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Technical Advisory

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SUBJECT: How To Value Leased Business Personal Property Claims

BACKGROUND: Determining the value and proper amount of insurance for the leased personal property of business insureds can be confusing. Several elements can send insureds and agents off in many different directions, seeking the magic figure.

The lease signed by the insured can have provisions and requirements placed on the lessee (the insured). The IRS has rules that can come into play under certain lease arrangements. The insurance contract itself has both replacement cost and ACV conditions.

MAIN POINTS: The following article is reprinted from the IIABA's Virtual University. For additional articles, visit the VU website at: www.iiaba.net/vu.

How to Value Leased Property Claims

Abstract
Below is a recent "Ask an Expert" question we received involving a BusinessOwners Policy. While we attempted to address the valuation issues raised from the standpoint of the BOP, it became very clear that this particularly exposure was probably not suited for a BOP. While BOP's can be ideally suited for many mainstream businesses, it isn't for everyone. For a similar problem, check out our "If the BOP Don't Fit..." article

Question: An agency recently had a major fire loss to a restaurant/bar. One of the situations that has arisen in the adjustment of the loss concerns how to properly adjust "leased personal property."

The client is insured on an ISO form BP 00 02 12 99. Under Coverage A. it states that we will pay for direct physical loss to A.1. Covered Property...b. Business Personal Property... including: (4) "Leased personal property for which you have a contractual responsibility to insure, unless otherwise provided for under Paragraph A.1.b.(2)."

Under A.1.b.(2) it states "Property of others that is in your care, custody or control, except as otherwise provided in Loss Payment Property Loss Conditions E.6.d.(3)(b)."

Under E.6.d.(3)(b) it states "The following property at actual cash value: Property of others, but this property not covered for more than the amount for which you are liable..."

Business personal property under the form is insured on a replacement cost basis.

It seems that the insured, as is normal, leases a large amount of his restaurant equipment. The lease calls for the Lessee (the insured) to bear the entire risk of destruction of the equipment, and that if the Lessor determines that any part of the equipment is destroyed or damaged beyond repair (which is the case) that the Lessee shall at Lessor's option either replace the same with like equipment in good repair acceptable to Lessor or pay Lessor in case all amounts due under the lease up to the date of loss, the accelerated balance of total amounts due for the remaining term of the lease discounted to present value at a discount rate of 9% as of the date of the loss, and the Lessor's estimate as of the time the lease was entered into of Lessor's residual interest in the equipment.

The insurance provisions of the lease require that the Lessee provide insurance in an amount not less than the full replacement value of the equipment. The lease also states that the equipment is and shall remain the property of the Lessor until the end of the lease at which the Lessee is entitled to purchase the equipment for a residual value of $1.00.

The agent was not made aware of the leased equipment, and did not have the Lessor added to the policy.

The insurance adjuster is wanting to adjust the leased equipment at ACV. The insured is trying to state that the lease was actually a "conditional sale." The insured's accountant says the IRS required him to treat the lease as a "capital lease" because ownership of the equipment transfers at the end of the lease and thus the IRS views it as a purchase. The leasing company says that as a part of the lease agreement the Lessee has, under certain circumstances, the right to purchase the equipment at the end of the lease. The insured wants a replacement cost loss adjustment.

The question is how should the BOP policy respond to this leased equipment and what kind of adjustment should the policyholder expect?

I did notice that the older BOP form does not have A.1.b.(4), and that the leased personal property section was added several years ago. I have to assume that the language was added for a specific reason. Any background on the reason why? And does the reason provide any possibility that the leased property should be adjusted on a replacement cost basis?

Answer: Below are some responses from our faculty. As you can see, the consensus is that it doesn't matter how the IRS treats this...lease or conditional sale. The important thing is how the insurance contract reads and the fact that the insured does not yet "own" the property. Agreement was pretty much universal that the "solution" would be the CP 14 60 endorsement...of course, since this was written on a BOP, it's not available (which might indicate that perhaps a CPP would be more appropriate than a BOP, at least for this specific exposure). Also discussed is how this situation is treated by the new CP forms.

Faculty Response #1: The leased property was added because of the split from contents to Your Business Personal Property and Personal Property of Others. In the first editions, it was an oversight. Corrected in the first update.

Leased property is not the insured's Business Personal Property, rather the Personal Property of Others. In tort theory, the Personal Property of Others is adjusted on an ACV basis (example: striking the vehicle of another). The problem in this claim is that the insured signed a contract obligating him for damages in excess of tort.

Even if the leased property was Business Personal Property, because of the contractual responsibility to insure, the settlement would be ACV. The only way around this would be the Leased Property (CP 14 60) endorsement for the CP program. No such endorsement exists in the ISO BOP program. But you gets what you pay for.

The CP2000 program addresses this by the option for Replacement Cost on the Personal Property of Others, but with rather tricky wording for contractual responsibility to insure. It can still pay less than Replacement Cost. The insured may still need the CP 14 60 to provide a complete solution.

I have used this type of example in my "Insuring Leased Property" class and the class still has trouble recognizing the full extent of the problem.

Case law indicates to me that the insured has the responsibility to read the policy, absent special relationship.

Faculty Response #2: This has been a problem for agents for some time. The BOP form has the following valuation clause (and there is no option to insure property of others at replacement cost, unlike the new CP2000 and existing CP 14 60 forms):

(3) The following property at actual cash value:

(b) Property of others, but this property is not covered for more than the amount for which you are liable, plus the cost of labor, materials or services furnished or arranged by you on personal property of others;

This has also been the case in the Commercial Property Building and Personal Property form. Losses for property of others have always been settled at ACV even when the replacement cost option was selected:

3. Replacement Cost

a. Replacement Cost (without deduction for depreciation) replaces Actual Cash Value in the Loss Condition, Valuation, of this Coverage Form.

b. This Optional Coverage does not apply to:

(1) Personal property of others;

If elected, the replacement cost valuation option replaces actual cash value with replacement cost as the basis of loss settlement for all covered property except personal property of others, manuscripts, residential contents, fine arts, and stock.

Personal property of others. An actual cash value settlement on damaged personal property of others could create goodwill problems for the insured. It would be especially problematic if there is a contract obligating the insured to insure such property on a replacement cost basis. Fortunately, beginning with the 2000 edition, the building and personal property coverage form includes an option to cover personal property of others on a replacement cost basis.

With pre-2000 editions of the form, one way to resolve this problem with respect to leased property is to use the leased personal property endorsement CP 14 60 to establish an insured value acceptable to the lessor. A manuscript endorsement would be needed to amend the valuation basis for non-leased personal property of others.

Since historically, the BOP changes have followed those made to the Commercial Property forms, we can probably expect this change to be made to the BOP sometime in the future. Until then, an unendorsed ISO BOP may not be the appropriate form for this specific exposure.

Faculty Response #3: While leased property (required by contract to be insured) has been included in the Business Personal Property category since the October 1990 CP forms, valuation has been on an ACV basis until recently. I think the Leased Property End. (CP 14 60) can be used to state a valuation basis. The CP 00 40, Legal Liability won't help much, since it excludes contractual. However, these are moot points since we're talking about a BOP here, not the CP program. Unless the company is willing to provide or manuscript coverage based on other than ACV valuation, the BOP just doesn't work in this claim.