

# Preferred Provider

[ Business Insurance ]

## What is it Worth? by Ken Von Forell, CPCU Hortica Insurance & Employee Benefits

Value is in many ways a personal thing. If you've ever watched any of the myriad of television shows that feature pawn shop transactions, antique valuations, home selling or junk dealer adventures, you have seen in action the old adage that "one man's junk is another man's treasure."

Any of us who are trying to build wealth through the aggregation of real or personal property are well aware of the vicissitudes of the market place. Building inventories to sell at a profit can be a real roll of the dice. Will my customers find this as appealing as I do? Will this color scheme be in fashion in six months? Will I have to sell at a loss just to clear my floor for the next season?

I have been in the business of selling commercial insurance to business owners for more than 30 years. Something I learned early on is that an insurance buyer thinks a building is worth one amount when he goes to

purchase insurance for it, and worth considerably more when it burns down in a fire.

Total losses by any peril, including fire, are really pretty rare. But when total losses do occur, the instance of under insurance is very common. One of the most startling examples was the Oakland Hills fire. The Oakland Hills fire in October 1991 burned 3,354 single-family homes and 437 apartment and condominium units in the suburbs of Oakland, Ca. The fire killed 25 people and injured 150 others. When I moved to California in 1993, media coverage about affected homeowner woes were still dominating the news, and in particular, the insurance trade press. The prevailing, common theme of the media coverage was that homes lost in the fire had been insured for less than the cost to replace them.

The insurance industry figured out many years ago that to collect enough premium from all policy holders to

pay the partial and total losses of the few, property had to be insured for full value, or the rate per unit would have to increase.

To meet the goal of providing full protection at a reasonable rate, property insurance contracts contain a valuation clause known as the co-insurance clause. This is a penalty for not insuring to the full value of your property. If you insure a building for only 50% of the value to replace it, not only will your limit of insurance be too low to replace the building, but the limit will be reduced by a penalty.

Insurance companies develop rates on the basis of insuring buildings to at least 80-90% of the full replacement value. Insuring below the 80-90% level typically leads to application of the co-insurance penalty at the time of loss. If you have a \$1 million building, and insure it for \$900k, the only shortfall you will have in a total loss is the difference between the \$900k and \$1 million. If you insure it for only \$600k, you might think you would collect \$600k and be done with it. If there is a co-insurance clause, you could suffer an additional \$200K penalty for under-insuring your property. The proceeds would be reduced to \$400K. Not a pleasant revelation. In addition, the penalty can apply to partial losses in the same manner.

Professional insurance agents and companies work hard to help customers value their real property correctly, so that in the event of a loss, you will be able to rebuild your property.

If space permitted, I could go on and on about dashed hopes and disappointed owners who got caught in a co-insurance trap. The instances of under-insurance are not limited to buildings; they are perhaps more common when talking about inventory and equipment. I'll save those stories for another time.

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