



THE PRACTICAL IMPLICATIONS OF
THE REPLACEMENT COST
ENDORSEMENT

October 1994



DOLDEN WALLACE FOLICK LLP

DOLDEN WALLACE FOLICK LLP INSURANCE LAWYERS
TENTH FLOOR – 888 DUNSMUIR STREET
VANCOUVER, B.C. V6C 3K4
Tel: 604.689.3222 Fax: 604.689.3777
WWW.DOLDEN.COM



THE PRACTICAL IMPLICATIONS OF THE REPLACEMENT COST ENDORSEMENT

Most in the insurance industry are familiar with the replacement cost endorsement.¹ Yet few are aware of the origins of the replacement cost endorsement, or, the judicial constraints on its use. The purpose of this paper is to explore the modern development of the replacement cost endorsement and the limitations the provision poses for insurers.

A. HISTORICAL DEVELOPMENT

It is generally believed that the concept of a special type of insurance to indemnify for the monetary difference between actual cash value and replacement cost developed at the turn of the century, either in Germany, or in London.² Initial opposition to the replacement cost endorsement centred on the concept that such a provision would violate the fundamental principle of indemnity and as such act as an incentive for arson. Only when the insurance industry was able to satisfy itself that replacement value was not payable until the property was actually replaced, and the requirement to replace would operate as a disincentive to criminal acts, did the provision gain widespread acceptance.³

B. WHAT "TRIGGERS" THE ELECTION TO REBUILD THE PREMISES?

To successfully invoke the replacement cost endorsement the insured must satisfy several pre-conditions. Firstly, the insured must make a clear and unequivocal election to rebuild as opposed to claiming actual cash value. In examining the insured's intentions one judge has remarked that the test is:

"... the existence or non-existence of acts or statements clearly, distinctly and unambiguously signifying that a choice has been made."⁴

Secondly, there is normally a requirement that the insured proceed with "due diligence and dispatch" in undertaking a replacement. There is scant judicial discussion of what constitutes "due diligence" and it is obvious that this is a question of fact contingent upon

¹ See precedents at Appendix A to C.

² Manes, "Insuring New Value", III Fire Insurance Monthly Bulletin, No. 1 (1928).

³ Kelly, "The Insurance of Profits, Reinstatement Value, Agreed Amount and the Principal of Indemnity", *The Insurance Law Journal*, September 1966 No. 5.

⁴ *Evangeline Savings & Mortgage Co. v. General Accident Insurance Co.* (1984), 7 C.C.L.I. 12 at p. 25.



the type of building being replaced. One case example suggests that 15 months from the date of loss to the date of submitting a Proof of Loss does not constitute "due diligence and dispatch".⁵

Frequently an insured will commence replacement having exercised "due diligence and dispatch" but encounter delays and difficulties attributable to either their own impecuniosity, or, as a result of the acts of a third party. Invariably, delay results in greater costs, and the issue is whether the insurer must bear these costs. The answer appears to be "no". The measure of recovery is what a reasonable contractor would charge acting with reasonable dispatch in completing the repairs or replacement. An illustration of this principle is the decision in *Gannon and Associates Ltd. v. Advocate General Insurance Co et al.*⁶ The insured was without financing and as a consequence could not proceed with skilled contractors acting with reasonable dispatch. The Court allowed only the costs of a "reasonable" contractor and stated:

"The insured's impecuniosity, in my view, is not a factor affecting the extent of indemnity. The policy terms govern the rights of the parties without regard to the particular circumstances of the insured. He must proceed with due diligence but if his financial disabilities increase the cost beyond that which is reasonable and produce delays in the work, in my view, such factors are not features of indemnity provided in the replacement cost endorsement."⁷

Conduct on the part of the insurer can act to postpone the insured's duty to exercise "due diligence and dispatch". The insurer can waive this requirement.⁸ In addition, if an insurer fails to acknowledge its obligation under the policy, this failure "suspends" the due diligence requirement. For example, if the insurer entirely denies the claim in view of a possible arson defence, the due diligence requirement is postponed until the moment the insurer acknowledges liability under the policy.⁹ As Mr. Justice Meredith stated:

"... the obligation of the insured to rebuild does not attach until the insurer has acknowledged its reciprocal obligations under the policy. The insurer chose to wait to satisfy itself as to those obligations It follows, in my view, that it is only when the obligation to pay is acknowledged (as against when the loss occurred) that the obligation to rebuild arises."¹⁰

5 *Caruso v. Manitoba Public Insurance Corp.* (1990), 44 C.C.L.I. 234 at p. 241.

6 (1984), 12 C.C.L.I. 61.

7 *supra*, at p. 77.

8 *Shrinkaruk Enterprises Ltd. v. Commonwealth Insurance Co.* (1992), 8 C.C.L.I. 198 at p. 207.

9 *Onega Inn Ltd. v. The Continental Insurance Co.* (1987), 24 C.C.L.I. 10.

10 *supra*, at p. 12.



For reasons to be examined later in this paper it is now fairly clear that an insurer's repudiation of the policy entirely relieves the insured of the need to rebuild. A wrongful repudiation "suspends" the operation of the insured's election to rebuild until a point in time when the insurer either acknowledges liability, or is assessed with liability by a court.

C. MUST THE INSURED REPLACE THE PROPERTY IF THE INSURER DECLINES THE CLAIM?

There can be a variety of reasons why the property insurer would decline a claim. The insured in those circumstances is uncertain as to whether it will be fully indemnified if work is undertaken to rebuild. The Canadian cases make it quite clear that in such circumstances the insured's election to either accept actual cash value or to replace the property is "suspended" until the insurer acknowledges its liability. If liability is found at trial the insured will be given a defined period in which to make an election.

A defence of arson best illustrates the problem. In *Olynyk v. Advocate General Insurance Company*¹¹ the insurer refused a Proof of Loss contending that the loss was attributable to arson. The insured elected for replacement, but took no action in furtherance of its election prior to the trial of the action. At trial the insured was successful. In giving the insured 60 days from the date of judgment in which to elect to either take actual cash value or to rebuild the Court stated:

"... an insurance company which wrongfully repudiates the contract and refuses to make any payment at all cannot defeat the claim of the insured to be indemnified against the costs of actual replacement simply because the insured has not exercised due diligence in getting on with the rebuilding. The breach by the insured is overshadowed by the much more basic breach by the insurer. In this case the repudiation by the insurance company, however understandable, turned out to be unjustifiable and it is very much a smudged finger which the company points at the insured for delaying the decision to rebuild. It is not inequitable that an insured person who has paid the premium set by the company for replacement indemnity should be able, when the risk materializes to have a fair opportunity of deciding what to do in the light of the funds which will be available. Complete repudiation by the insurance company cripples the anticipated freedom of action of the insured."¹²

¹¹ (1984), 12 C.C.L.I. 7.

¹² *supra*, at p.13.



The trial judge's views on the matter were affirmed by the Manitoba Court of Appeal without much comment.¹³ The Court felt it would be foolish on the part of the insured, faced with a denial of the claim, to proceed with rebuilding. This same result has been reached by Courts in British Columbia¹⁴, Saskatchewan¹⁵, and Ontario.^{16 17}

It should also be noted that at least one court has gone so far as to suggest that payment of merely part of the claim (the balance not having been paid by the insurer due to a policy dispute) acts to suspend the insured's election.¹⁸

D. MUST THE INSURER PAY THE ACTUAL CASH VALUE PRIOR TO REBUILDING BEING COMPLETE?

There exists a division of opinion as to whether the insurer must pay cash value prior to the rebuilding being complete. This has significant implications for the insured. Absent financing many insureds look to the actual cash value proceeds to finance construction. While as a matter of practice many insurers fund the rebuilding as work progresses, the narrow legal issue is whether the insurer is obligated to do so. It would appear that in B.C. the preferred view is that the replacement cost endorsement dictates payment only once replacement is complete and the insurer is not obligated to make progress payments.¹⁹ However, that view is not universally shared, and in at least one province the opposite conclusion has been reached.²⁰

The principle that an insurer is obligated to make progress payments is best exemplified by the decision in *Gannon & Associates Ltd. v. Advocate General Insurance Company*. Mr. Justice Simonsen stated:

"The standard provisions of the policy provide for payment of actual cash value, however, with the addition of a replacement cost endorsement an insured may seek indemnity for replacement if the repairs or replacement is effected in accordance with the terms of the endorsement. I see nothing in the endorsement or policy terms which negates or modifies the insurer's obligation to pay actual cash value within 60 days of the proof if an insured

13 (1985) 12 C.C.L.I. 17 at p.19.

14 *Datatech Systems Limited v. Commonwealth Insurance Co.* (1983), 1 C.C.L.I. 210.

15 *Caesar's Palace Ltd. v. Elite Insurance Co.* (1987), 22 C.C.L.I. 170.

16 *Peters et al v. Commonwealth Insurance Company* (1990), 47 C.C.L.I. 288.

17 *Donald A. Foley Limited v. The Canadian Indemnity Company et al* (1982), I.L.R. 1-1556.

18 *Bayers Road Bowlrama Ltd. v. Phoenix Assurance Co. of Canada et al* (1986), 20 C.C.L.I. 195 at p. 219.

19 *Carlyle v. Elite Insurance Company* (1986), 18 C.C.L.I. 111.

20 *Gannon & Associates Ltd. v. Advocate General Insurance Co.* (1984), 12 C.C.L.I. 61, 32 Man. R. (2d) 1 (Q.B.).



opts for replacement. It therefore follows that the insurer has the initial contractual obligation to pay actual cash value within 60 days of the proof while settlement for the additional costs of replacement or repair is delayed until replacement has been effected."²¹

That view, evident in Manitoba, has the support of at least one Judge of the B.C. Court of Appeal.²²

Of significance is a recent decision of the British Columbia Supreme Court in *Folk v. Saskatchewan Mutual Insurance Company*.²³ In *Folk* the insured sought a preliminary determination that he was entitled to actual cash value prior to actually completing the reconstruction of the building. In adopting the view evident in *Gannon & Associates Ltd.*, *supra*, the Court stated:

"I am satisfied that the policy does give rise to an obligation on the part of the insurer to pay the actual cash value of the property destroyed up to the limits of the policy or the insured's interest, whichever is less. A further obligation remains: to pay any additional amount expended by the insurer to repair or replace the building up to the limits of the policy provided the insured elects to proceed under that clause and complies with its terms and conditions."

However, the dominant view, in British Columbia, is that the replacement cost endorsement contemplates that the insurer will pay the cost of replacement after the replacement is complete and progress payments are not required.²⁴ In *Carlyle* there were various expressions of opinion to that effect. For example, Esson, J.A. expressed the following opinion [at page 343]:

"As a matter of practice, it appears that insurers will generally pay the actual cash value where that is less and may make other progress payments, but the policy does not, as I read it, require them to do so."

The second judge who concurred in the majority, Seaton, J.A., expressed no opinion on the issue stating [at page 350]:

"I propose to express no view on the matter that has just been discussed. I think it is not essential to the decision."

Therefore, at least in British Columbia, there is a divergence of opinion as to whether there is any obligation under the policy to pay money pursuant to the replacement cost

²¹ *supra*, at p. 76.

²² *Carlyle v. Elite Ins. Co.* (1986), 18 C.C.L.I. 111 at p. 127.

²³ (1992), 14 C.C.L.I. (2d) 128.

²⁴ *supra*, at p. 123-124.



coverage until the replacement has been made. However, it seems that an order directing payment of the replacement costs, which is the effect of ordering the insurer to fund the replacement, is not allowable.²⁵

E. DOES THE REPLACEMENT BUILDING NEED TO BE IDENTICAL?

Most replacement cost endorsements stipulate that the replacement building be constructed of "like kind and quality". Generally, these words require:

- (a) an equal amount of usable space;
- (b) substantially the same utility;
- (c) equivalence in terms of heating, lighting, plumbing and electricity;
- (d) that the previous style be followed.²⁶

As was stated in one earlier decision:

"It is my opinion that replacement cost as used here means the cost of erecting a building which would be similar to the destroyed buildings in the following characteristics: It would have the same amount of useable area; It would have substantially the same utility; Its heating, lighting plumbing and electrical or other facilities would be equivalent; Its style if lending any intrinsic value, would be followed and to assure the foregoing its construction and finish would be comparable in the context of today's building practices."²⁷

For this reason the insured cannot simply apply the insurance proceeds to a partially constructed building on the existing building site if the building constitutes an entirely different structure.²⁸

F. CAN YOU THE INSURED RECOVER ITS FINANCING COSTS INCURRED DURING CONSTRUCTION OF THE BUILDING?

We have seen that an insurer is not obligated to fund the cost of construction until the building has been replaced. Often this means that the insured will need to obtain

²⁵ *Anastasov et al v. Halifax Insurance Company* (1987), 26 C.C.L.I. 7.

²⁶ *Chemainus Properties Ltd. v. Continental Insurance Co.* (1989), 43 C.C.L.I. 146.

²⁷ *Berenbaum v. Halifax Insurance Co.* (1966), 57 W.W.R. 148 at p. 14.

²⁸ *Andriash et al v. Canadian Northern Shield Insurance Co.* (1987), 24 C.C.L.I. 91.



financing which inevitably gives rise to financing charges. The interesting issue is whether those financing charges are recoverable from the insurer. This issue arose in *British Columbia Buildings Corp. v. Reed Stenhouse Ltd. et al.*²⁹ The insured owned a correctional centre that was destroyed by fire. The insured incurred interest charges of \$105,000.00 resulting from the financing of the repairs. The Court concluded that a broad form "All Risk" policy that extended to "physical loss or damage" necessarily precluded financing costs which were indirect or consequential and not direct. However, the Court did make clear that if the insurer wrongfully refuses coverage, and as a consequence the insured incurs such costs, they are recoverable as damages for breach of contract.³⁰

G. DOES PURCHASING A BUILDING, RATHER THAN REBUILDING CONSTITUTE REPLACEMENT?

In rare cases, assuming the replacement cost endorsement does not require replacement on the same site, the acquisition of a like building at a nearby site can constitute replacement even though the insured is not rebuilding. In *Chemainus Properties Ltd. v. Continental Insurance Co.*³¹ the insured has a warehouse destroyed by fire and chose to purchase a new property rather than rebuild. The insurer argued that the insured had not "replaced" the property. Given that the term replacement was undefined the Court relied on American cases to the effect that an insured may effect replacement by purchasing a substitute of equivalent use.

In April 1993 the Alberta Court of Queen's Bench confirmed that the purchase of an existing building at a different location can indeed constitute "replacement" within the meaning of a Replacement Cost Endorsement in a property policy. In *319107 Alberta Ltd. v. New Hampshire Insurance Co.*³² the Court ruled that the insured's purchase of a similar hotel in a different town constituted "replacement" under the multi-peril subscription policy issued by the insurers. It should be noted, however, that the policy in question specifically authorized replacement "on the same or another site" as the insured's building.

The case is similar to the B.C. Supreme Court decision in *Chemainus Properties v. Continental Insurance*,³³ which held that an insured may in appropriate cases effect replacement of a building by purchasing a substitute building of equivalent use and at a different location. While the policy under consideration in *Chemainus* did not expressly

²⁹ (1989), 38 C.C.L.I. 87.

³⁰ Citing *Lepin v. Uniguard Mutual Insurance Co.*, *supra*, at p. 92.

³¹ (1989), 43 C.C.L.I. 146.

³² (1993), 9 Alta. L.R. (3d) 151 (Q.B.).

³³ 1990 CanLII 319 (B.C.S.C.)



permit replacement on a different site, the clause requiring replacement on the same or an adjacent site had been deleted from the policy at the insured's insistence.

319107 Alberta Ltd., supra, is of additional interest to insurers for its discussion of an insurer's obligation to engage in meaningful dialogue with the insured on the replacement issues. It is well known that the insured's obligation to replace with "due diligence and dispatch" can be suspended or postponed where the insurer denies liability under the policy. For example, if the insurer denies the claim on grounds of arson, the due diligence requirement is postponed until either the insurer acknowledges liability under the policy (i.e. relinquishes the arson defence) or has liability imposed upon it by a Court. But, in the absence of a denial of coverage, how much must the insurer consult with the insured concerning what constitutes "replacement" under the policy?

In *319107 Alberta Ltd., supra*, the Court ruled that there is an implied term in this type of policy whereby the insurer is required to engage in meaningful dialogue with the insured on the question of replacement. Justice Picard commented:

"[There are] three principles which emerge from the cases ... applicable to the issue of due diligence ... one is that the insured should have a "fair opportunity of deciding what to do in light of the funds which will be available". The second is ... that refusal to pay any sum "cripples" the anticipated freedom of action of an insured ... to effect replacement. A third principle is that the insured, faced with a disputed interpretation of coverage, would be foolhardy to go ahead with a purchase.

The Defendants take the position that they were not required under the contract to offer any opinion or advice, or to speculate as to whether any proposed replacement would be covered. They argued that any obligation to do more than pay the actual cash value does not arise until after replacement has been effected and paid for. I disagree. While it would be unreasonable to require an insurer to give a commitment or even an opinion based on insufficient information about a proposed replacement, or to give final approval before satisfactory completion of the project, in my view more than silence or mere "boiler plate" is required.

It is true that there is no express term in the contract requiring the insurer to consult with the insured concerning what constitutes replacement under the contract. However, the business reality is that it would be imprudent, and sometimes impossible for an insured to replace an item or building worth large sums of money when there is uncertainty as to whether he will be reimbursed by the insurer. The insured has contracted and paid the required premium for an endorsement which will permit him to fully replace his loss, up to the policy limit. It is therefore reasonable to imply terms which facilitate or enable the insured to make use of the replacement cost endorsement for which he has given valuable consideration and upon which he has relied. An insurer is required to engage in some kind of meaningful dialogue with an insured seeking information as to what will be covered under the policy.



Thus an insurer may not rely on lack of due diligence of an insured in replacing a loss if the insurer has failed to cooperate with the insured in a substantive way to determine whether a proposed replacement might or would qualify under the contract. This would include consulting with an insured concerning whether a generic type of replacement ... or a specific proposed replacement ... would qualify under the contract. If an insurer wrongly informs the insured that a replacement does not qualify, failure of an insured to follow through with that replacement cannot be construed as lack of due diligence."

Unlike the *Chemainus* case, the insured in *319107 Alberta Ltd.* had not actually completed the purchase of the substitute hotel. Rather, it sought declaratory relief that the proposed purchase did constitute replacement under the policy. The Court granted the declaration sought but also imposed the condition that the insureds had to provide valuations for the building and its contents and that the insurer was not required to pay out any balance of the claim (the difference between a.c.v. already advanced and the actual replacement cost) until the purchase had been completed.

The case also addresses the issue of whether pre-judgment interest can be awarded to the insured before replacement is actually completed and fully paid for. After reviewing the cases in the area, the Court concluded that pre-judgment interest is payable on the replacement cost from the date the insured's cause of action against the insurer arose, being the date when the insurer took the position that the proposed replacement building did not qualify as a replacement under the policy.

H. DOES THE INSURED OBTAIN INDEMNITY FOR THE REPLACEMENT COST IF A BYLAW MAKES REBUILDING IMPOSSIBLE?

If the insured cannot rebuild as a result of zoning regulations, then the insured's remedy is payment of compensation equivalent to the value of the former building and not the notional cost of a building that complies with the regulations. In the Court's view, to do otherwise would be an attempt by the insured to convert the replacement cost endorsement into an actual cash value provision inflated to an amount equivalent to the cost of constructing a new building built to higher standards than the building insured.³⁴

I. SUMMARY AND CONCLUSION

From this brief review of recent jurisprudence it should be apparent that the courts have been vigilant in ensuring that the replacement cost endorsement is strictly enforced and is not abused by insureds who would seek to profit by obtaining more than full indemnity.

³⁴ *Shrinkaruk Enterprises Ltd. v. Commonwealth Insurance Co.* (1992), 8 C.C.L.I. (2d) 198 (Sask. Q.B.).



To that extent the replacement cost endorsement has fulfilled the mandate that was intended from its inception at the turn of the century.



APPENDIX "A"

"In case of loss, destruction or damage by a peril insured against under the Policy, it is understood and agreed that, at the request of the Insured, settlement shall be based on the cost of repairing, replacing constructing or reconstructing (whichever is the least) the property on the same site or one an adjacent site, with materials of like kind and quality and for like occupancy without deduction for depreciation.

The foregoing shall be subject otherwise to all the terms, conditions and limitations of the Policy including endorsements thereon and to the following:

- (a) the repair, replacement, construction or reconstruction, as the case may be, must be effected by the Insured with due diligence and dispatch;
- (b) until repair, replacement, construction or reconstruction has been effected by the Insured, liability shall be that which would have existed had this endorsement not been in effect. Liability shall in no event exceed the amount actually and necessarily expended for repair, replacement, construction or reconstruction;
- (c) if repair, replacement, construction or reconstruction with material of like kind and quality is restricted or prohibited by any by-law, regulation, ordinance or law, any increase in the cost of repair, replacement, construction or reconstruction due thereto shall not be covered by this endorsement;
- (d) if replacement, construction or reconstruction is necessary, it must be on the same site or on an adjacent site;
- (e) failing compliance by the Insured with any of the foregoing provisions, this endorsement shall be null and void;"



APPENDIX "B"

- "2. In the event of loss, destruction or damage to the property insured, the Insurer agrees to make settlement on the basis of replacement cost subject to the following provisions:
- (a) replacement shall be effected by the Insured with due diligence and dispatch;
 - (b) replacement shall be on the same site or on an adjacent site;
 - (c) settlement on a replacement cost basis shall be made only when replacement has been effected by the Insured and in no event shall it exceed the amount actually and necessarily expended for such replacement;
 - (d) failing compliance by the Insured with any of the foregoing provisions, settlement shall be made as if this endorsement had not been in effect, except that paragraph 1 hereof shall still apply;
 - (e) any other insurance effected by or on behalf of the Insured in respect of the perils insured against by this Policy on the property to which this endorsement is applicable shall be on the basis of replacement costs as defined herein;
 - (f) if this Policy insures two or more items, the foregoing applies separately to each item to which this endorsement applies.
3. Any increase in the cost of replacement occasioned by a restriction or prohibition in any by-law, regulation, ordinance or law is not insured by this endorsement.
4. In this endorsement,
- "replacement cost" means the cost of replacing, repairing constructing or re-constructing (whichever is the least) the property on the same site, with materials of like kind and quality and for like occupancy without deduction for depreciation; and
- "replacement" includes repair, construction or re-construction with materials of like kind and quality."



APPENDIX "C"

"OPTIONAL LOSS SETTLEMENT CLAUSE (Does not apply with respect to a summer or seasonal dwelling):

In the event of loss or damage to the building(s), at the option of the Insured, the Insurer agrees to make settlement on the basis of the cost of repairs to or the replacement cost of the building(s) (whichever is the lesser) with material of like kind and quality without deduction for depreciation, subject to the Exclusions and the following provisions:

1. that if there is other valid insurance such insurance is written subject to this Optional Loss Settlement Clause in identical terms, and
2. that replacement must be on the same site, and
3. that repair or replacement must be executed with due diligence and dispatch.

In the event of the Insured exercising this option, the Insurer's Limit of Liability shall be the least of the following:

- (a) the amount of the actual expenditure for repair or replacement, or
- (b) the amount of insurance applicable to such building(s), or
- (c) that proportion of the cost of repair or replacement which the total amount of all valid insurance applicable thereto under all like options in force at the time of the loss or damage bears to 80% of the replacement cost of the entire building."