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The Big Read Book series

Volume 3

A guide to indemnity and reinstatement value conditions

Dear reader

Welcome to Volume 3 of Norton Rose Fulbright's The Big Read Series on Reinstatement Value Conditions.

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Introduction:

At claims stage disputes frequently arise between insurers and insureds regarding the measure of the indemnity to be paid. In property insurance, reinstatement value conditions encourage the insured to reinstate the property and provide the insured with the benefit of receiving the value of new property in place of old property.

Word usage

Indemnity payment – refers to the sum of money to be paid by the insurer to the insured in terms of the insuring clause.

Insuring clause – refers to the operative clause of the policy which indemnifies the insured against loss or damage caused by an insured peril.

Reinstatement – means the repair, rebuilding or restoration of damaged property at least to a similar condition as it was in prior to the loss event.

Betterment – refers to the benefit that the insured receives following replacement, reinstatement or repair of its property when it receives the benefit of new property in place of old property.

Direct reinstatement – refers to a situation where, acting in terms of the policy, the insurer elects not to pay the insured a sum of money but instead undertakes to repair, rebuild or replace the damaged property at the insurer's own cost.

Valued policy – refers to a policy where the value of the insured property and the indemnity payment to be made in the event of a total loss is agreed at the time of entering into the policy and recorded in the policy document.

Reinstatement Value Conditions/RVCs – refers to clauses commonly found in property insurance policies in terms of which it is agreed that the insurer will accept the value of new property as a measure of the indemnity payment. Accordingly, the insured receives the benefit of betterment without any deduction being required.

Subrogation – refers to the principle whereby an insurer who has indemnified the insured steps into the shoes of the insured and is entitled to recover from any third party who may be legally liable to the insured for the loss which may be subrogation under the common law after a full indemnity, or contractual subrogation under the policy wording, after a full or partial indemnity.

General principles of indemnity

In contracts of indemnity insurance, the insurer agrees to indemnify an insured against loss caused by the insured perils, subject to the terms of the policy.

Property insurance policies normally provide for indemnification either:

Directly – by actual reinstatement (repair, rebuilding or replacement) of the damaged or lost property.

Indirectly – by the payment of a sum of money as compensation for the insured's loss.

Direct reinstatement

If the policy does not provide for the option of direct reinstatement or if the insurer elects not to reinstate, the insurer must compensate the insured indirectly by payment of a sum of money. Where the policy does provide the insurer with the option of electing to reinstate directly and the insurer makes such an election, its election is irrevocable and the insurer is bound to comply with its undertaking to reinstate the property. If the insurer fails to do so, it will have breached its undertaking. Insurers hardly ever elect to reinstate fixed property because it can lead to endless arguments with the insured about whether the building has been properly reinstated.

Indirect compensation – indemnity payment

In terms of the insuring clause, the insurer can indemnify the insured in respect of any damage covered by the policy, subject to any contractual limitations, by payment of a sum of money calculated to place the insured in the same position that it was in prior to the loss event.

Once the indemnity payment has been made by the insurer, the insured is under no obligation to use the funds for the purpose of reinstatement or replacement of the insured property. The insured is free to retain the funds or use the funds for any other purpose.

The calculation of the indemnity payment involves a comparison between:

- The value of the property to the insured immediately prior to the event.
- The value of the property to the insured immediately after the event.

The terms of the insurance policy may contain clauses which provide that the insured will not be entitled to a full indemnity. For example, policies may limit the indemnity payable to the sum insured, require the insurer to pay an excess/deductible, and provide for average to be applied in the event of under insurance.

Over compensation/betterment

The insured should not ordinarily be over compensated so that it profits from the loss event.

Following a loss and the repair/replacement/reinstatement of the insured's property, the insured usually has the benefit of receiving new property in place of old. If this benefit is unreasonably generous, the insurer should consider making a deduction (termed betterment) to take into account this benefit. Insurers must be able to prove and calculate the advantage and value to the insured of such betterment. In the absence of such proof and calculation, no deduction should be made.

What is the value of the property to the insured?

Where the insured has an unlimited interest in the property (e.g. the insured is the owner of the property), the value of the insured's interest will usually be calculated with reference to the market value of the property. The indemnity should be calculated as the loss in the market value of the property.

However, in some instances the value of the property to the insured is not properly reflected by its market value and another measure should be used to calculate its value. Thus, for example, where an insured runs a successful business using unique machinery for which there is a limited market, the value of the machinery to the insured may exceed the pre-event market value. In these cases the indemnity to the insured may be calculated by the costs of reinstatement or replacement less an appropriate deduction for any betterment.

The property insured may hold special value for the insured and the insured may intend to reinstate it even if such reinstatement would be uneconomical. For example, the cost of reinstating or repairing a historic building may be far greater than its market value and an insured, for sentimental or statutory reasons, may then wish to insure the property for its reinstatement value.

The measure of the indemnity is a matter of fact and degree in the circumstances of each case and is materially affected by the insured's intentions. There may be a dispute between insurers and insureds as to whether the value of the property to the insured is the reinstatement/replacement value or the market value. Disputes often arise in circumstances where, following the loss, the insured has not commenced with reinstatement/replacement and there is doubt as to whether the insured intends to reinstate/replace the property. This is an area of some controversy and there are recent decisions of the English courts (which are persuasive to South African courts) from which it can be noted that:

- The primary focus should be on the insured's intention immediately prior to the loss.
- Only where there is a risk that the insured may be over compensated by indemnification calculated on a reinstatement basis do the insured's intentions after the loss become relevant.
- The issue remains controversial. In one of these decisions it was held that insured (in the particular circumstances of that case) needed to show a genuine, fixed and settled intention to reinstate at all times following the loss (this decision was *Western Trading Ltd v Great Lakes Reinsurance* (UK) SE (formerly Great Lakes Reinsurance (UK) plc) [2016] EWCA Civ 1003). However, this view has been departed from in in a subsequent judgment dealing with different circumstances (*Sartex Quilts & Textiles Ltd v Endurance Corporate Capital Ltd* [2019] EWHC 1103 (Comm)).

Contractual quantification and Reinstatement value conditions

Many property policies contain clauses which have the effect of agreeing, prior to the loss of occurring, the manner in which the indemnity will be calculated. Common examples of these clauses are:

- Valued policies, in terms of which the value of the insured property and the indemnity payment to be made in the event of a total loss, is agreed at the time of concluding the policy. In the event of a total loss the insured will be entitled to receive the agreed value, but the insurer may have grounds to avoid the policy if the property was significantly overvalued and this materially affected the insurer's assessment of the risk.

- Policies incorporating Reinstatement Value Conditions (RVCs) or similar clauses in terms of which it is agreed that the insurer will accept value of new property as a measure of the indemnity payment. Accordingly, the insured receives the benefit of betterment (new property) without any deduction.

Reinstatement Value Conditions (RVC)

A typical RVC clause is:

If property other than stock is damaged, the basis on which the amount payable is calculated will be the cost of replacing or reinstating on the same site property of the same kind or type but not superior to nor more extensive than the insured property when new provided that:

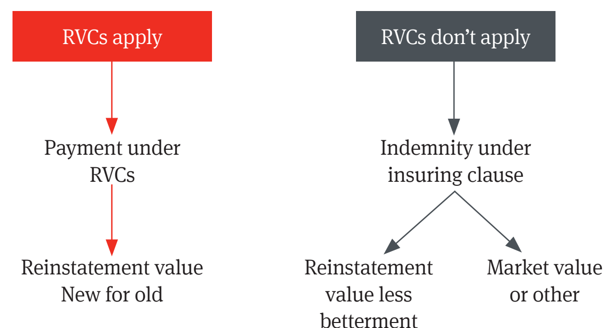
- The insured must intimate to the company within six months of the date of damage, or such further time as the company may in writing allow, its intention to replace or reinstate the property.
- The work of replacement or reinstatement must be commenced and carried out with reasonable dispatch.
- The work may be carried out upon another site and in any manner suitable to requirements of the insured provided that the liability of the company is not increased.
- The insured must be willing and able to replace or reinstate the property on the same or on another suitable site.
- Until expenditure has been incurred by the insured in replacing or reinstating the property, the company will not be liable for any payment in excess of the amount that would have been payable if these reinstatement value conditions had not been incorporated herein.
- If, at the time of replacement or reinstatement the replacement or reinstatement value of the whole of the insured property exceeds the sum insured immediately prior to the damage to the property by a defined event, the insured will be considered to be their own insurer for the excess and must bear a rateable proportion of the loss.

These provisions may therefore include:

- The insured must give notice to the insurer of its intention to replace or reinstate within a specified time period.
- The insured is required to commence and carry out the work with reasonable despatch, meaning that the work must start and progress at a reasonable pace.
- The insured must actually incur expenditure in replacing or reinstating the property, otherwise the insured will only be entitled to an indemnity payment in terms of the indemnity clause.

The following flowchart is a diagrammatic representation of the general principles that apply to typical RVCs wordings across the industry:

Reinstatement value conditions (RVCs flowchart)



What constitutes reinstatement?

Typically, in RVC clauses reinstatement means the repair or restoration of property damaged to a condition equivalent to or substantially the same as but not better or more extensive than its condition when new. In the case of immovable property (buildings), many policies allow reinstatement to take place on another site.

In the course of reinstating or replacing property, the insured may wish to make changes to improve or expand the property. The cost of any such improvements must be paid for by the insured. In such cases, the insured should clearly identify to its insurer the improvements which it intends to make and pay for the improvements.

Where the improvements are extensive, it may be necessary to draw up a costing of a notional plan to reinstate the property to the same condition together with a costing for the actual (more extensive or improved) plan. The insurer will only be liable for the notional cost of reinstatement and the additional costs will be for the account of the insured. (see the English case of *Tonkin v UK Insurance Ltd* [2007] Lloyd's Rep IR 283).

What if the insurer disputes its liability?

When insurers elect to avoid the policy or reject the claim and such decision is disputed by the insured, the insured will need to decide whether to commence reinstatement in order to comply with the RVCs pending the finalisation of the dispute. The insured may not have funds to do so or may reasonably not wish to use its own funds to do so until such time as the dispute has been determined in its favour.

In such instances, South African courts have decided that the RVCs, particularly the obligation on the insured to commence and carry out the work of reinstatement with reasonable despatch, will be suspended until the dispute is finalised (see *Watson and another v Renasa Insurance Co Ltd* 2019 (3) SA 593 (WCC) and *Grand Central Airport (Pty) Ltd v AIG South Africa Ltd* 2004 (5) SA 284 (W)).

In circumstances where no interim payment has been made by insurers, South African courts have even gone so far as to order insurers to pay under the RVCs in circumstances where reinstatement has not commenced and the insured had not incurred any expenses in reinstating (*Watson and another v Renasa Insurance Co Ltd*).

Cession and assignment of right to reinstatement value

Many policies prohibit the insured from transferring any of its rights under the policy to third parties. Where the policy does not prohibit the insured from transferring its rights or if insurers have given their consent to such a transfer, it is debatable whether the right to claim under the RVCs is included in such a cession or assignment.

Such a situation may arise where insured decides to sell the damaged property to a third party together with cession of the right to claim the reinstatement amount under the policy of insurance.

There are foreign court decision that suggests that RVCs are contingent on the insured itself carrying out the reinstatement works. These decisions reason that if reinstatement is to be carried out by a third party then the claim will be limited to the indemnity value (see judgment of New Zealand Supreme Court in *Xu & Another v IAG* [2019] NZSC 68).

It is doubtful that South African courts will follow this approach because the right to cede the proceeds of an indemnity policy is generally permissible. Any decision will be subject to the wording of the particularly policy. To avoid uncertainty, it is suggested that prior to entering into any agreement to sell or purchase damaged property which is the subject to an RVC claim, that the seller, purchaser and insurer all agree on the measure of indemnity that the purchaser will be entitled to claim.

Value-added tax

Value-added tax (VAT) for an RVC indemnity is deemed to be a supply made by the insured. If the insured is a registered vendor, the amount received under the policy (in tax parlance also an 'indemnity payment') as a result of a loss suffered in the insured's business, is deemed to be received for a service rendered by the insured (refer section 8(8) of the Value-Added Tax Act, 1991). The insured must account for output tax to SARS on the indemnity payment received. There are exceptions to this rule which are unlikely to be relevant to RVCs.

Value of claim in subrogation

After indemnifying the insured, the insurer may step into the shoes of the insured and be entitled to recover from any third party who may be legally liable to the insured for the loss. The terms of the policy of insurance are not relevant to the quantification of the claim against the third party because it is not a party to the contract of insurance. Accordingly, the value of the recovery action will not be increased if the insurer had paid out under RVCs or paid out in terms of a valued policy. The value of the claim against the third party will also not be decreased by a limit of the sum insured, average clause or deductible.

The quantification of the recovery action will depend on the nature of the third party's liability to the insured and whether the claim is in terms of a contract with the third party or is a statutory or delictual claim independent of any contract.

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