

ACTUAL CASH VALUE GUIDELINES

BUILDINGS

PERSONAL PROPERTY

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ANALYSIS OF THE WORDS "ACTUAL CASH VALUE"

III

The drafters of the 1943 New York Standard Policy elected to delete the parenthetical words, ascertained with proper deductions for depreciation, which followed, and were apparently intended to qualify the phrase actual cash value, they reasoned that it was superfluous, redundant, and added nothing which would clarify the phrase.⁶ They believed that cash value meant worth expressed in terms of money and that it was unnecessary to say depreciation must be considered. However, the omission of the words opened up a broad area of controversy within the property insurance field and in the courts. Many were convinced that the meaning of the phrase actual cash value had been altered, changed completely or, in any event, made obscure.

In our attempt to analyze the phrase actual cash value to seek out its meaning and application to property we find that:

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| <u>Actual</u> | means real, factual, being, existing at the present moment (not fanciful or theoretical nor existing at some time in the past or the distant future.) |
| <u>Cash</u> | means ready money; currency or coins. |
| <u>Value</u> | means monetary or material worth. Worth in usefulness or importance to the possessor. |

Viewed in light of these definitions, actual cash value of property may be paraphrased as: ITS WORTH IN MONEY AT THE PRESENT MOMENT.

It would appear highly improbable that a reasonable person would, by any process, arrive at the actual cash value of a building without taking into consideration depreciation however it may have been caused . . . whether physical deterioration, functional or economic obsolescence.

CUSTOMARY APPROACHES IN ESTIMATING ACTUAL CASH VALUE OF BUILDINGS

IV

Prefacing any discussion of the approaches to estimating the actual cash value of buildings, it should be pointed out that, considering the millions of buildings covered by insurance, only a relative though extremely important few present any serious problem of valuation for establishing the amount of insurance or the amount of loss in the event of destruction. Reconstruction cost less a reasonable deduction for physical depreciation is the generally acceptable

rule. (Under policies covering Full Replacement Cost, depreciation is not taken.)

While it is true that there can be differences of opinion as to the construction cost of particular buildings and as to the amount of depreciation to be deducted, these are matters of opinion. It is well known that even when builders make competitive estimates using the same set of plans and specifications, the spread from the high bid to the low bid is often as much as 20 to 30 percent. Also, opinions as to the amount of depreciation to be deducted for wear and tear vary considerably . . . depending on whether it is on a flat percentage or taken item by item and based on the probable life expectancy of the item.

The courts vary in their interpretation of actual cash value due largely to the different circumstances and situations under which the question arises. While it is ill-advised to generalize from isolated and specific cases, nevertheless there is a substantial body of opinion and rulings by the courts which apply to most situations encountered.

Disagreements emerge where the actual cash value of buildings, residential and particularly commercial, involve physical, functional and economic depreciation which are such dominant factors that the cost of repairing partial damage or replacing the structure may exceed its actual cash value (i.e., its real worth in cash excluding the land). Many of these controversies have found their way into the courts, resulting in a wide variety of important decisions.

Case law reflects three general tests or categories used by the courts and by appraisers to measure the actual cash value of property:⁷

1. Replacement/Reconstruction Cost, less depreciation, if any
2. Market value, where the property is of such a nature that its market value can be readily determined
3. The Broad Evidence Rule under which any evidence logically tending to the formation of a correct estimate of the value of the property might be considered in determining actual cash value.

**Reconstruction Cost
Less Depreciation -
Total Losses**

As stated earlier, reconstruction cost less reasonable deduction for depreciation, in most instances, has been an acceptable approach for estimating actual cash value. "At one time, this was the only standard for determining ACV. It was felt that all one had to do was calculate the cost of replacing the damaged property (building or contents), subtract a fair amount for depreciation and, with mathematical certainty, one arrived at ACV. This was a quick and easy way to find ACV."⁸

This approach works to most everyone's satisfaction where buildings are of fairly recent construction and where they may show physical depreciation (wear and tear) if any and, little or no economic or functional obsolescence. **Physical depreciation is a visible condition** and, while subject to opinion as to extent, it is generally subject also to negotiation between insured and insurer.

It provides indemnity to the insured on total losses and on most partial losses. The exceptions are to be found in isolated court decisions. (See Partial Losses - Depreciation)

The courts have been fairly consistent and clear on insisting that an old building may not be valued at replacement cost new and that **deductions for physical depreciation** are to be made.

"The actual cash value of the property at the time of loss is not ordinarily the same as the cost of replacing the property with new property with like kind or quality. As to a building, it is the cost of a new building of the same material and dimensions of the one destroyed, **less the amount the destroyed building had deteriorated by use.** Boise Assn. of Creditmen v. U.S. Fire Insurance Co. 44 Idaho 249, 256 P. 523 (1927)."

The right to take depreciation into account in the estimation of a partial loss was, to a great extent, taken for granted before the 1943 Standard Policy eliminated the parenthetical expression "ascertained with proper deductions for depreciation" after the word "value". Since 1943 there has been an increase in the decisions of courts refusing to take depreciation. A widely cited case is Farber v. Perkiomen Mutual Insurance Company, 370 Pa. 480, 88 At. 2d 776 (1952), where the Supreme Court of Pennsylvania so held. The judge observed:

**Reconstruction Cost
Less Depreciation -
Partial Losses**

"As already stated, if the defendants (insurers) wish to bring about a different result under circumstances similar to those present here, they will have to change the terms of their policies in order to achieve this end."

This case involved the so-called rule of consistency; i.e. applying the same percentage of depreciation on the loss side as on the value side where the policy contained a coinsurance clause. The court held the loss was not subject to depreciation, but the value was. The insurers contended that loss and value should be depreciated the same percentage.

In another case involving a coinsurance clause, the court held the parties bound by the appraisal agreement which allowed 20 percent depreciation on the loss side but 45 percent on the value side. The Court, however, plainly stated that in the absence of the appraisal agreement, the Court would allow no depreciation on the loss side. Lazaroff v. Northwestern National Insurance Company, 121 N.Y.S. 2d 122; aff'd 218 App. Div. 672 (1952).

A similar view was taken by the court in Glen Falls Insurance Co. v. Gulf Breeze Cottages Inc. 850, 38 S. 2d 828 (1949) where 50 percent depreciation was allowed in determining value but no depreciation was allowed on the loss.

An important case handed down by a New York court supports no depreciation and contains the following statement by the judge:

"Testimony on behalf of the plaintiffs is that even if allowance were made for new material, the value of the building after repairing it would be no more than it was prior to the fire, and I have reached a conclusion to that effect — moreover, I find that with the use of new materials the plaintiff would have no better building than they had prior to the fire, and in fact, the proof is that the building would lack certain materials and facilities which were a part of the building when the fire occurred." Andrews v. Empire Cooperative Fire Insurance Company, 103 N.Y.S. 2d 177 (1951).

This statement seems to emphasize more than most cases, the reaching out by the court to close the gap between indemnification and betterment.

There are very few cases in which the courts have ruled that depreciation must be taken on partial losses. Of the half dozen or so, most lack a discussion that would justify the deduction, and most involve situations where a deduction for depreciation is so apparent that to rule otherwise would be grossly unjust.

A second approach to estimate "actual cash value" is the "fair market value" approach, a term usually defined as:

Fair Market Value

"The price at which property would change hands between a willing buyer and a willing seller, each having a reasonable knowledge of all pertinent facts and neither being under compulsion to buy or sell."

Appraising is not an exact science and the element of opinion plays a major role. Therefore, the estimating of fair market value can generate wide divergence of opinion among appraisers. In spite of the often quoted definition above, it is seldom that situations for estimating fair market value involve a completely willing buyer and completely willing seller, each having equal negotiating ability.

Appraisers of market value include in their calculation (1) the cost approach, (2) the market data approach and (3) the income or capitalization approach. These various approaches are valued, correlated and weighted to arrive at a final estimate.

- (1) The cost approach takes into account reconstruction cost* less depreciation, i.e. physical deterioration, functional and economic obsolescence.
- (2) The market approach compares the property to sales and listings of similar properties in the same or similar areas.
- (3) The income or capitalization approach measures present worth of expected future net income derived from the property. It estimates vacancy, gross income, expenses and other charges. Net income is capitalized to estimate probable value as an investment.

The "market value" approach is considered the rule in California. See Jefferson Insurance Co. of New York v. Superior Court 475 P. 2d 880 (1970). The California Supreme Court, construing its standard fire insurance policy, held that:

*Note reconstruction cost, not replacement cost. See Replacement Cost v. Reconstruction Cost for explanation of the distinction.

- damage; depreciation.
- (13) Obsolescence.
 - (14) Present use of building and its profitability.
 - (15) Alternate building uses.
 - (16) Present neighborhood characteristics; long-range community plans for the area where building is located; urban renewal prospects; new roadway plans.
 - (17) Insured's intention to demolish building.
 - (18) Vacancy, abandonment.
 - (19) Excessive tax arrears.
 - (20) Original cost of construction.
 - (21) Inflationary or deflationary trends.

This list, of course, is not intended to include all elements. Each person's claim is as unique as a fingerprint and new elements of ACV always crop up."¹³

Seventeen of these 21 elements or factors relate directly to and have an influence on the market value of a building. Four of them, 1, 12, 20 and 21, relate to and have an influence on the replacement/reproduction cost less depreciation value of a building. If we include or associate economic value with market value, the Broad Evidence Rule offers the only two realistic approaches for estimating the actual cash value of any building whether it be a new one, one of recent construction, one of functional or economic obsolescence, an abandoned building or one about to be demolished. The two approaches are (1) Market/Economic value, (2) Replacement/Reconstruction value less depreciation. Implicit in both of these approaches is the Rule that every fact and circumstance tending to the formation of a correct estimate of the value must be given due consideration.

APPLICATION OF APPROACHES IN ESTIMATING ACTUAL CASH VALUE

V

Insurance underwriters and claim personnel are regularly faced with the problem of estimating the actual cash value of buildings. The underwriter is concerned that buildings are neither over-insured nor under-insured. The claims person's interest is that, in the event of loss, the insured is properly and adequately indemnified within the terms and provisions of the policy. Insureds and producers are likewise concerned.

**Replacement Cost
v. Reconstruction
Cost**

Throughout this study of actual cash value the term replacement/reconstruction cost has been used rather than the word replacement or the word reconstruction, except where the individual words could be used correctly. In both the real estate and the property insurance fields a distinction is necessary between replacement and reconstruction costs. Replacement is held to mean: To provide another functionally equivalent building, though it need not necessarily be an identical building. Reconstruction means: To restore a building to exactly the same design, size and dimensions as it was originally using materials identical as to kind and quality.

**Reconstruction Cost
Less Depreciation**

Whenever reconstruction cost less depreciation meets and satisfies a given set of circumstances, one need go no further in arriving at the actual cash value. As stated earlier, this approach works satisfactorily for the majority of buildings throughout the country. It deals solely with the building as a unit without concern for the value of the land to which it is attached. The actual cash value arrived at will, in most cases, provide indemnity to the insured should the building be damaged or destroyed, if the original estimate was reliable and kept current.

**Replacement Cost
Less Depreciation**

In many rural areas it is very common to find large, older, private dwellings that have become architecturally, sometimes structurally, obsolete. The framing is usually the full "nominal" sizes, i.e. 2"x4" instead of the present-day 1.5"x3.5" and 2"x10" instead of 1.5"x9.25"; many have parquet flooring; non-stock size and type windows and doors; fancy molded casings, baseboards and other trim of oak and chestnut - no longer available; ornamental plaster on wood lath, and ceilings that are nine and ten feet high. The roofing is often heavy slate shingles; there is a box gutter and wide overhanging, ornamental (gingerbread) cornice, and sometimes wood columns in front. It is not unusual to see three or four brick chimneys, with fireplaces in several rooms, most or all closed up after some form of central heat was installed.

When a building like the one described is functioning satisfactorily as a private, single family residence, a practical approach to the actual cash value, and one consistent with the Broad Evidence Rule, is to estimate the replacement cost as defined herein, that is, the cost of a building functionally equivalent though not identical. In most situations this approach will indemnify the insured in the event the building is damaged or destroyed. Any attempt to measure the actual cash value of buildings of this kind on the basis of the reconstruction cost would result in an amount many times the market value and far in excess of the true value to the insured.

There are many occasions when it is practicable to apply a similar approach to the actual cash value of older buildings that are occupied for commercial, manufacturing and residential (multiple family dwellings) purposes but which have been subject to major architectural, structural and plan obsolescence. Replacement with a building that is functionally equivalent and has the same capacity and utility for the occupants or tenants, usually will indemnify the insured physically and economically. Reconstruction cost less physical depreciation would produce excessive insurance requirements — something neither the insured nor insurer desire.

To use market value as the sole and exclusive measure of actual cash value of the buildings that fall into this classification would, in all probability, result in an insufficient amount of insurance to enable the insureds to repair a substantial partial loss and preclude replacing the building in event of a total loss. It would not indemnify the insureds. This is not to deny that, in these cases, there can be and often is a fine line between the application of replacement cost and market value for measuring actual cash value.

Replacement cost and reconstruction cost approaches to actual cash value, as outlined above, are understood easier than the fair market/economic approach. They are also easier to apply because the process closely follows standard and traditional methods for estimating building construction costs. Builders and appraisers, accustomed to the cost per square foot and cubic foot, and the detailed stick-by-stick and brick-by-brick methods of estimating, are very much at home with these two approaches.

**Fair
Market/Economic
Value**

Guidelines For Identifying Buildings in this Classification

While the term market value in itself is readily understood by definition, there is a divergence of opinion as to when and how it is to be used, on what kind of property it is to be used, and to what extent it affects the actual cash value of the property. This raises serious problems for both insured and insurer when trying to establish a proper amount of insurance to be carried. Looking to the Broad Evidence Rule for answers, as it was first enunciated and the numerous elements that have since appeared in court decisions where the Rule has been used, it is quite clear, that buildings that have come within the range of the Rule are those whose actual cash values are closer to fair market value than to replacement/reconstruction cost less depreciation. When the insurance is not adequate to comply with the provisions of a coinsurance clause, and a partial loss occurs, the insured would prefer that the fair market value of the building be the sole measure of its actual cash value, and thus avoid a penalty. When the

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