Do You Need Full Replacement Coverage for Your Commercial Property?

The owners of a new company found a building on the market for an affordable price, so they bought it. Built in the 1940s to manufacture aircraft for the war effort, the metal structure had a large open space.

The company occupying this space was in the software development business and the building was much larger than it needed, but the price made it seem like a sensible move. However, the owners got a surprise from their insurance agent about property coverage.

Most commercial insurance policies will cover the cost of replacing a building and its contents exactly as everything was before the loss. But the cost of reconstructing this old building to its original state was much higher than both its purchase price and that of other similar properties due to its unique architecture and out-of-production artisan materials used in its construction.

The company did not need that much insurance, and paying the higher premium for it would have been wasteful, so the owners asked the agent for alternatives. What if, they asked, we don't rebuild our building as it was and go for a less expensive replacement?

After a fire or some other catastrophe destroys a building, its owners may decide not to rebuild or replace with a similar structure for a number of reasons:

- As was the case with the software company, the current building's design may be impractical. If it were to rebuild, it would almost certainly choose a smaller building with a different layout.
- Old buildings often include materials that builders do not commonly use today, such as plaster and lathe. Reconstruction with these materials is expensive and often unnecessary for the continued operation of the business.
- The company may decide to consolidate the operations of two locations into one and not rebuild the property at all.
- Depending on the building's age, it may not meet current building codes. Rebuilding the structure up to code could be extremely costly.

The insurance options

There are two standard business property insurance policies:

An actual cash value policy — This pays for the cost of replacing any damaged property, minus an amount for depreciation.

A replacement value policy — This type of policy compensates for the full cost of replacing damaged property and contents using new materials of the same quality. This naturally entails higher premiums than for actual cash value coverage.

Due to the lower premium, the software firm opted for an actual cash value policy. This would allow them, in the event of a claim, to replace the building with a new one that costs less to construct than replacing the structure — or they could cash out and not replace the building.

The actual cash value policy may also provide a small amount of additional insurance (typically the lesser of 5% of the insurance on the building, or $10,000) to cover the increased cost of construction resulting from changes in building codes.

Other alternatives

If you feel that your business does not need an exact replacement of its current building(s), you should ask us about adding a "functional building valuation" endorsement to your policies.

This type of endorsement establishes a limit of insurance somewhere between actual cash value and full replacement cost and allows the property owner to replace the building with one that fulfills the same function as the old one at a lower cost.

It would also be wise to look at increasing your policy's "ordinance or law" coverage to provide additional insurance for higher costs from new building codes.

With the right attention to detail, a business can get the property insurance it needs without having to waste money on unnecessary coverage.

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