Replacement Cost v Actual Cash Value

Actual Cash Value is defined as the cost new (replacement cost) on the date of the loss minus physical depreciation.

Replacement Cost is defined as the cost to replace new with like kind and quality on the date of the loss. There is no allowance or penalty for age, depreciation or condition.

But here's the most important factor:

The insured must simply insure the property at what it will cost to buy or build it brand-new today.

Attention must be paid to the beginning point in the calculation of ACV, the cost new on the date of the loss.

ACV is not based on the value when it was purchased or at any point between that date and the date of the loss.

The cost new on the date of the loss is the figure that matters.

This is key when choosing limits, the insured must still calculate the cost new even if using ACV as the loss settlement option.

Does Replacement Cost Violate the Indemnification Rule?

The Indemnification Rule promises to put a person back into the same position as at the time of loss, not one penny better nor one penny worse.

It would seem that Replacement Cost violates the principle of indemnification as the insured is placed in a better position than existed immediately prior to the loss.

For instance, the insured's five-year-old production machine is destroyed by a covered cause of loss and they get a new one in its place.

This seems to be an abuse of the insurance mechanism.

Does Replacement Cost Violate the Indemnification Rule?

Indemnification principles are not violated and are, in fact, upheld because the amount of insurance purchased is intended to equal the cost new of all eligible and insured property on the day of the loss.

To illustrate, the machinery involved in a loss cost $100,000 new five years ago; it has a current resale (market) value of $50,000; but to buy a new piece of equipment of like kind and quality cost $150,000 today.

The only amount that matters when insuring on replacement cost basis is what it cost on the date of the loss; thus, the insured would insure that machine for $150,000.

The same process is applied to all real and personal property insured to develop the true value or its full replacement cost.

To insure to value requires calculating the current cost to buy or build another one like it (whatever “it” is) on the date of loss.

Does Replacement Cost Violate the Indemnification Rule?

"Going Out Of Business"

Insureds occasionally decide not to rebuild or replace lost property following a loss and instead elect to go out of business.

Property policy provisions guard against violating the principal of indemnification when this decision is made.

Insureds choosing not to rebuild or return to previous operations will receive the property's actual cash value.

The principal of indemnification remains intact because the insured gets no more than the remaining value of the insured property – the remaining use (cash) value of what they lost.

Indemnification is complete when the insured is returned to essentially the same condition that existed prior to the loss (subject to policy provisions and exclusion).

Replacement cost accomplishes this by providing the insured a fully furnished and equipped operation and no better.

If the insured chooses not to reopen, they are out "nothing," they don't need the lost contents any more, and are essentially made whole by being paid the remaining use value (depreciated value) of what they had.