

Insurance: Points to Ponder

by Ken Roberts



Replacement Cost: Coinsurance or Agreed Value?

A few months ago, we discussed the differences in insuring your properties for *Replacement Cost* and *ACV*, or Actual Cash Value, and while there are a number of compelling reasons to opt for either of those choices when purchasing coverage, you need to make sure that they are what they say they are. Beware of the wolf in sheep's clothing! Replacement Cost coverage is sometimes sold in such a way that it won't provide enough coverage to replace your property in the event of a total loss. It usually involves one of two problematic pitfalls: Coinsurance or Agreed Value.

Coinsurance is the principle by which you agree to insure your property for a specified percentage of its true replacement cost, usually at least 80%, and in return, the insurance company will charge you less premium but still fully replace whatever is damaged or destroyed. The problem comes when you have a loss and the amount of insurance you have purchased isn't at least the specified percentage of replacement cost that you have agreed to. This makes you subject to a *coinsurance*

penalty where the insurance company reduces the amount that they will pay for a loss based on how close you were to buying the proper amount of insurance. Here's an example of how it works:

\$1,000,000 building with an 80%
Coinsurance clause
\$500,000 insurance purchased with
\$1,000 deductible
Building is totally destroyed by fire.
The insurance company will divide
the amount of insurance purchased
by the amount you should have
purchased and multiply that factor
with the amount of the *insured*
loss:

$80\% \text{ of } \$1,000,000 = \$800,000$
 $\$800,000 \div \$500,000 = .625$
 $\$500,000 \times .625 = \$312,500$
minus your \$1,000 deductible =
\$311,500 to replace a \$1,000,000
building

As you can see, even if you don't understand the math, you can tell that you get much less than you need if you have a coinsurance clause in your policy and you don't buy enough insurance. The key is

to have your agent tell you up front what the insurance company deems to be the appropriate amount of coverage.

The other devil in disguise is replacement cost coverage written on an *agreed amount* basis. Coinsurance is waived in this situation, and you agree on the maximum amount that the insurance company will pay for a total loss *regardless of the actual cost to replace your property*. Using the previous example, you would receive \$500,000 for the same loss, which is an improvement, but still nowhere near what you would need to rebuild.

The bottom line in both coinsurance and agreed value is that in order to recover enough to truly replace your damaged property, you must make sure that you purchase enough insurance coverage. Make sure the lines of communication between you, your agent and the insurance companies are wide open so you can avoid any unwanted surprises. *Replacement Cost is not replacement cost unless you can actually replace what you've lost.*

For more information about the AACT Insurance Program, contact:

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