WITHHOLDING OVERHEAD AND PROFIT IS WRONG IF INSURANCE COMPANIES ARE TRYING TO ACT RIGHT

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INTRODUCTION

A recurring issue following property damage losses has been whether an insurance company may withhold or refuse to pay overhead and profit associated with repair work not yet performed on a residential or commercial structure. In the absence of specific policy language addressing the issue, many insurance carriers routinely withhold payment of overhead and profit following a loss. This paper discusses the duties of property insurance carriers toward their insureds and then the evolution of the law regarding the circumstances in which overhead and profit is part of a covered loss and when an insurer may withhold benefits for overhead and profit.

I. INSURANCE COMPANIES SHOULD ANALYZE THE OVERHEAD AND PROFIT ISSUE IN THE CONTEXT OF THEIR OBLIGATION OF GOOD FAITH AND FAIR DEALING – ESPECIALLY WHEN CONSIDERING CLAIMS CONDUCT NOT SPECIFICALLY ADDRESSED IN THE INSURANCE POLICY

A. Most States, Including Florida, Require Insurers To Adjust First-Party Property Insurance Claims In Good Faith And To Engage In Ethical Claims Handling Conduct.

In 1982, the Florida Legislature passed legislation requiring insurance companies to act in good faith. Section 624.155, Fla. Stat., provides in pertinent part:

> (1) Any person may bring a civil action against an insurer when such person is damaged:

> (a) By a violation of any of the following provisions by the insurer:
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> 1. §626.9541(1)(i)….
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> …
>
> (b) By the commission of any of the following acts by the insurer:
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> 1. Not attempting in good faith to settle claims when, under all the circumstances, it could and should have done so, had it acted fairly and honestly toward its insured and with due regard for her or his interests;
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> 2. Making claims payments to insureds or beneficiaries not accompanied by a statement setting forth the coverage under which payments are being made; or
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> 3. Except as to liability coverages, failing to promptly settle claims, when the obligation to settle a claim has become reasonably clear, under one portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage….

Section 624.155(1)(b)(1) provides that an insurer is liable for "reasonably foreseeable" damages caused when an insurer does "not attempt[] in good faith to settle claims when, under all the circumstances, it could and should have done so, had it acted fairly and honestly toward its insured and with due regard for her or his interests."[1] This includes court costs and reasonable attorney's fees incurred by the plaintiff.[2]

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[1] *Fla. Stat*. § 624.155(1)(b)(1) and (8) (2005); *Fidelity & Cas. Co. v. Cope*, 462 So. 2d 459, 461 (Fla. 1985). Additionally, punitive damages are available, but only if the policyholder can prove that the insurer's "acts giving rise to the violation occur with such frequency as to indicate a general business practice and these acts are: (a) Willful, wanton, and malicious; (b) In reckless disregard for the rights of any insured; or (c) In reckless disregard for the rights of a beneficiary under a life insurance contract." *Fla. Stat*. § 624.155(5) (2005). Under the common law, punitive damages are available only if the insured can prove "deliberate, overt and dishonest dealing." *Butchikas v. Travelers Indemnity Co*., 343 So. 2d 816, 818 (Fla. 1976).

[2] *Fla. Stat*. § 624.155 (4) (2015)("Upon adverse adjudication at trial or upon appeal, the authorized insurer shall be liable for damages, together with court costs and reasonable attorney's fees incurred by the plaintiff."); *Brookins v. Goodson*, 640 So. 2d 110, 113-114 (Fla. 4th DCA 1994)("These damages include

In enacting this statute, the Florida Legislature recognized the vulnerability of an insured or injured claimant in a contract dispute with an insurer and sought "to develop a system of effective regulation, which adequately protects the public interest and preserves the many benefits of private insurance."[3] The statute "creates an economic incentive for insurers to settle claims in good faith" by raising the specter of "potentially large bad-faith damages" when "an insurance company acts in bad faith by dragging out disputes and forcing a lawsuit simply to delay paying the insured."[4] The Legislature achieved this balance by providing the insurer an opportunity to cure its bad faith conduct. Before an injured party can file suit under the statute, it must provide detailed written notice of the violation to both the insurer and the Department of Insurance, and the insurer then has sixty days to cure the error.[5] If the insurer takes advantage of this second chance, there can be no bad faith claim under the statute, and the most the insurer would have to pay on a claim is the policy limit.[6]

The Unfair Trade Practices portion of this act, section 626.9541(1)(i), defines the following as unfair methods of competition and unfair or deceptive acts or practices:

> (i) Unfair Claim Settlement Practices –
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> 1. Attempting to settle claims on the basis of an application, when serving as a binder or intended to become a part of the policy, or any other material

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interest, court costs and reasonable attorney's fees incurred in both the bad faith litigation and in the resolution of the underlying claim as a result of the insurer's conduct in delaying payment.")

[3] Bill Analysis, House Committee on Insurance, HB 4-F at page 1 (April 9, 1982).

[4] *Kearney v. Auto-Owners Ins. Co*., 664 F. Supp. 2d 1234, 1245 (M.D.Fla. 2009).

[5] *Fla. Stat*. § 624.155 (3) (2005).

[6] *Talat Enterprises, Inc. v. Aetna Cas. and Sur. Co*., 753 So. 2d 1278, 1283 (Fla. 2000)("section 624.155(2)(d), Florida Statutes (1993), cannot reasonably be construed to require payment of extra-contractual damages to avoid bad-faith litigation until the conditions for payment under the policy have been fulfilled and the insurer has failed to cure within the sixty-day statutory period for cure after notice is filed in accord with the statute."); *Lane v. Westfield Ins. Co*., 862 So. 2d 774, 779 (Fla. 5th DCA 2003)("[T]he purpose of the civil remedy notice is to give the insurer one last chance to settle a claim with its insured and avoid unnecessary bad faith litigation-not to give the insured a right of action to proceed against the insurer even after the insured's claim has been paid or resolved.")

document which was altered without notice to, or knowledge or consent of, the insured;

2. A material misrepresentation made to an insured or any other person having an interest in the proceeds payable under such contract or policy on less favorable terms than those provided in, and contemplated by, such contract or policy; or

3. Committing or performing with such frequency as to indicate a general business practice any of the following:

   a) Failing to adopt and implement standards for the proper investigation of claims;

   b) Misrepresenting pertinent facts or insurance policy provisions relating to coverages at issue;

   c) Failing to acknowledge and act promptly upon communications with respect to claims;

   d) Denying claims without conducting reasonable investigations based upon available information.

   e) Failing to affirm or deny full or partial coverage of claims, and, as to partial coverage, the dollar amount or extent of coverage, or failing to provide a written statement that the claim is being investigated, upon the written request of the insured within 30 days after proof-of-loss statements have been completed.

   f) Failing to promptly provide a reasonable explanation in writing to the insured of the basis in the insurance policy, in relation to the facts or applicable law, for denial of a claim or for the offer of a compromise settlement;

   g) Failing to promptly notify the insured of any

additional information necessary for the processing of a claim; or

h) Failing to clearly explain the nature of the requested information and the reasons why such information is necessary.

B. Florida Regulatory Law Imposes a Requirement of Good Faith and Ethical Claims Conduct, by way of Florida Administrative Code Chapter 4-220, Requiring Insurance Companies to Provide Fair, Honest, Prompt, Truthful and Ethical Treatment to Policyholders.

Insurance adjusters in the State of Florida are required to be licensed, and they must follow the rules set forth in the Florida Administrative Code as follows:

69B-220.201 Ethical Requirements for All Adjusters and Public Adjuster Apprentices.

…

(3) Code of Ethics. The work of adjusting insurance claims engages the public trust. An adjuster shall put the duty for fair and honest treatment of the claimant above the adjuster's own interests in every instance. The following are standards of conduct that define ethical behavior, and shall constitute a code of ethics that shall be binding on all adjusters:

(a) An adjuster shall not directly or indirectly refer or steer any claimant needing repairs or other services in connection with a loss to any person with whom the adjuster has an undisclosed financial interest, or who will or is reasonably anticipated to provide the adjuster any direct or indirect compensation for the referral or for any resulting business.

(b) An adjuster shall treat all claimants equally.

1. An adjuster shall not provide favored treatment to any claimant.
2. An adjuster shall adjust all claims strictly in accordance with the insurance contract.

(c) An adjuster shall not approach investigations, adjustments, and settlements in a manner prejudicial to the insured.

(d) An adjuster shall make truthful and unbiased reports of the facts after making a complete investigation.

(e) An adjuster shall handle every adjustment and settlement with honesty and integrity, and allow a fair adjustment or settlement to all parties without any compensation or remuneration to himself or herself except that to which he or she is legally entitled.

(f) An adjuster, upon undertaking the handling of a claim, shall act with dispatch and due diligence in achieving a proper disposition of the claim.

(g) An adjuster shall not negotiate or effect settlement directly or indirectly with any third-party claimant represented by an attorney, if the adjuster has knowledge of such representation, except with the consent of the attorney. For purposes of this subsection, the term "third-party claimant" does not include the insured or the insured's resident relatives.

(h) An adjuster shall not advise a claimant to refrain from seeking legal advice, nor advise against the retention of counsel or the employment of a public adjuster to protect the claimant's interest.

(i) An adjuster shall not attempt to negotiate with or obtain any statement from a claimant or witness at a time that the claimant or witness is, or would reasonably be expected to be, in shock or serious mental or emotional distress as a result of physical, mental, or emotional trauma associated with a loss. The adjuster shall not conclude a settlement when the settlement would be disadvantageous to, or to the detriment of, a claimant who is in the traumatic or distressed state described above.

(j) An adjuster shall not knowingly fail to advise a claimant of the claimant's claim options in accordance with the terms and conditions of the insurance contract.

(k) An adjuster shall not undertake the adjustment of any claim concerning which the adjuster is not currently competent and knowledgeable as to the terms and conditions of the insurance coverage, or which otherwise exceeds the adjuster's current expertise.

(l) No person shall, as a company employee adjuster or independent adjuster, represent him- or herself or any insurer or independent adjusting firm against any person or entity that the adjuster previously represented as a public adjuster.

C. The Insurance Industry Recognizes that it has a Special Relationship with Policyholders and the Obligation of Good Faith and Ethical Claims Conduct.

No person can expect to learn how adjusters are taught to treat policyholders by only reading bad faith case law. These cases tend to show only the worst insurances claims practices by insurers, adjusters, lawyers, and policyholders alike. Most claims representatives are taught to handle claims honestly and ethically. Indeed, the standard textbook for claims handlers, which leads to an Associate in Claims designation, is James J. Markham's, *The Claims Environment* (1st ed., Insurance Institute of America 1993).[7] Markham's textbook sets forth simple, clear claims handling principles, including:

> "Claims representatives….are the people responsible for fulfilling the insurance company's promise."

Markham at vii.

> "When a covered loss occurs, the insurance company's obligation under its promise to pay is triggered. The claim function should ensure the prompt, fair, and efficient delivery of this promise."

Markham at 6.

> "Therefore, the claim representative's chief task is to seek and find coverage, not to seek and find coverage controversies or to deny or dispute claims."

Markham at 13.

> "…the insurance company should not place its interests above the insured's."

Markham at 13.

> "The claim professional handling claims should honor the company's obligations under the implied covenant of good faith and fair dealings."

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[7] There is now a second edition of *The Claims Environment.* Doris Hoopes, *The Claims Environment, (2d ed.*, Insurance Institute of America 2000).

Markham at 13.

> "No honest and reputable insurer has either explicit or implicit "standing orders" to its claim department to delay or underpay claims."

Markham at 274.

> "When an insurance company fails to pay claims it owes or engages in other wrongful practices, contractual damages are inadequate. It is hardly a penalty to require an insurer to pay the insured what it owed all along."

Markham at 277.

> "All insurance contracts contain a covenant of good faith and fair dealing."

Markham at 277.

> "If bad faith is a tort in a third-party claim, it should be a tort in a first-party claim as well."

Markham at 277.

> "Insurance is a matter of public interest and deserves special consideration by the courts to protect the public."

Markham at 277.

> "Insurance contracts are not like other contracts because insurers have an advantage in bargaining power. Insurers should therefore be held to a higher standard of care."

Markham at 277.

> "Recovery for breach of an insurance contract should not be limited to payment of the original claim."

Markham at 277.

> "The public's expectations are elevated by insurers' advertising, slogans, and promises which give policyholders the impressions that they will be taken care of no matter what happens."

Markham at 277.

> "Policyholders buy peace of mind and are not seeking commercial advantage when they buy a policy. In addition, they are vulnerable at the time of the loss."

Markham at 277.

> "Policy language is sometimes difficult to understand. The benefit of interpretation should be given to the policyholder."

Markham at 277-278.

> "Upper management also has a responsibility to maintain proper claim-handling standards and practices."

Markham at 300.

The Second Edition of *The Claims Environment* explains, in part, various aspects of good faith claims handling:

> **Unbiased Investigation**
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> Claim representatives should investigate in an unbiased way, pursuing all relevant evidence, especially that which establishes the legitimacy of a claim. Claim representatives should avoid using leading questions that might slant the answers. In addition, they should work with service providers that are unbiased. As mentioned previously, courts and juries might not look sympathetically on medical providers or repair facilities that favor insurers. Investigations should seek to discover the facts and consider all sides of the story. Claim representatives should not appear to be looking for a way out of the claim or for evidence to support only one side.
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> **Prompt Evaluation**
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> As described in Chapter 9, unfair claims settlement practices acts often specify time limits within which to complete evaluations of coverage and damages. Claim representatives should be sure to comply with those requirements to reduce their exposure to bad faith claims.

Doris Hoopes, *The Claims Environment* 10.7 (2d ed., Insurance Institute of America 2000).

There are professional designations in the insurance trade. Perhaps the most prominent is the Society of Chartered Property and Casualty Underwriters (CPCU). An individual becomes a CPCU after a course of professional study, an examination, and making a professional commitment. A CPCU must agree to abide by the CPCU Code of Professional Ethics and take this lofty professional oath:

> I shall strive at all times to live by the highest standards of professional conduct; I shall strive to ascertain and understand the needs of others and place their interests above my own; and shall strive to maintain and uphold a standard of honor and integrity that will reflect credit on my profession and on the CPCU designation.

The CPCU Professional Commitment, *AICPCU/IIA Catalog*, 1999-2000, at 66.

The CPCU Code of Professional Ethics are established standards, generally known, accepted, and followed within the insurance trade. The Canons from the Code of Professional Ethics of the American Institute for the CPCU are:

CANON 1: CPCUs should endeavor at all times to place the public interest above their own.

CANON 2: CPCUs should seek continually to maintain and improve their professional knowledge, skills and competence.

CANON 3: CPCUs should obey all laws and regulations; and should avoid any conduct or activity which would cause unjust harm to others.

CANON 4: CPCUs should be diligent in the performance of their occupational duties and should continually strive to improve the functioning of the insurance mechanism.

CANON 5: CPCUs should assist in maintaining and raising professional standards in the insurance business.

CANON 6: CPCUs should strive to establish and maintain dignified and honorable relationships with those whom they serve, with fellow insurance practitioners, and with members of other professions.

CANON 7: CPCUs should assist in improving the public understanding of insurance and risk management.

CANON 8: CPCUs should honor the integrity of the CPCU designation and respect the limitations placed on its use.

CANON 9: CPCUs should assist in maintaining the integrity of the Code of Professional Ethics.

David H. Brownell & Stephen Herald, *Ethics in the Insurance Industry: A Case Study Approach* 6-7(Am. Inst. For Chartered Prop. Cas. Underwriters Ins. Inst. Of Am.).

Insurance companies employ most of the nation's CPCUs. But insurance companies should not be exempt from established trade customs, trade standards, and trade usage simply because not all of their employees are CPCUs, nor because only individuals can earn the professional designation.

In 1973, the Supreme Court of California decided *Gruenberg v. Aetna Insurance Co.*, 510 P.2d 1032 (Cal. 1973), which first found that an insurer owed an implied covenant of good faith and fair dealing to its policyholder and that the breach of the covenant would give rise to a bad faith claim in tort. Known as "first-party bad faith," this tort allowed insurance claimants to collect extra-contractual damages for an insurer's bad faith refusal to pay an insurance claim.

Since 1973, a majority of states have adopted this tort cause of action. Victor E. Schwartz & Christopher E. Appel, *Common-Sense Construction of Unfair Claims Settlement Statutes: Restoring the Good Faith in Bad Faith*, 58 Am. U. L. Rev. 1477,

1486 n. 43(2009); *See also* Dominick C. Capozzola, Note, *First-Party Bad Faith: The Search for a Uniform Standard of Culpability*, 52 Hastings L.J. 181, 182 (2000); Stephen S. Ashley, *Bad-Faith Actions: Liability and Damages* 2-54 (2d. ed., West Group 1997)("A substantial minority of jurisdictions have rejected a common-law tort cause of action for bad-faith in first-party cases."). And the states that do not recognize a common law tort cause of action, including Florida as mentioned above, provide a statutory cause of action. *See generally* Roger C. Henderson, *The Tort of Bad-Faith in First-Party Insurance Transactions After Two Decades*, 37 Ariz. L. Rev. 1153, 1156 (1995)(noting that since *Gruenberg*, over thirty jurisdictions recognize remedies for first party insurer misconduct when private statutory remedies are considered).

Thus, each state in the nation recognizes that insurers owe a distinct duty to their policyholders which exceeds the obligations inherent to parties to a typical commercial contract. Professor Henderson, of the University of Arizona College of Law, explained the public policy driving this distinction:

> In a free enterprise system, economic development steadily increases the number of situations in which individuals can suffer "loss." At the same time, economic development enhances the ability to avoid the prospect of "loss." In other words, in a relatively affluent society, there is much more to lose in the way of property and other economic interests as the human condition improves. In such a society, however, individuals are more likely to have the requisite discretionary income to transfer and to spread the attendant risks of loss. Disruptive losses to society, as well as to the individual, are obviated or minimized by private agreements among similarly situated people. In this way, the insurance industry plays a very important institutional role by providing the level of predictability requisite for the planning and execution that leads to further development. Without effective planning and execution, a society cannot progress.
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> ….
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> This perceived social significance has set apart insurance contracts from most other contracts in the eyes of the law. Insurance is

purchased routinely and has become pervasive in our society. It protects against losses that otherwise would disrupt our lives, individually and collectively. The public interest, as well as the individual interests of millions of insureds, is at stake. This is the foundation for the general judicial conclusion that the business of insurance is cloaked with a public purpose or interest. This perception also explains the extensive regulation of the insurance industry in the United States, not just through legislative and administrative processes, but also through the judicial process. In fact, as with developments in other areas of tort law, the recognition of the tort of bad faith in insurance cases represents a judicial response to the perceived failure of the other branches of government to regulate adequately the claims processes of the insurance industry. Had the early attempts at regulation been more effective, the tort of bad faith might never have come into existence.

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The insureds' disadvantage persisted as insurance took on more and more importance in this country. In order to purchase a home or a car, or commercial property, most people had to borrow money, and loans were not obtainable unless the property was insured. In addition, the lender often required that the life of the borrower be insured. On another front, the cost of medical care was rising beyond the reach of many people and insurance programs were developed to spread that risk. The purchase of insurance was no longer a matter of prudence; it was a necessity. Then losses occurred and the inevitable disputes arose. These disputes, however, were not about an even exchange in value. Rather, they were about something quite different.

Insureds bought insurance to avoid the possibility of unaffordable losses, but all too often they found themselves embroiled in an argument over that very possibility. Disputes over the allocation of the underlying loss worsened the insureds' predicament. In most instances, insureds were seriously disadvantaged because of the uncompensated loss; after all, the insured would not have insured against this peril unless it presented a serious risk of disruption in the first place. The prospect of paying attorneys' fees and other litigation expenses, in addition to the burden of collecting from the insurer, with no assurance of recovery, only aggravated the situation.

These additional expenses could prove to be a formidable deterrent to the average insured. For most insureds, unlike insurers, such

> expenses were not an anticipated cost of doing business. Insureds did not plan for litigation as an institutional litigant would. Insurers, on the other hand, built the anticipated costs of litigation into the premium rate structure. In effect, insureds, by paying premiums, financed the insurers' ability to resist claims. Insureds, as a group, were therefore peculiarly vulnerable to insurers who, as a group, were inclined to pay nothing if they could get away with it, and, in any event, to pay as little as possible. Insurance had become big business.

Roger C. Henderson, *The Tort of Bad Faith in First-Party Insurance Transaction: Refining the Standard of Culpability and Reformulating the Remedies By Statute*, 26 U. Mich. J.L. Ref. 1, 10-14 (1992).

It is far more profitable for an insurance company to take a person's money and not pay for a covered loss rather than to promptly and fully pay what is owed. This financial incentive conflicts with the public trust placed in the insurance industry, and this is why codes of ethics, good faith duties and common law and statutory remedies exist. Public policy demands that insurers are held accountable for acts and negligent omission in the claims handling process that cause their insureds to incur contractual and extracontractual damages. **And it is against this backdrop that insurers' decisions to withhold overhead and profit benefits are considered.**

II. THE ORIGIN OF THE OVERHEAD AND PROFIT ISSUE

From the best information available, the first insurance company to withhold contractor overhead and profit was State Farm Fire & Casualty Insurance Company. A claims manager, Tony Prosperini, has been deposed in a number of actions involving this issue. *See* Depositions of Tony Prosperini in *Aita v. State Farm Fire & Cas.,* Superior

Court of N.J., Middlesex Cty. (1995), Case No. L-12024-95, taken April 15, 1998; *Gonzalez v. State Farm*, Superior Court of California, Los Angeles County; Case No. 4:97-CV-832-4; taken December 4, 1997; *Harrington v. State Farm Lloyds, Inc.,* U.S.D.C., N.D. Case No. 4:97-CV-832-4. Indeed, State Farm was a party in the first case which indicated that an insurance company may withhold overhead and profit. *Snellen v. State Farm Fire & Cas. Co.*, 675 F.Supp. 1064 (W.D. Ky. 1987).

In short, State Farm argued that under a replacement cost insurance policy, the total amount payable for replacement of a structure is not paid until the insured actually incurs an expense of replacement. As a general contractor's overhead and profit is an expense of repair or replacement that is not incurred until it is paid, an insurance carrier may withhold the overhead and profit portions of adjusted loss until the insured actually incurs the expense. Mr. Prosperini testified that no overhead and profit should be paid if the work is not performed by a general contractor.

In *Snellen,* the U.S. District Court for the Western District of Kentucky approved of State Farm's practice of settling and paying actual cash value claims by determining the total replacement cost and then subtracting overhead and profit. In that case, the fire damaged home was covered by replacement cost insurance, but the policyholders did not repair the damage. Thus, the policy limited the policyholder's recovery to actual cash value. The total amount withheld by State Farm included the general contractor's overhead and profit, permits, and depreciation. The court found that State Farm's method of calculation was appropriate under Kentucky's "Broad Evidence Rule" for determining actual cash value.

> Since the goal is to arrive at the actual cash value of the damage, non-damage factors, which are applicable only in the instance of

> repair or replacement such as clean up, profit, overhead and permits, were properly deducted. These factors have no relation to the value of the damage but only the expense, which would be incurred if repair or replacement were involved.

Ronald Reitz, an insurance defense attorney, commented that the *Snellen* court's reasoning suggests that "Actual Cash Value" does not include "non-damage factors" that have not actually been incurred. R. Reitz, Overhead & Profit: Can They Be Deducted in ACV Settlements?, *Claims Magazine* 64, 65 (Aug. 2000).

Subsequently, the Kentucky Department of Insurance found this conduct and type of adjustment inappropriate. The Department subjected Allstate Insurance Company to a market conduct examination regarding this very issue and found Allstate's actions of withholding overhead and profit to be improper. *See Kentucky Market Conduct Examination of Allstate Insurance Company*, August 4, 1993, and Order dated December 8, 1994. Accordingly, while insurers may be able to point to *Snellen* as support for withholding overhead and profit, they should be informed that the Kentucky Department of Insurance has found the same policy violates public policy.

III. HOW THE ISSUE OF OVERHEAD AND PROFIT AROSE IN FLORIDA

Following the 1987 *Snellen* decision, many other carriers withheld overhead and profit as a matter of routine claims practice. Hurricane Andrew brought the matter to the Florida Department of Insurance's attention after a number of consumers complained that insurers were not paying the full amount of estimated damage. The Florida Department of Insurance issued Bulletin 92-036 on December 8, 1992:

> The payment of a partial loss on real property must be handled in a manner consistent with existing statutes and case law.
>
> Section 627.702(2) Florida Statutes, while specifying only fire and lightning losses, is instructive in discerning legislative intent in applying the Valued Policy Law to partial losses on real estate resulting from Hurricane Andrew. This statute provides that the insured is entitled to the "actual amount of such loss," not to exceed the amount of insurance specified in the policy as to such property.
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> The Florida Supreme Court, in *Sperling v. Liberty Mutual*, So.2d 297 (Fla. 1973), held that the "actual amount of such loss" is the cost of placing the building in as nearly as possible the same condition that it was before the loss, without allowing depreciation for the materials used.
>
> This authority is specifically applicable to the practice by insurers of imposing a "holdback" of insurance proceeds greater than actual cash value until replacement has taken place. While this practice is appropriate for personal property, this bulletin serves to place insurers on notice that for partial losses on real property, the "holdback" is inconsistent with established precedent.
>
> The application of a "holdback" to repair of real property can particularly cause hardship to the insured when the actual cash value payment is insufficient to enter into a contract to make repairs. In such an instance, the insured may be forced to seek other funding sources, at his expense, in order to contract for repairs.
>
> Insurers who have been applying "holdbacks" in claims for partial loss on real property should pay the actual amount of the loss. The best indicator of actual loss is the contract for repair entered into by the insured. Once an actual amount of loss is determined by contract, the full loss payment should be made with no hold back applied. This arrangement satisfies the public policy interests both in timely and sufficient claim payments, and in encouraging rebuilding. In instances where a holdback is currently being applied and a repair contract has been executed, the holdback should be released.

While the bulletin clearly states with regard to the repair or replacement of real property, holdbacks are inconsistent with established precedent, some insurers have relied

upon language in the last paragraph to continue the practice. Adjusters indicated that they would hold back various aspects of the full replacement or repair estimate, unless the policyholder signed a construction contract with a general contractor. The debate regarding whether insurance companies are wrongfully withholding overhead and profit continued.

The precedent upon which the bulletin relied was the Florida Supreme Court's 1949 decision in *Glen Falls Ins. Co. v. Gulf Breeze Cottages*, 38 So.2d 828,830 (Fla. 1949), in which it held that when considering the amount of a property loss, "the property should have been placed in as nearly as possible the same condition that it was before the loss, without allowing depreciation for the materials used." The court reaffirmed this rule in *Sperling v. Liberty Mutual Insurance Company*, 281 So. 2d 297 (Fla. 1973), holding that the "actual amount" of any partial loss was determined without allowing depreciation. 281 So.2d at 298.

Although some insurers sought to distinguish *Sperling* by arguing it involved Florida's valued policy law, it provides no basis to withhold overhead and profit. Section 627.702(2) provides that "in the case of a partial loss by fire or lightning of any such property [a building, structure, etc], the insurer's liability, if any, under the policy shall be for the actual amount of such loss but shall not exceed the amount of insurance specified in the policy as to such property and such peril." That a partial loss by fire triggers this statute is immaterial to the discussion of how to determine the "actual amount" of a loss discussed in *Sperling* or *Glens Falls*. The valued policy statute merely provided the reason the court looked at the actual amount of the loss in *Sperling*. Notably, *Glens Falls* did not discuss the valued policy law.

IV. TEXAS AND COLORADO DEPARTMENTS OF INSURANCE HAVE FOUND WITHHOLDING OF GENERAL CONTRACTOR OVERHEAD AND PROFIT IMPROPER.

On June 12, 1998, the Texas Department of Insurance issued Bulletin #B-0045-98, indicating that the deduction of a prospective contractor's overhead and profit and sales tax, in determining the actual cash value under a replacement cost policy, is improper. The Department noted that the wrongful interpretation of language in the Texas Standard Homeowner's Policy generated two class action lawsuits and various inquiries to the Department's position on the matter.

In explaining its reasoning, the Department noted that "there is no situation in which the deduction from replacement cost of depreciation and contractor's overhead and profit and/or sales tax on materials will be the correct measure of the insured's loss." Further, the Department noted that insurance companies are not allowed to charge premiums in excess of the risk to which they apply. Thus, under a replacement cost policy, the value of the contractor's overhead and profit, as well as sales tax on building materials, are included in the premium, and if the insurer receives a premium on insurable values which loss may never be paid, "the insurer reaps an illegal windfall."

Finally, the Department dispensed with the common argument that contractor's overhead and profit, as well as sales tax on building materials, should be excluded from actual cash value settlements because the insured has not incurred these expenses as illogical:

> Using this logic, an insured who opts not to repair or replace damaged property would not incur any of the expenses necessary to repair or replace the damaged property, including the costs of building materials, and would collect nothing under an actual cash

> value loss settlement. This result would be contrary to the purposes of the subject insurance policy.

The Colorado Department of Insurance issued 12-98 on December 21, 1998, prohibiting the deduction of a contractor's overhead and profit from replacement costs where repairs are not made. The Department stated:

> The position of the Division of Insurance is that the actual cash value of a structure under a replacement cost policy, when the policyholder does not repair or replace the structure, is the full replacement cost with proper deduction for depreciation. Deduction of contractor's overhead and profit, in addition to depreciation, is not consistent with the definition of actual cash value.

V. THE MAJORITY OF COURTS TO ADDRESS THE ISSUE HAVE HELD THAT INSURANCE COMPANIES ARE NOT ENTITLED TO WITHHOLD OVERHEAD AND PROFIT, ALTHOUGH THEY MAY DEDUCT A PORTION OF OVERHEAD AND PROFIT WHEN PAYING ACTUAL CASH VALUE BENEFITS.

In *Ferguson v. Lakeland Mututal Ins. Co.*, 596 A. 2d 883 (Pa. Super. 1991), lightning struck an organ inside the insureds' mobile home. The insureds made a claim, which Lakeland disputed, and the parties proceeded to court. *Id.* at 884. The trial court instructed the jury to disregard the holdback provision in the policy that required the insureds to either repair or purchase a replacement prior to receiving the replacement value of the item. The trial court found the provision was oppressive and unfair because it required the insureds to expend a large sum of money prior to a liability determination. The appellate court agreed and refused to enforce the holdback provision because it unconscionably favored the insurer.

> Since appellant denied liability, appellees were faced with the unsavory choice of either accepting the lower actual cash value of the organ or expending a large sum of money in replacement costs without a guarantee of reimbursement. In fact, under the terms of the contract, appellees could have only received replacement value in this instance after expending the replacement or repair funds and obtaining a judicial determination concerning liability.

Id. at 885. Notably, *Ferguso*n held that the insurer could not enforce the holdback provision as it applied both to personal property and to repair or replacement of a structure.

In *Gilderman v. State Farm Ins. Co.*, 659 A. 2d 941 (Pa. Super. 1994), the Pennsylvania Superior Court declined the insurance industry's request to limit *Ferguson* by holding that State Farm could automatically withhold a flat twenty percent of the repair or replacement costs of a covered loss, representing contractor overhead and profit, in calculating its advance payment to its insured of the actual cash value of the covered loss. Reversing the trial court's grant of summary judgment in favor of the insurer, the court held that "the actual cost of repair or replacement" necessarily includes any cost that an insured could be reasonably expected to incur in repairing or replacing a covered loss. Because this will, in many instances, include use of general contractor and contractor's twenty percent overhead and profit, State Farm's automatic twenty percent holdback impermissibly benefited the insurer. The court explained that because policyholders pay higher premiums for repair and replacement coverage, they are entitled to overhead and profit when use of a general contractor would be reasonably likely, even if no contractor is used or no repairs are made. "It can hardly be said that an insured reaps a windfall by obtaining payment of actual cash value determined in a fair and reasonable

manner when that is precisely what the insurer has agreed to pay under its policy in advance of actual repair or replacement." *Id.* at 946.

Following *Gilderman,* the Michigan Court of Appeal decided *Salesin v. State Farm Fire & Cas Co*., 581 N.W. 2d 781 (1998 Mich.App.), holding that State Farm owed the policyholder for general contractor overhead and profit, despite the fact that the policyholder would "almost certainly" not incur that expense. *Salesin* involved a water loss to a residential house caused by a leaking washing machine hose. The policyholder asserted that State Farm wrongfully withheld $5,581.79 in general contractor profit and overhead when adjusting the loss. The policy at issue was State Farm's "HO5 Replacement Cost Policy" which permitted holdback of "depreciation" but did not directly address contractor overhead and profit.

The *Salesin* Court stated:

> It is uncomfortably true that finding that State Farm owes Salesin an additional $5,581.79 for contractors' overhead and profit will result in a payment to him for costs that he has not incurred and almost certainly will not incur. However, it is true Salesin has paid a premium for a full replacement cost policy. There is no logical reason, nor any reason based on the insurance policy itself or the record below, for deducting estimated contractor's overhead and profit when making payments under §I.c.(1) of State Farm's insurance policy…[T]he reasoning in *Gilderman* is, we believe, superior to the reasoning in *Snellen.*

Id. at 369.

Likewise, in *Ghoman v. New Hampshire Ins. Co*., 159 F. Supp. 2d 928 (N.D. Tex. 2001), a commercial hotel was badly damaged by wind and hail. The parties went to appraisal, and the appraisal award valued the replacement cost at $299,907 and the actual cash value award at $262,353. New Hampshire Insurance Company then offered an amount less than the appraisal award for actual cash value, withholding depreciation,

contractor's overhead and profit, and sales tax. The policyholder contended that except for depreciation and the deductible, the items were wrongfully withheld, and that he was entitled to the amount of the actual cash value award.

Relying upon *Salesin* and *Gilderman*, the *Ghoman* court held that "repair or replacement costs include any costs an insured is reasonably likely to incur in repairing or replacing a covered loss….Contractor's overhead and profit and sales tax clearly fit this definition. These amounts should be included in the actual cash value award." *Id*. at 934. The *Ghoman* court also held that the insurance company breached the policy by unilaterally deducting those sums from the appraisal award and explained that:

> …..the policy in this case entitles plaintiff to recover the actual cash value of his loss whether or not he repaired the damaged property. *See also Harrington v. Amica Mutual Insurance Co*., 223 A.D. 2d 222, 226, 645 N.Y.S. 2d 221, 223 (N.Y. App. Div. 1996) ("Plaintiff would have been entitled to recover the actual cash value from defendant even if a third party had completed the repairs at no cost to plaintiff.") What plaintiff actually spent to repair his property—indeed, whether he repaired the property at all – does not affect his right to recover actual cash value. The fact that plaintiff was able to complete the repairs for less than the appraisal award does not result in a windfall. Plaintiff was covered for the actual cash value of his loss and is entitled to recover that sum, less his deductible.

Similarly, the New York Superior Court Appellate Division followed *Guilderman* in *Mazzocki v. State Farm Fire & Cas. Corp.*, 1 A.D. 3d 9, 13 (2003), holding that the term replacement cost—as opposed to actual replacement cost—in State Farm's policy could reasonably be interpreted to include profit and overhead whenever it is reasonably likely that a general contractor will be needed to repair or replace the damage. *Id.* The court rejected State Farm's argument that since such an expense may not be actually incurred, it is contingent and should not be included. "[W]e conclude that a replacement

cost estimate is equally hypothetical or contingent as to all materials, labor and contractor services." *Id.* However, an insurer may be permitted to allocate a proportion of the estimated overhead and profit that is subject to depreciation until repair or replacement occurs.

In 2006, the Superior Court of Pennsylvania resolved conflicting interpretations of *Gilderman* in *Mee v. Safeco Ins. Co. of Am.*, 908 A.2d 344, 347-48 (Pa. Super. 2006). The insured interpreted *Gilderman* as holding that in any claim in which more than one trade is required to perform repairs, it is "reasonably likely" that the a general contractor will be required. In this circumstance, an insurer must include overhead and profit as part of its actual cash value payment, even if the insured makes the repairs himself, hires a handyman instead of a team of subcontractors, or chooses not to make the repairs at all. The insurer interpreted *Gilderman* requiring an insurer to look at the facts of each case in determining whether the use of a contractor is reasonably likely. Because the insured performed the repairs himself and did not hire a general contractor, the insurer argued that use of a general contractor was not reasonably likely, so the insured was not entitled to overhead and profit.

The superior court held that both "interpretations miss the mark." The court explained that in *Gilderman*, it did not adopt a bright-line rule for determining whether use of a general contractor is reasonably likely. Courts should consider the facts of each case, including: the extent of the property damage, the number of trades required to repair the damage, and expert evidence of building industry standards regarding the correlation between use of a general contractor and the number of trades required to repair damage. The court concluded that the insured was entitled to overhead and profit if he could

establish on remand that use of a general contractor would be reasonably likely. The fact that the insured "chose to—or was required to—make the repairs himself does not necessarily preclude him from recovering [overhead and profit]."

In *Nguyen v. St. Paul Travelers Insurance Company*, no. CIV.A. 06-4130, 2008 WL 4534395 (E.D. La. Oct. 6, 2008), the insureds filed a breach of contract suit, arguing that the insurer breached its insurance contract with plaintiffs by not including general contractor's overhead and profit costs when adjusting their claims for losses resulting from Hurricanes Katrina and Rita. The policy provided that defendant will pay "no more than the actual cash value of the damage until actual repair or replacement is complete," and the insurer determined that repair of their house would require the involvement of ten trades. Nevertheless, the insurer did not include general contractor overhead and profit as part of its actual cash value payment.

Citing industry standards and custom, the insureds argued in response to the insurer's motion for summary judgment that the insurer was required as a matter of contract to include overhead and profit in actual cash value payments whenever its estimate reflects that three or more trades are necessary to perform an insured's repairs. The federal court rejected that argument, ruling that it could find no Louisiana law that supported the insured's argument that an insurer was required as a matter of contract to include overhead and profit in actual cash value payments whenever its estimate reflects that three or more trades are necessary to perform an insured's repairs. However, the federal court ruled that the insureds pleaded a sufficient breach of contract claim to defeat the insurer's motion for summary judgment.

In *Goff v. State Farm Florida Ins. Co.*, 999 So. 2d 684 (Fla. 2d DCA 2008), Florida's Second District Court of Appeal also cited *Gilderman* in holding that overhead and profit are included in the scope of an actual cash value policy "where the insured is reasonably likely to need a general contractor for repairs." *Id*. The court explained that overhead and profit are like all other costs of a repair, such as labor and materials, that an insured is reasonably likely to incur. But a portion of overhead and profit, like a portion of all other costs, could be depreciated in an actual cash value payment. *Id*. at 690.

The Florida Supreme Court approved *Goff* in *Trinidad v. Fla. Peninsula Ins. Co.*, 121 So. 3d 433, 438 (Fla. 2008). The court held that scope of replacement cost insurance coverage under the applicable provisions of the 2008 Florida Statutes included overhead and profit when the insured is reasonably likely to need a general contractor for the repairs. As neither the applicable statute, section 627.7011, nor the policy required the insured to actually repair the property as a condition precedent to payment of benefits owed, the insurer was not authorized to withhold replacement cost benefits, including overhead and profit, pending actual repair of the damaged property.[8] As occurred in *Goff*, the supreme court remanded the case to the trial court to determine whether the insured was is reasonably likely to need a general contractor for the repairs to his covered loss.

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[8] Section 627.7011 was amended, effective May 17, 2011, to permit insurers to hold back depreciation, which presumably includes the depreciated portion of overhead and profit, until repair or replacement work is performed. Section 627.7011(3)(a) states:

> In the event of a loss for which a dwelling or personal property is insured on the basis of replacement costs:
>
> (a) For a dwelling, the insurer must initially pay at least the actual cash value of the insured loss, less any applicable deductible. The insurer shall pay any remaining amounts necessary to perform such repairs as work is performed and expenses are incurred. If a total loss of a dwelling occurs, the insurer shall pay the replacement cost coverage without reservation or holdback of any depreciation in value, pursuant to s. 627.702.

And in *Tolar v. Allstate Texas Lloyd's Company*, 772 F. Supp. 2d 825, 831 (N.D. Tex. 2011), the insureds alleged that Allstate breached its contracts when it depreciated general contractor overhead and profit and sales tax when calculating the ACV for payment of the claim. The insureds filed a motion for partial summary judgment, arguing the terms actual cash value and depreciation were ambiguous and should be construed in their favor because they were not defined in the insurance policy. They further argued that only the value of the property itself was depreciable, and overhead and profit and sales tax were not depreciable. The Court noted under Texas law, "undefined terms on not per se ambiguous terms…. When analyzing undefined terms, the Court must first assign the undefined term its plan, ordinary meaning…. If the ordinary meaning of the term is susceptible to more than one reasonable interpretation, the term is considered ambiguous." The court ruled in Allstate's favor, holding that overhead and profit and sales tax are "considered 'replacement costs' because they are factored into policy limits and contractors' bids…. Because [overhead and profit] sales tax, repair costs, and property value together represent the total replacement cost value, it follows naturally that [overhead and profit], sales tax, repair costs, and property value ought to be depreciated together to reach the ACV payment."

CONCLUSION

Policyholders expect and deserve full and prompt payment for their covered property losses. When addressing the issue of overhead and profit holdbacks from the standpoint of good faith claims conduct, the law is now fairly well settled that an insurer does not act in good faith if it withholds payment for overhead and profit from an actual

cash value payment when a contractor's services are reasonably necessary. This determination will turn on the facts of each particular loss and the covered repairs, but the fact that a general contractor has not been hired and that one ultimately may not be hired does not necessarily affect the analysis. Although an actual payment of overhead and profit may be contingent upon a general contractor's services, for an actual cash value payment, overhead and profit is indistinguishable from other costs of a repair, such as labor and materials, that an insured is reasonably likely to incur.