expenses, to arrive at net sales or sales value of production, add other earnings from the business, and deduct "cost of goods sold," certain other allowable expense deductions, and, if "ordinary payroll" expense is either excluded or limited, the uninsured portion of ordinary payroll expense.

Note that for business income "cost of goods sold" differs from the same term in conventional accounting parlance, in that for the insurance there is no deduction for any labor consumed in the process. Each of the items on the report/work sheet is carefully described so that even a lay person not well versed in accounting terminology can, with a little study, figure out how to complete the report/work sheet in a satisfactory manner.

Note also that the availability of year-end figures for business earnings usually lag behind the end of each fiscal year, so it is a good idea to have the annual policy expiration or anniversary and the effective date of the Agreed Value Option to also lag perhaps three months behind the end of the fiscal year, to allow time for accurate preparation of the report/work sheet, showing exact fiscal year figures.

Another change in the Business Income Agreed Value Option occurred under the ISO 1995 revision. Previously, the report/work sheet used to determine insurable values became a part of the policy. This provision was eliminated in the 1995 revision. ISO, in its Bulletin describing the many 1995 changes, makes no mention of this change or any reason behind it.

Presumably ISO felt that whether the report/work sheet was or was not a part of the policy had little bearing on the adjustment of any Business Income loss. Unless it could be definitely established that the values shown were deliberately understated no penalty could be assessed, while if deliberately understated, the fraud clause of the policy could be invoked to void the coverage entirely, whether the report/work sheet was or was not considered a part of the policy.

Included on Form 15 15, along with the last fiscal year figures, is an estimate of the figures for the 12 months, beginning not with the start of the current fiscal year, but with the date of the estimate. So with a growing business this difference should be recognized and the numbers adjusted accordingly.

Summary

The use of the Agreed Value Option is an excellent tool for insureds to avoid the possible penalty affects of the coinsurance clause in both property and business income insurance.

Great care must be taken in its use, however, to be sure that 1) the values used to set the amount of insurance are reasonably accurate; 2) the new values for the future year are established and the Option extended before its expiration to avoid reapplication of coinsurance; and 3) the amount of insurance actually carried equals or exceeds the amount called for in the Option.

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