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SALVAGE: Dealing with Undamaged and Partially Damaged Property After a Loss

By Joseph S. Harrington, CPCU, ARP

FROM THE EDITOR

Planning ahead of time for the disposition of salvage — or at least understanding the alternatives — can save a lot of time, money and contention following an insured property loss.

The insight that author Joseph Harrington offers in this issue of Adjusting Today® is aimed at helping business insurance managers effectively do such planning. Among the aspects of salvage Mr. Harrington discusses are its underlying principles, the three basic approaches that insurance companies take to salvage, and a key policy provision which if ignored, could put the insurance claim itself at risk!

*Sheila E. Salvatore
Editor*



If you're a commercial landlord or business owner and your location is damaged by fire, wind, water or some other peril, chances are you'll want to clean up the site, collect your insurance money and start anew as quickly as possible.

It's not that simple, however. To avoid delays and disputes in the wake of an insured loss, it pays to plan ahead for how you will deal with property that is undamaged or partially damaged and can still be sold as salvage.

Questions about salvage arise following damage to both buildings and contents — but they are an especially important concern for policyholders with most of their value as inventory, supplies, equipment and furnishings.

Beware of Impairment

One common insurance policy provision related to salvage can jeopardize coverage entirely if it is overlooked or ignored in the frenzy and confusion following a loss event.

An “impairment of recovery rights” clause may allow an insurer to avoid paying on a loss if the policyholder has impaired salvage recovery by any act or agreement after suffering a loss. So, a hasty decision to dispose of damaged property could have serious consequences.

Commercial property insurance policies typically have explicit provisions for how the value of salvage is to be factored into the settlement of a claim.

For all but very small losses, salvage value is usually estimated by professional salvors who undertake a comprehensive survey to determine the extent of damage and the cost of repair (if practical), and the cost to move the property (if required) from the loss location to another site for restoration, storage and/or sale.

Commercial insureds need to be prepared for several issues that may arise during this process.

For example, whose responsibility is it to separate damaged from undamaged property, the policyholder or the salvor? This can be an especially costly undertaking if hazardous substances are

involved or if damage at the insured location makes it hard to access the property.

While professional salvors can help with the logistics of salvage disposal, they cannot help with disputes that arise over insurable interests in the property. Damaged goods destined for sale may not be owned outright by the insured but held under contract for purchase or sale, or on consignment from the owner.

For various reasons, any one of the parties in such an arrangement may not want the salvage to be sold at all.

Among other things, no vendor likes to have their products offered in a “fire sale.” What’s more, marked-down salvage items that are functionally equivalent to their “brand new” counterparts can dilute brand value and market demand for the “real thing.” Salvage sales can also lead buyers to question the cost and value of new items.

For these and other reasons commercial insureds are well-advised to know their rights and obligations regarding treatment of salvage, before a loss occurs.

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Basic Principles

The treatment of salvage under property insurance policies follows these basic principles:

The owner of the property generally has the right to decide whether to retain the salvage itself but cannot require the insurer to take it. If the owner retains property with salvage value, that value will be debited from the insurer's loss payment.

If an insurer pays for a full loss to property, the insurer is entitled but not required to take possession of that property for salvage. However, the insurer cannot debit the loss payment for salvage and claim possession of the salvage.

As an example, suppose a clothier experiences a water loss to garments and cannot sell them afterward at their full value.

In some cases, the clothier would be able to retain the water-damaged garments and be compensated by the insurer for their loss in value plus extra expenses needed to dry them out and prepare them for sale at a marked-down price.

Conversely, the clothier could choose to accept payment from the insurer for the full value of the garments. In almost all cases, the insurer would be entitled to take the garments and sell them to offset its loss payment. This is typically done by salvors who recover and/or restore property and then earn a commission on its sale.

In essence, salvage value amounts to the undamaged portion of a loss. These basic principles can be expressed as a simple equation:

Insurance recovery = property damage plus expenses to recover or restore property minus value of salvage.

Brands and Labels Coverage

Clothiers are among the many vendors of well-known "brand name" goods who are reluctant or prohibited from selling damaged goods with their original labels, even if the goods have been refurbished. In anticipation of a potential loss, manufacturers, distributors, and vendors of brand name articles can purchase "brands and labels" coverage, typically provided as an endorsement to a property insurance policy.



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A brands and labels endorsement could stipulate that no items bearing certain brands and labels can be sold in second-hand or salvage markets. Alternatively, the endorsements can cover the costs of removing or obscuring labels so the goods can be sold as salvage while limiting the impact on the brand.

How Low Can You Go?

The equation on page 3 should clarify for insureds a fact that may seem counter-intuitive: *It is generally in the insured's interest to establish the lowest reasonable salvage value for property.* Pride of ownership or confidence in their market savvy shouldn't blind insureds to this reality.

If a commercial insured retains property for salvage, the lower the estimated salvage value, the less the salvage debit — and the greater the insurance payment. If an insured ends up earning more than expected on the salvage sale, the insured may have to reimburse the insurer for a share of the loss payment, but the insured is still guaranteed a certain amount of recovery.

On the other hand, when policyholders retain property for salvage, insurance companies have an interest in pursuing the highest reasonable salvage value for that property; this increases their salvage debits and reduces their payouts, while insureds retain the market risk for selling the salvage.

Not to fear, however. These competing incentives are not a formula for contention, as both parties have countervailing incentives not to seek too high or too low a value for salvage.

For purposes of estimating loss development and reserve requirements, insurers must avoid over-estimating the value of salvaged property. To do so could not only lead to adverse loss development and inadequate reserves, but also to bad-faith claims were it ever determined that different estimates of the same property values were used for different purposes.

Similarly, insureds cannot “lowball” their salvage estimates excessively without, at some point, driving down the value of all damaged property and reducing their insurance loss recovery.

How Much Coverage?

The basic principles concerning salvage work well enough — as long as the amount of applicable insurance (the “limit” on the policy declarations) meets or exceeds the total amount of a loss.

Things get complicated when the applicable limit is less than the amount of the loss. In that case, the parties have to decide if and how to allocate the value of salvage between the share of the loss that is covered under the limit and the remaining loss that is uninsured.

Among other factors, that determination will rely upon varying laws governing loss settlement in different jurisdictions.

The topic is hotly contested between those who believe insurers have a right to salvage for any property they have covered, and those who believe salvage rights reside exclusively with insureds unless and until they are made whole.

Three Basic Approaches

To illustrate, suppose there is a \$100,000 loss to property that is insured for \$75,000, and the parties agree that the damaged goods have a salvage value of \$25,000. For purpose of simplicity, we will presume there is no deductible or coinsurance requirement.

Depending on the applicable law and the wording of a policy, there are three potential approaches to settling the claim:

- The insurer pays the full \$75,000 limit and assumes all of the salvage, leaving the insured with a final loss of \$25,000.



If a commercial insured retains property for salvage, the lower the estimated salvage value, the less the salvage debit – and the greater the insurance payment.

- The insurer pays the full \$75,000 limit and the insured retains the damaged property, leaving the insured with at least a theoretical possibility of being made whole.
- The insurer deducts all or part of the \$25,000 salvage value from the \$75,000 recovery payment, leaving the insured with some or all of the salvage, but no opportunity to be made whole.

We can see that the insured in this scenario has an opportunity to be made whole only if the insurer pays the full limit and allows the insured to retain the damaged property without being debited for salvage.

Enter Complications

The presence of a deductible and/or coinsurance requirement, and the loss settlement terms, would further complicate the settlement.

Suppose the policy included a \$5,000 deductible. Would the deductible be taken against the total \$100,000 loss, with the insured receiving the entire \$75,000 available under the limit? Or would the deductible be taken against the portion of the loss that is insured, leaving the policyholder with, in effect, only \$70,000 of coverage?

Then there are the questions of coinsurance and the valuation of loss settlements.

Personal property losses can be settled on a replacement cost basis, which is the cost to repair or replace damaged property with something equivalent, or on an actual cash value basis, the cost to repair or replace minus a deduction for depreciation.

Coinsurance is the requirement that your limit of insurance be equal to a certain percentage of the value of the covered property, typically 70 percent to 80 percent, but sometimes as low as 50 percent. The rationale behind coinsurance requirements is that, the more value you have at risk, the greater the chance you will have a loss. (To illustrate, when an organization insures five buildings for windstorm damage, it has a greater chance of incurring a windstorm loss than if it insured only one building. Even if the limit of coverage is only enough to replace a single building, the basis for rating the coverage must consider the value of

the five buildings, the full extent of the exposure. When the amount of insurance is substantially less than the value covered, a coinsurance penalty is often deducted from the amount of recovery.) A coinsurance penalty reduces your insurance recovery for a loss to the percentage of the limit you purchased to the total value at risk.

So, how might estimates of salvage value affect the determination of actual cash value or replacement cost? Could a robust estimation of salvage value work to drive up the replacement cost or actual cash value of the property subject to loss? Could that, in turn, trigger a coinsurance penalty?

Give It Back?

So much for complications that arise before a loss settlement. What happens after a loss payment if an insured that retained salvage makes more money than anticipated on its sale?

Standard commercial property insurance policies include “recovered property” provisions that require the insured to reimburse the insurer for any property that was paid for and later recovered (less expenses for recovery and repair).¹

It’s not clear whether and how greater-than-anticipated salvage sales would equate to “recovered” property under the ISO provision. But numerous other property forms include a “salvage and recovery” provision which stipulates that all recoveries from salvage after a settlement would be considered as if they had occurred before the settlement, and that all payments would be adjusted accordingly.²

Under such a provision, an insured will have to reimburse its insurer for any salvage recovery that exceeded the estimated agreed upon value in the settlement.

The Bottom Line: Be Informed!

Perhaps the only certainty in dealing with insurance claims involving salvage is that no two cases will be exactly the same. To avoid unpleasant surprises after a loss, commercial property and business owners are well-advised to know ahead of time their rights, obligations and options regarding salvage, and all conditions in the law and in their policy that will affect the amount and timing of an insurance payment.



Handling Salvage, Step-By-Step

Here are important steps for dealing with undamaged and partially damaged property after a loss:

- 1. Take all reasonable steps to protect damaged property from further loss.** This is a common requirement under property insurance policies. Failure to do so will jeopardize recovery.
- 2. Decide whether to utilize a professional salvor, if the insurer has not already designated one.** Unless the property under consideration is very unique, a professional salvor is typically the best option. Salvors have knowledge of markets for salvage plus experience in preparing and transporting salvage for sale.
- 3. Develop a comprehensive inventory of the affected property that details the extent of damage.** Salvors often provide this service.
- 4. Identify all special measures needed** for securing, handling, or transporting any property that is difficult to access or hazardous.
- 5. Identify all ownership interests in the affected property,** whether it be owned outright or held under contract or on consignment.
- 6. Identify all other insurance policies that could respond to the loss.**
- 7. Estimate the salvage value of the damaged property,** understanding that if the owner/insured wishes to retain the damaged property, the insurer has an interest in valuing that property at the highest reasonable amount in order to reduce the insurance settlement.
- 8. Identify the benefits and drawbacks of having the insured retain the damaged property or surrendering it to the insurer.**
 - The first approach, retaining the property, will result in a salvage deduction against the insurance loss recovery but allow the insured to control the disposition of its damaged property.
 - The second approach, surrendering the property to the insurer, will avoid the deduction and result in a bigger loss payment but could affect the insured's brand and market position.
- 9. Negotiate an agreed-upon salvage value for the damaged property.** The recommendations of professional salvors carry a lot of weight in these deliberations.
- 10. Evaluate all potential scenarios when factoring values** into the claim calculations and settlement.



ABOUT THE AUTHOR



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Mr. Harrington is an independent insurance writer and communications specialist. He served for over 20 years as communications director for the American Association of Insurance Services (AAIS). His work has been published in *Best's Review*, *Rough Notes*, publications of The Institutes, and elsewhere.

¹Insurance Services Office, Inc., Building and Personal Property Coverage Form CP 00 10 10 12, 2011, p. 12, included in *The Institutes' Handbook of Insurance Policies*, 11th edition, 2014.

²For example, see *Colorado Counties Casualty & Property Pool Excess Property Insuring Agreement & Summary*, p. 19; accessed at <http://www.ctsi.org/memberscounty/pdf/2012%20CAPP%20Excess%20Property%20Policy%20with%20summary.pdf>.

See also *School District of Duval County Broker Manuscript Form*, p. 11 (page 6 of third excess schedule) accessed at https://dcps.duvalschools.org/site/handlers/filedownload.ashx?moduleinstanceid=49880&dataid=59277&FileName=James%20River%20Policy_000613364.pdf.

See also Physical Loss or Physical Damage, Riots, Strikes, Civil Commotion, Malicious Damage, Terrorism and Sabotage Insurance, Lloyd's Marketing Association, p. 7; accessed at <https://www.lmalloyds.com/AsiCommon/Controls/BSA/Downloader.aspx?iDocumentStorageKey=aefbf091-6738-4f70-a8bb-50f929b8e4dd&iFileTypeCode=DOC&iFileName=LMA3092%20RSCC>.

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