IN THE SUPREME COURT OF TENNESSEE
AT NASHVILLE

GREGORY J. LAMMERT, JAMIE LAMMERT, LARRY REASONS, and SUSAN REASONS,

Movants,

v.

No. M2017-02546-SC-R23-CV

AUTO-OWNERS (MUTUAL) INSURANCE COMPANY,

Respondent.

Rule 23 Certification from U.S. District Court, Middle District of Tennessee
No. 3:17-cv-00819

BRIEF OF *AMICUS CURIAE* UNITED POLICYHOLDERS IN SUPPORT OF MOVANTS, GREGORY J. LAMMERT, ET AL

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Amicus curiae United Policyholders ("UP") submits this brief in support of the position of Plaintiffs, Gregory J. Lammert, Jamie Lammert, (collectively "Lammerts"), Larry Reasons and Susan Reasons, insureds under property insurance policies issued by Auto-Owners (Mutual) Insurance Company. Counsel hopes that its efforts will assist both the attorneys and this Court, by focusing on public policy considerations surrounding the analysis of whether labor costs should be depreciated in the context of reaching an actual cash value adjustment of a property insurance claim. It files simultaneously with this brief a motion under Tenn. App. R. App. P. 31(a) for leave to file this brief.

IDENTITY AND INTEREST OF *AMICUS CURIAE*

UP is a non-profit public interest consumer advocacy organization dedicated to helping preserve the integrity of the insurance system. UP serves as a voice and an information resource for consumers in all 50 states and is based in San Francisco, California. UP was founded in 1991 after the Berkeley/Oakland Hills Firestorm to assist homeowners with coverage and claim problems. UP's work is supported by donations, grants, and volunteer labor. UP does not sell insurance or accept funding from insurance companies.

Much of UP's work is aimed at helping individuals and businesses purchase appropriate insurance and repair, rebuild, and recover after disasters through its *Roadmap to Preparedness* and *Roadmap to Recovery Programs*. UP engages with local governments, stakeholders, and other advocates to provide insurance claim and coverage guidance for victims of natural disasters. UP coordinated with Tennessee Insurance Commissioner Julie McPeak and her staff in assisting households impacted by the Sevier wildfire (https://www.uphelp.org/blog/sevier-wildfire-tennessee-insurance-claim-help-0). UP hosts a library of publications for consumers on its website at www.uphelp.org. Through its *Advocacy and Action Program*, UP engages with

regulators, legislators, academics, and various stakeholders in connection with legal and marketplace developments relevant to all policyholders and all lines of insurance with a special emphasis on lessons learned in disaster areas. UP's Executive Director is an official consumer representative to the National Association of Insurance Commissioners.

A diverse range of individual and commercial policyholders throughout the U.S. regularly communicate their insurance concerns to UP which allows UP to submit *amicus curiae* briefs to assist state and federal courts decide cases involving important insurance principles. UP has filed *amicus curiae* briefs in approximately 400 cases throughout the United States since the organization's founding in 1991, the majority of which have been filed in California. UP's *amicus curiae* brief was cited in the United States Supreme Court's opinion in *Humana, Inc. v. Forsyth*, 525 U.S. 299 (1999) and arguments from UP's *amicus curiae* brief were cited with approval by the Court in *Vandenburg v. Superior Court*, 21 Cal. 4th 815 (Cal. 1991). Additionally, UP appeared as *amicus curiae* in the Supreme Court case, *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408 (2003).

The issue involved in this case – depreciation of labor in the context of actual cash value adjustments of homeowners' claims – has significant ramifications for Tennessee insurance policyholders. When insurers reduce claim payouts by depreciating labor they are failing to meet their duty to indemnify insureds for a necessary cost of restoring insured assets to pre-loss condition.

In this brief, UP seeks to fulfill the "classic role of *amicus curiae* by assisting in a case of general public interest, supplementing the efforts of counsel, and drawing the court's attention to law that escaped consideration." *Miller-Wohl Co., Inc. v. Comm'r. of Labor & Indus.*, 694 F.2d 203, 204 (8th Cir. 1982). This is an appropriate role for *amicus curiae*. As commentators have

stressed, an *amicus curiae* is often in a superior position to "focus the court's attention on the broad implications of various possible rulings." R. Stern, E. Greggman & S. Shapiro, *Supreme Court Practice*, 570-71 (1986) (quoting Ennis, *Effective Amicus Briefs*, 33 Cath. U.L. Rev. 603 (1984)).

ARGUMENT

I. SUMMARY OF ARGUMENT

Building owners purchase property insurance to protect themselves if their property is damaged by fire, hail, tornadoes, or other often catastrophic events. In the case of homeowners, adequate insurance coverage is often what stands between them and homelessness after a disaster. Insurers have been known to use various strategies to minimize benefit payments after a loss, even though they eagerly accepted the policyholder's premium payments. The wrongful depreciation of labor is one of those strategies.

The question of whether labor should be depreciated in determining actual cash value requires interpretation of the insurance contracts themselves. As such, the issue is a question of law that should be decided by the court.

Tennessee law honors and enforces the principle that insurance policies should be interpreted to effectuate indemnity and uphold policyholders' reasonable expectations of coverage. Consistent with those principles, the cost of labor should not be depreciated. Depreciation of labor results in policyholders not receiving the full amount that they reasonably are entitled to under their actual cash value coverage, and it often results in policyholders also being unable to collect replacement cost value benefits for which they have paid an additional premium. That is an often life-changing loss for the policyholders and provides a windfall to the insurer.

Courts generally use one of two methods to calculate the actual cash value of damaged property, either replacement cost less depreciation, or the broad evidence rule. Yet, the conclusion that labor should not be depreciated does not change based on what method is used. Under any method, as a matter of law, labor should not be depreciated.

II. UNDERSTANDING THE TERMS ACTUAL CASH VALUE, REPLACEMENT COST VALUE, AND DEPRECIATION.

Determining whether labor should be depreciated depends on the understanding of unique property insurance concepts and coverages, such as those contained in the Plaintiffs' policies at issue in this case.

Actual cash value

The precise interpretation of actual cash value is at the heart of this dispute. Generally speaking, actual cash value (often referred to as "ACV") is the amount required to put a policyholder back to where he or she was before the loss. "Actual cash value of property may be paraphrased as: ITS WORTH IN MONEY AT THE PRESENT MOMENT." National Committee on Property Insurance, *Actual Cash Value Guidelines: Buildings, Personal Property,* 5 (1982) (emphasis in original). Actual cash value coverage is "pure indemnity coverage." *Travelers Indem. Co. v. Armstrong,* 442 N.E.2d 349, 352 (Ind. 1982). To indemnify "means simply to place the insured back in the position she enjoyed prior to the loss." Johnny Parker, *Replacement Cost Coverage: A Legal Primer*, 34 Wake Forest L. Rev. 295, 296 (1999). Its purpose "is to make the insured whole but never to benefit him because a [loss] occurred." *Armstrong,* 442 N.E.2d at 352. Obviously, the corollary to this principle is that the ACV approach should never be employed to underpay a claim by providing less than indemnity.

For example, if a policyholder owned a house with a ten-year old roof destroyed by hail, actual cash value would be the price of providing the policyholder a ten-year old roof that was

not destroyed by hail. Disputes arise because it is not possible to buy a ten-year old roof (or ten-year old roofing materials) to install on an existing building. This dilemma has led to various methods of attempting to value the cost of putting policyholders back in the position they were in prior to the loss.

In the absence of policy language adequately (or, sometimes, at all) defining the method of determining the actual cash value of a loss, courts have generally used two different methods. Before these two methods are discussed, an understanding of insurance industry terms "replacement cost value" and "depreciation" is useful.

Replacement cost value

"Replacement cost coverage reimburses an insured for the full cost of repairs, if she repairs or rebuilds the building, even if that results in putting the insured in a better position than she was in before the loss." 5-47 New Appleman on Ins. Law Library Ed. §47.04[2][b] (2016). In other words, using the above example of a ten-year old roof, replacement cost coverage will pay for the cost of a *new* roof, as opposed to the ten-year old roof destroyed by hail. Because replacement cost value coverage (often referred to as "RCV") places policyholders in a better position than before the loss (they now have a new roof rather than a ten-year old roof), it is not indemnity coverage. Policyholders must pay an additional premium for replacement cost coverage.

The timing of actual cash value and replacement cost value payments differs. Actual cash value benefits are paid as soon after the loss as the amount owed by the insurance company is determined. Replacement cost value benefits, in contrast, are typically paid ***if and when*** repairs have been substantially completed, and only if they are done within a specified period of time after the loss. For this reason, insurers may try to allocate as much of the loss as possible into

replacement cost coverage rather than actual cash value so it is less likely that they will ever have to pay any replacement cost coverage.

Depreciation

Depreciation is "the amount an item has lessened in value since it was purchased, taking into account age, wear and tear, market conditions, and obsolescence. Although depreciation has been defined in several ways, the principal definition attributable to that term refers to 'physical deterioration.'" 5-47 New Appleman on Ins. Law Library Ed. §47.04[2][a] (2016); *Black's Law Dictionary* (10th ed., 2014) (depreciation is "[a] reduction in the value or price of something; specif., a decline in an asset's value because of use, wear, obsolescence, or age"). "Physical depreciation is a visible condition." National Committee on Property Insurance, *Actual Cash Value Guidelines: Buildings, Personal Property* (1982). Thus, the concept of depreciation considers that a ten-year old roof is not valued the same as a new roof.

Common law and policy methods of determining actual cash value

Courts generally use one of two methods for determining actual cash value. The first is replacement cost value with deduction for depreciation. *Travelers Indem. Co. v. Armstrong,* 442 N.E.2d 349, 355 (Ind. 1982). United Policyholders agrees with Plaintiffs that the policies at issue in this case require Auto-Owners to use this method.

The second method is the so-called broad evidence rule. That rule allows the fact-finder to consider any relevant factor to establish a correct estimate of the value of the damaged or destroyed property. *Id.* at 355-56.

Auto-Owners argued at the trial court level that actual cash value is based on a third method, "the monetary value of the insured property itself, such as roofs and decks, which unquestionably can and do depreciate in value over time." (Dkt. 36, at 9). But even in the policy

Auto-Owners issued to the Lammerts, which defines depreciation as "a decrease in value because of age, wear, obsolescence or market value," market value is at most one of several factors for determining actual cash value. Logically, market value cannot be the only factor because it is impossible to determine the value of a roof or a deck except as a component of the house or other building to which it is attached; and the market value of that house or other building is itself determined in part by the property on which it sits. *See id.* at 355, citing Note, *Valuation and Measure of Recovery Under Fire Insurance Policies*, 49 Colum. L. Rev. 818, 820 (1949).

The fallacy of Auto-Owners' argument is shown by its hypothetical that a roof might have deteriorated to the point that it has no value. In that situation, Auto-Owners argues that the labor to install the roof has been reduced to no value. Although a worn roof might not have any *market value*, it certainly has some value to those whom the roof protects from the weather. Those are the same people who Auto-Owners now asserts should not receive any of the insurance coverage for which they have paid.

At a minimum, property insurance policies provide coverage for actual cash value, and may also provide replacement cost value benefits. In other words, ***actual cash value*** coverage is the basic coverage, meant to return the policyholders to the same position as before the loss. ***Replacement cost value*** coverage is provided for an additional premium, and covers the cost of replacing often deteriorated building material with new material. ***Depreciation*** is the difference between the amount an insurer must pay as actual cash value and the amount it must pay as replacement cost.

III. THE QUESTION OF WHETHER LABOR SHOULD BE DEPRECIATED IS A MATTER OF CONTRACT INTERPRETATION AND SHOULD BE DECIDED AS A MATTER OF LAW.

The interpretation of an insurance policy is a question of law. *See Nat'l Ins. Ass'n v. Simpson,* 155 S.W.3d 134, 138 (Tenn. Ct. App. 2004) ("[q]uestions relating to the interpretation of written contracts involve legal rather than factual issues. . . . Insurance policies are contracts, and thus scope of coverage issues present questions of law"). The resolution of whether labor should be depreciated is not a question of fact, but a question of law and policy language interpretation appropriate for a court's independent determination.

Classifying the depreciation of labor issue as a matter of fact instead of a matter of law may have profound and adverse consequences upon policyholders. The harmful effect of not deciding the issue as a matter of law is that factfinders could render opposite awards to policyholders in identical situations. For example, consider respective owners of two ***identical*** houses, who purchased identical insurance policies from the same carrier, and have houses that were built side-by-side by the ***same*** builder at the ***same*** time, and with the ***same*** roof damage from the ***same*** hailstorm. They could receive ***different*** actual cash value benefits. When policyholders and their insurers disagree regarding the amount of loss, an insurer may seek to resolve the dispute through appraisal by having a panel that would decide as a matter of fact whether labor should be depreciated. If the depreciation of labor issue is decided as a question of fact, it is possible that one owner's appraiser could determine that labor ***should*** be depreciated, while the other owner's appraiser could determine that labor ***should not*** be depreciated.

Worse, some insurers might across the board insist on depreciating labor when making a settlement offer. Many homeowners do not have the knowledge or resources to argue that doing so is incorrect. Thus, this issue should be decided as a matter of law.

IV. A REASONABLE CONSTRUCTION OF THE INSURANCE POLICIES IS THAT LABOR SHOULD NOT BE DEPRECIATED.

"Contracts of insurance should receive a reasonable construction so as to effectuate the purposes for which they are made." *Aetna Life Ins. Co. v. Spencer,* 32 S.W.2d 310, 312 (Ark. 1930). A reasonable construction of the insurance policies in this case is that labor is not included in depreciation. Not only would depreciating labor require ignoring the definition of common words, it would also fail to effectuate the purpose of actual cash value coverage of indemnifying the policyholders for their loss.

Depreciation is defined by insurance law hornbooks, *Black's Law Dictionary,* and the Lammerts' policy as a decrease in value because of factors including age, wear and tear, market conditions or value, and obsolescence. 5- 47 New Appleman on Ins. Law Library Ed. §47.04[2][a] (2016); *Black's Law Dictionary* (10th ed. 2014), *supra* at 6; Dkt. 28-4, at 12 (Lammerts' policy). The principal definition of depreciation "refers to 'physical deterioration.'" New Appleman on Ins. Law Library Ed., *supra* at 6; *Depreciation* is the reduction in value of **tangible** property." Robert J. Prahl, Introduction to Claims, 87 (1988) (bold emphasis added).

As discussed in Plaintiffs' brief, the factors of age, wear and tear, market conditions or value, and obsolescence can only apply to material, not labor. To the extent that labor is subject to market conditions, its value generally rises as wages go up. Labor is not a physical thing that can deteriorate.

Material is defined as: "1. A solid substance such as wood, plastic, metal, or paper. 2. The things that are used for making or doing something." *Black's Law Dictionary* (10th ed. 2014). Labor is "[w]ork of any type." *Id.* Last month, the United States District Court for the Northern District of Mississippi explained in *Titan Exteriors, Inc. v. Certain Underwriters at Lloyd's, London*, 2018 WL 1057139 at *5 (N.D. Miss. Feb. 26, 2018), "Labor does not suffer

use, wear, or obsolescence. It does not physically deteriorate." Thus, it is difficult to envision any scenario in which labor would depreciate since it is not susceptible to aging or wear.

The National Underwriter Company publishes under the name FC & S, or Fire, Casualty & Surety, a comprehensive library of reference books for insurance professionals. FC & S also provides online bulletins in which its experts respond to questions from insurance professionals. The bulletin is used by insurance agents and brokers to interpret standard insurance policy provisions. FC & S has stated that its position is that depreciation should not apply to labor unless a policy explicitly states that it should. FC & S Bulletin, *Should depreciation be applied to demolition, cleaning, and odor control costs following a fire loss?* (Nat'l Underwriter Co. December 5, 2014).

Auto-Owners and other insurance carriers should not be allowed to reap the benefit of a term that it chose not to define in its policies. Even the International Risk Management Institute ("IRMI"), an independent insurance industry entity that provides instruction to risk management and insurance industry professionals concerning the application of policy provisions, has explained that if an insurance company wants its own interpretation to apply, it can define that term in its own policy. Mike McCracken, International Risk Management Institute, Inc., What Exactly is Actual Cash Value? Better Yet, How Do You Calculate It? available at https://www.irmi.com/articles/expert-commentary/what-exactly-is-actual-cash-value (Dec. 2007).

In this case, Auto-Owners could have easily defined actual cash value to include depreciation of labor but did not do so. Therefore, Auto-Owners should not benefit by deducting labor from the policyholder's actual cash value payment. As explained below, even if the term is

subject to more than one reasonable interpretation, traditional rules of contract construction would favor the policyholders' position.

Insurance companies have long been subject to market conduct examinations by various state departments of insurance. In this type of examination, the claims handling of an insurance company is often evaluated and may subject an insurer to possible penalties for inappropriate claims conduct.

A 2011 examination by the Ohio Department of Insurance considered "depreciation of labor" the exception, and not the rule. "In order to be consistent with the industry practice of not depreciating labor, the examiners considered the depreciation of labor to be an exception." *Ohio Department of Insurance Market Conduct Examination of Sandy and Beaver Valley Farmers Mutual Insurance Company*, NAIC #10270, June 20, 2011 (found at http://www.insurance.ohio.gov/Company/MC/Sandy%20and%20Beaver%20Valley%20Exam%20Report.pdf. pp. 4 & 6). Under the examiner's recommendations, it was noted that "during interviews with the examiners the Company indicated that its procedure was not to depreciate labor." *Id* at 12. As such, the examiner recommended that "the Company should ensure that independent adjuster estimates do not include labor depreciation, in order to maintain consistency between claimant settlements and adherence to Company policies and procedures. *Id.*

Moreover, depreciating labor would not effectuate the purpose of actual cash value coverage, which is indemnity, or placing the policyholders back in the position they enjoyed prior to the loss. Of course, ACV coverage can never put the policyholders back in the *precise* position they were in prior to the loss. In the example previously discussed, the policyholders had a ten-year old roof that was destroyed by hail. The only way to return the policyholders

back to the exact position they were in before the loss would be to install a ten-year old roof. That is not feasible as you cannot buy and install a used roof, or used roofing material. Therefore, actual cash value benefits will provide the policyholders the cost of a new roof, depreciated by the amount that their roof has deteriorated. But if the insurer also depreciates the cost of labor, the insureds will not receive enough money to install the roof. Before the loss, the insureds had a ten-year old roof that was installed on the house. To be made whole, the insurer must pay enough money to install a ten-year old roof on the insureds house. Whether installing a new roof or a ten-year old roof, the price of labor is the same. Depreciating labor will not make the policyholder whole, and will frustrate the indemnity purpose of the actual cash value coverage.

V. TO THE EXTENT THE POLICY TERMS "ACTUAL CASH VALUE" AND "DEPRECIATION" ARE SUBJECT TO MORE THAN ONE REASONABLE INTERPRETATION, THE POLICIES MUST BE INTERPRETED IN FAVOR OF THE POLICYHOLDERS.

The rule requiring that ambiguous clauses in insurance policies be interpreted in favor of a policyholder has grown out of a centuries-long history of insurers attempting to wrongfully deny or minimize coverage despite the vital role that insurance coverage plays in society:

> [T]he 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.
>
> ....
>
> 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.

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. of Mich. J. L. Ref. 1, 9-11 (Fall 1992) (footnotes omitted).

The field of insurance is different from any other business involving commercial contracts, based on its high degree of interaction with a potentially vulnerable portion of the consuming public. As explained in an insurance industry treatise, *The Legal Environment of Insurance* in its chapters on Insurance Contract Law:

> The insurance contract has the same basic requisites as other contracts. There is a need for an agreement, competent parties, consideration, and a legal purpose. However, the insurance contract also has other distinctive features. Insurance contracts cover fortuitous events, are contracts of adhesion and indemnity, must have the public interest in mind, require the utmost good faith, are executory and conditional, and must honor reasonable expectations.

James J. Lorimer, et al, *The Legal Environment of Insurance* 176 (American Institute for Charter Property Casualty Underwriter, 4th ed. 1993). A particularly scholarly discussion explaining why insurance is treated differently by courts is found in an article written by Professor Henderson of the University of Arizona College of Law, which includes the following discourse:

> 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. . . . 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. of Mich. J. L. Ref. 1, 13-14 (Fall 1992) (footnotes omitted).

Against this background, to protect policyholders and create consistency, comprehensive rules of policy interpretation have developed. They boil down to this:

> [w]hen interpreting insurance policies, as a matter of public policy, ambiguities are generally construed in favor of the insured and against the insurer. Thus, where the policy is found to be unclear and ambiguous, the court's construction of an insurance policy will be guided by the reasonable expectations of the insured.

Ponder v. State Farm Mut. Auto. Ins. Co., 12 P.3d 960, 967 (N.M. 2000) (internal quotation omitted); *see also Gen. Cas. Co. of Wis. v. Hills,* 561 N.W.2d 718, 722 (Wis. 1997) ("[o]f primary importance is that the language of an insurance policy should be interpreted to mean what a reasonable person in the position of the insured would have understood the words to mean").

Tennessee law is in accord. *Harrell v. Minn. Mut. Life Ins. Co.,* 937 S.W.2d 809, 810 (Tenn. 1996) (rejecting interpretation of policy that is "contrary to the understanding and

reasonable expectations of the average insurance policyholder"); *Stovall v. N.Y. Indem. Co.*, 8 S.W.2d 473, 477 (Tenn. 1928) ("[w]here words are so used in the contract of insurance that their meaning is ambiguous, or susceptible of two interpretations differing in import, that interpretation which will sustain the claim of the policy holder and cover the loss should be adopted").

The same principles apply to the question of whether labor should be depreciated. Last month, in *Titan Exteriors, Inc. v. Certain Underwriters at Lloyd's, London*, 2018 WL 1057139 at * 5 (N.D. Miss. February 26, 2018), the United States District Court for the Northern District of Mississippi held that actual cash value, when defined in the policy as "replacement cost value less depreciation," is subject to more than one reasonable interpretation. Thus, the court found the meaning of "actual cash value" to be ambiguous, and resolved the ambiguity against the policyholder as a matter of law that the insurer was not allowed to depreciate labor to determine the actual cash value. *Id.*

To the extent any ambiguity in the policies at issue in this case exists, that ambiguity must be resolved in favor of the policyholders. Where the language of an insurance policy is fairly susceptible of more than one meaning and therefore ambiguous, Tennessee law directs that the ambiguity be construed against Auto-Owners and in favor of the Plaintiffs. *Tata v. Nichols*, 848 S.W.2d 649, 650 (Tenn. 1993).

It is illogical to assume that insureds, such as the Plaintiffs in this case, would be able to infer that labor would depreciate from an ACV coverage policy when the term "actual cash value" possesses no definition. *See* Adam J. Babinat, *Ensuring Indemnity: Why Insurers Should Cease The Practice of Depreciating Labor*, 22 Drake J. Agric. L. 65, 78, 85 (Spring 2017)(recommending that Iowa adopt a regulation similar to California that the expense of labor

to repair, build or replace damaged property is not a component of physical depreciation.) Here, holding in favor of Auto-Owners would place a burden on the insureds, which unjustly benefits Auto-Owners. *Id.* at 78.

Allowing insurers to depreciate labor would be contrary to the reasonable expectations of the policyholders, would cause them significant financial harm, and would create a windfall for the insurers. The reasonable expectation of the policyholders is that the indemnity policy they purchased will provide coverage sufficient to actually indemnify them, or put them back in the position they were in prior to the loss. If the policyholders' property had a roof before the loss, indemnity requires that they be paid the depreciated value of the roofing materials and the cost of installing those depreciated materials. As discussed in the Plaintiffs' brief, even the Tennessee Department of Insurance has indicated that "[i]t is generally the belief that labor is not depreciable" and that it "do[es] not believe insurers are depreciating labor unless their [insurance policy] calls for it." (Plaintiffs' Brief at 9).

The harm to policyholders and the windfall to insurers from depreciating labor is obvious on its face with respect to policies that do not include replacement cost coverage. Depreciating labor means that insurers will *never* pay the cost of labor, and policyholders will never receive that portion of their loss.

Many property insurance policies also include replacement cost value coverage, for which policyholders pay an additional premium. Even when replacement cost value coverage exists, it is not as simple as the insurer paying whatever amount it has calculated as depreciation on labor as replacement cost coverage rather than actual cash value coverage. In fact, where the policyholders have paid for replacement cost coverage, depreciating labor will often result in an even bigger windfall for the insurer than where there is no replacement cost coverage.

Standard property insurance policies provide that replacement cost coverage is not paid until the repairs have actually been made. Moreover, those repairs must be completed within a specified time, in some cases as little as 180 days after payment of the actual cash value, or replacement cost coverage is forfeited. *See Sher v. Allstate Ins. Co.*, 947 F.Supp.2d 370 (S.D.N.Y. 2013).

When an insurer retains amounts for depreciation of labor and pays less in ACV coverage, it is likely the policyholder will not have enough funds to rebuild the damaged property within the required time period, or at all. In that instance, the insurer *never pays* the replacement cost coverage for which the policyholders contracted and paid. The insurer receives a windfall. The policyholders remain without a roof.

Even if the policyholders do manage to save enough money to make repairs and eventually receive replacement cost value benefits from the insurer, in the interim, the insurer has earned income on the depreciation holdback amount. Meanwhile, the policyholders have been denied the use of those funds when they may need them the most (to pay their contractors.)

VI. LABOR SHOULD NOT BE DEPRECIATED NO MATTER WHAT METHOD IS USED TO CALCULATE ACTUAL CASH VALUE.

As set forth in the Plaintiffs' brief, both policies at issue here require the use of the replacement cost less depreciation method for determining actual cash value. But with respect to the question of whether labor should be depreciated, it makes no difference whether that method is used or the broad evidence rule is used. As a matter of law, labor should not be depreciated. Under the replacement cost less depreciation method, labor is not included in depreciation because as a matter of law, it is not an element of depreciation. Under the broad evidence rule, as a matter of law, depreciation of labor should not be a relevant factor to be considered to

establish the actual cash value of the property because labor does not depreciate as a physical asset does.

The Plaintiffs have provided a comprehensive discussion of insurers' use of Xactimate for estimating the value of losses, and how the simplicity of that program has led to insurers increasingly and improperly depreciating labor. But whether Xactimate or another estimating method is used by insurers, policyholders, or appraisal panels, as a matter of law, labor should not be depreciated.

CONCLUSION

UP recognizes and appreciates the extremely important role insurance companies play in modern society. Profitable and financially stable insurance companies promote a healthy society, allowing risk of loss to be spread widely and fairly. When the system works, prompt and proper payment goes to those who suffer life-altering catastrophes affecting their persons and property.

Unfortunately, some insurance companies are tempted to obtain an "edge" when it comes to claims payment, to bolster their bottom line. Depreciating labor when calculating actual cash value is an example of that unethical conduct. Depreciation of labor is contrary to the policies insurers have issued and the purpose of indemnifying policyholders. Even if policies are ambiguous, they must be interpreted in favor of the policyholders. Allowing insurers to depreciate labor would result in the policyholders not receiving the coverage they reasonably believed they purchased and create a windfall for insurers. That would occur no matter what method of calculating actual cash value is used.

For the foregoing reasons, United Policyholders respectfully submits that the Court should find labor costs should not be depreciated.

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned certifies a true and correct copy of the foregoing Brief of *Amicus Curiae* United Policyholders has been served via U.S. Mail, postage prepaid, on counsel of record, on this the 28 day of March, 2018:

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APPENDIX

1. FC & S Bulletin, *Should depreciation be applied to demolition, cleaning, and odor control costs following a fire loss?* (Nat'l Underwriter Co. December 5, 2014)

2. Mike McCracken, International Risk Management Institute, Inc., What Exactly is Actual Cash Value? Better Yet, How Do You Calculate It? (Dec. 2007)

3. National Committee on Property Insurance, *Actual Cash Value Guidelines: Buildings, Personal Property* (1982)

4. *Ohio Department of Insurance Market Conduct Examination of Sandy and Beaver Valley Farmers Mutual Insurance Company*, NAIC #10270, June 20, 2011

5. Robert J. Prahl, Introduction to Claims, 87 (1988)

FC&S LEGAL The National Underwriter Company

The Insurance Coverage Law Information Center

DEPRECIATION OF LABOR

Should depreciation be applied to demolition, cleaning, and odor control costs following a fire loss?

December 5, 2014

We have a commercial client who suffered a fire damage claim to his retail market. In the course of settlement, the insurance company applied depreciation to the demolition, cleaning, and odor control that is needed on the claim. We do not feel that depreciation is applicable to demolition, cleaning, or odor control methods and should apply only to the replacement or direct repair of the building. We are looking for some guidance on this part of the negotiation.

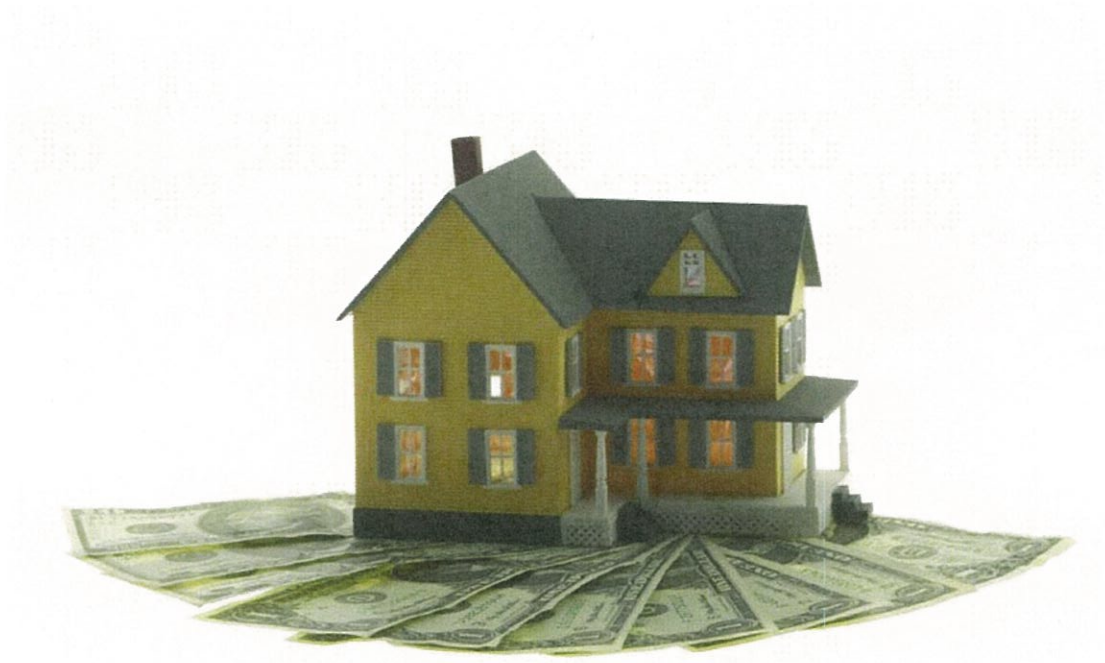
New Hampshire Subscriber

It has been our position that depreciation should not apply to labor unless a policy explicitly states that it should. We do, however, recognize that courts have come to varying conclusions on the topic. The following excerpt from a column written by a former *FC&S* editor for one of National Underwriter's publications, *Claims Magazine* discusses some of the court decisions on the topic:

> Two similar cases reached the Oklahoma Supreme Court and were answered within a day of each other in 2002. Both cases involved damage to roofs and an ACV settlement, and both addressed depreciation of labor.
>
> In the first, *Redcorn v. State Farm*, the court said that a "roof is the product of both materials and labor," and so depreciation of labor costs were allowable. But in a dissenting opinion, three justices argued that labor costs should not be depreciated. A roof, they stated, was not a single product consisting of "labor-and-shingles," but was a combination of products (shingles and nails) and a service (labor to install). Labor cannot lose value over time.
>
> One dissenting justice also pointed out that prior to the loss the insured had an installed sixteen-year old roof, and to be indemnified meant he was entitled to the value of the sixteen year old shingles plus the cost of installing them.
>
> The second case before the same court (*Branch v. Farmers Ins.*) also dealt with depreciation of labor. In this instance the court was asked to determine if labor costs for tear-off of a damaged roof could be depreciated, or whether these costs properly should be covered as "debris removal"? In answer to the first question, the court said that labor to install the new roof was a cost the insured was reasonably likely to incur, and so it was rightly included within the meaning of "replacement cost." It followed, then, that labor could be depreciated along with materials.
>
> But having said that, the court noted that homeowners policies contained a separate coverage for debris removal following a covered loss. If a roof were damaged to the extent it had to be replaced, then, said the court, the damaged portion was rubble, or debris. And, if the whole roof had to be torn off to repair or replace the damaged portion, then those torn off pieces must also be considered rubble. Therefore, although the cost of the labor to replace the roof could be depreciated, the cost to remove the debris of the old roof could not.

Expert Commentary

What Exactly Is Actual Cash Value? Better Yet, How Do You Calculate It?



Everyone knows what actual cash value (ACV) is, right? Everyone knows that ACV is replacement cost (RC) minus depreciation, right? Well, if everyone knows it, why does it seem that there are so many problems surrounding the issue of ACV at claim time?

Mike McCracken
December 2007
Personal Lines Insurance

Over the years, courts have defined ACV in one of three ways:

1. RC minus depreciation.
2. Fair market value.
3. According to the "broad evidence" rule—a judicious combination of numbers one and two.

Option number one is the traditional insurance industry definition. And, over the years, courts have upheld this meaning and interpretation. A Kansas court summed it up nicely: "The definition of 'replacement cost' stated in the policy as the 'full cost of repair or replacement (without deduction for depreciation)' implies that replacement cost is greater than actual cash value, and that actual cash value must mean 'full cost of repair or replacement (with deduction for depreciation)." Option number two—"fair market value"—also seems to be a rather straightforward method. It has always been thought of as "what a willing buyer will pay to a willing seller."

Turning to California

In the case of *Cheeks v. California Fair Plan*, 61 Cal. App. 423, 71 Cal. Rptr. 2d 568 (Ct. App. 1998), the California Appellate Court came down squarely on the side of using "fair market value" as the definition of ACV in California. In this case, Mr. Cheeks's home sustained earthquake damage in the Northridge earthquake of 1994. His policy with the California Fair Plan (CalFair) agreed to pay covered losses at "actual cash value at the time of loss, but not more than the amount required to repair or replace the property."

After determining the replacement cost of Mr. Cheeks's loss to be $563,888, CalFair applied depreciation and the deductible, to arrive at a final ACV payment of $44,343. Mr. Cheeks contended that the "value" of his home was considerably more than that figure and took the insurer to court. He knew what he could get if he were to sell the house.

Although Mr. Cheeks lost at the trial court level, he appealed. At the appeal level, the court quoted the State Supreme Court in *Jefferson Ins. Co. v. Superior Ct. of Alameda Cty.*, 3 Cal. 3d 398, 90 Cal. Rptr. 608 (1970): "It is clear that the legislature did not intend the term 'actual cash value' in the standard policy form, set forth in section 2071 of the Insurance Code, to mean replacement cost less depreciation."

In deciding in Mr. Cheeks's favor—that ACV means "fair market value"—the appellate court gave this advice to insurers and to those who draft insurance policies: "If it [the insurer] wants to determine 'actual cash value' on the basis of replacement cost less depreciation, all it has to do is say so in the policy."

Turning to Kentucky

I consulted on a commercial property claim in 2005, where calculation of the ACV was the central issue. The risk was a commercial building located in Kentucky. It was insured with a standard commercial property policy for $590,000 on a replacement cost basis. After a loss, the commercial property policy gives the insured the

option of proceeding with the replacement of the building or of taking an ACV cash settlement. Note that the option is the insured's and that the insurer may not dictate what path he must pursue.

In February of 2004, the Kentucky building was destroyed by a fire. After the fire, the insured obtained two estimates from local contractors who were familiar with the building. Both of these contractors estimated that the cost to replace the building would be around $750,000. At that point, the insured decided not to rebuild, but to take the actual cash value settlement, as allowed in the policy.

The policy was the standard commercial property policy, with at least one big exception: this policy actually defined ACV as "replacement cost less a deduction that reflects depreciation, age, condition, and obsolescence." By including this definition of ACV in the policy, both parties to the contract—insured and insurer—were limited to this use (and this use only) of the term.

When all calculations were finished, even after applying depreciation to the $750,000 replacement cost, the ACV was still more than the limit of liability. At this point, the insurer should have just proffered a check for the policy limit and walked away. But the insurer decided to reexamine the situation. It seems that this building was located in a deteriorating neighborhood and that, if he had tried to sell it, the building's owner could only have gotten about $294,000 for the building—nowhere near the limit of liability of $590,000. After finding out about the building's rather low market value, the insurer said it would pay no more than the estimated market value of the building, $294,000.

It was at that point that I became involved. Although I emphasized that I am not a lawyer, my take on the situation, from more than 25 years' experience, was that the definition of ACV in the policy bound both parties to it and that the insurer could not just "willy-nilly" decide to revert to market value for payment when it had already defined how it would pay. In appraisal, a settlement was reached for just under $590,000. The umpire even chastised the insurer for its efforts to circumvent the wording in its own policy.

An old saying goes: "Be careful of what you wish for—it might just come true." In this case, the advice to the insurer might have been: "Be careful of how you define a term—it may come back to haunt you."

Overhead and Profit

Another sticky point in negotiation between insured and insurer is the application of and payment for "overhead and profit" (O & P). When calculating ACV, some insurers start with replacement cost, then deduct depreciation, then deduct another 20 percent for contractor's overhead and profit.

In *Gilderman and Gilderman v. State Farm*, 649 A.2d 941, 437 Pa. Super. 217 (Pa. Super. Ct. 1994), the Pennsylvania Superior Court clearly said this practice was wrong. This decision was upheld in 1995 by the state supreme court's refusal to review the case. I think the important thing to remember is that the price of anything—a new roof for a home, a car, furniture, or clothing—includes a component for overhead and profit. If I were to go into a car dealer or a clothing store and tell the salesperson that I wanted to buy that car or that suit, but I would be taking 20 percent off the price for "overhead and profit," I'd be laughed out of the store. In the *Gilderman* case, the Pennsylvania Court advised insurers to be careful or they would be laughed out of town as well.

Unless otherwise dictated by statute or court decision, here is how I think overhead and profit should be handled in a homeowners loss:

RC of Damaged Property (no O&P):	$100,000
Overhead and Profit:	+20,000
Full RC of Damaged Property:	$120,000
Depreciation, for example, 30%:	-36,000
ACV Payment (RC – Depreciation):	$84,000

Turning to Florida

In Florida, the issue of overhead and profit and how to pay for a loss had become so bad, so contentious, that the legislature stepped into the fray. Provision 2.d of "Loss Settlement" in the standard HO-3 homeowners policy from Insurance Services Office, Inc. (ISO), says that the insurer will only pay ACV for a homeowners loss "until actual repair or replacement is complete." Paragraph 2.e of the same policy allows the insured to make an initial claim for the ACV of the loss and then take up to 180 days to decide if he or she wants to replace the damaged property.

Again, because of all the problems with homeowner claims and calculation of ACV in Florida, the Florida Legislature took away the ACV option. As of January 2006, paragraph 2.d only applies to mobile homes and paragraph 2.e has been removed.

So what loss settlement options are now open to homeowner insurers in Florida? Forgetting any insurance-to-value problems, insurers are now left with paragraph 2.a of the Loss Settlement provision. There, the policy agrees that it will pay the least of the following amounts

1. The limit of liability.
2. The replacement cost of the damaged portion of the home.
3. The amount actually spent to replace the damaged portion of the home.

And without paragraph 2.d that requires rebuilding prior to payment of the replacement cost amount, insurers must now write a check to the homeowner for the RC of the damaged portion—even if the insured chooses not to rebuild or repair the home. The insurer no longer has any options. It must proffer a check to the homeowner in the amount of the replacement cost of the damaged property, or the limit of liability, whichever is less.

Although there are many complicated issues surrounding homeowners insurance in Florida, I'm convinced that the insurance industry could have avoided the legislature's rather drastic measures in 2006. How? By including a definition of ACV in the homeowners policy.

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ACTUAL CASH VALUE GUIDELINES

BUILDINGS

PERSONAL PROPERTY

Prepared by
The National Committee on Property Insurance
55 Court Street
Boston, Massachusetts
1982

ANALYSIS OF THE WORDS "ACTUAL CASH VALUE" III

The drafters of the 1943 New York Standard Policy elected to delete the parenthetical words, ascertained with proper deductions for depreciation, which followed, and were apparently intended to qualify the phrase actual cash value, they reasoned that it was superfluous, redundant, and added nothing which would clarify the phrase.[6] They believed that cash value meant worth expressed in terms of money and that it was unnecessary to say depreciation must be considered. However, the omission of the words opened up a broad area of controversy within the property insurance field and in the courts. Many were convinced that the meaning of the phrase actual cash value had been altered, changed completely or, in any event, made obscure.

In our attempt to analyze the phrase actual cash value to seek out its meaning and application to property we find that:

Actual	means real, factual, being, existing at the present moment (not fanciful or theoretical nor existing at some time in the past or the distant future.)
Cash	means ready money; currency or coins.
Value	means monetary or material worth. Worth in usefulness or importance to the possessor.

Viewed in light of these definitions, actual cash value of property may be paraphrased as: ITS WORTH IN MONEY AT THE PRESENT MOMENT.

It would appear highly improbable that a reasonable person would, by any process, arrive at the actual cash value of a building without taking into consideration depreciation however it may have been caused . . . whether physical deterioration, functional or economic obsolescence.

CUSTOMARY APPROACHES IN ESTIMATING ACTUAL CASH VALUE OF BUILDINGS IV

Prefacing any discussion of the approaches to estimating the actual cash value of buildings, it should be pointed out that, considering the millions of buildings covered by insurance, only a relative though extremely important few present any serious problem of valuation for establishing the amount of insurance or the amount of loss in the event of destruction. Reconstruction cost less a reasonable deduction for physical depreciation is the generally acceptable

rule. (Under policies covering Full Replacement Cost, depreciation is not taken.)

While it is true that there can be differences of opinion as to the construction cost of particular buildings and as to the amount of depreciation to be deducted, these are matters of opinion. It is well known that even when builders make competitive estimates using the same set of plans and specifications, the spread from the high bid to the low bid is often as much as 20 to 30 percent. Also, opinions as to the amount of depreciation to be deducted for wear and tear vary considerably . . . depending on whether it is on a flat percentage or taken item by item and based on the probable life expectancy of the item.

The courts vary in their interpretation of actual cash value due largely to the different circumstances and situations under which the question arises. While it is ill-advised to generalize from isolated and specific cases, nevertheless there is a substantial body of opinion and rulings by the courts which apply to most situations encountered.

Disagreements emerge where the actual cash value of buildings, residential and particularly commercial, involve physical, functional and economic depreciation which are such dominant factors that the cost of repairing partial damage or replacing the structure may exceed its actual cash value (i.e., its real worth in cash excluding the land). Many of these controversies have found their way into the courts, resulting in a wide variety of important decisions.

Case law reflects three general tests or categories used by the courts and by appraisers to measure the actual cash value of property:[7]

1. Replacement/Reconstruction Cost, less depreciation, if any
2. Market value, where the property is of such a nature that its market value can be readily determined
3. The Broad Evidence Rule under which any evidence logically tending to the formation of a correct estimate of the value of the property might be considered in determining actual cash value.

Reconstruction Cost Less Depreciation - Total Losses

As stated earlier, reconstruction cost less reasonable deduction for depreciation, in most instances, has been an acceptable approach for estimating actual cash value. "At one time, this was the only standard for determining ACV. It was felt that all one had to do was calculate the cost of replacing the damaged property (building or contents), subtract a fair amount for depreciation and, with mathematical certainty, one arrived at ACV. This was a quick and easy way to find ACV."[8]

This approach works to most everyone's satisfaction where buildings are of fairly recent construction and where they may show physical depreciation (wear and tear) if any and, little or no economic or functional obsolescence. Physical depreciation is a visible condition and, while subject to opinion as to extent, it is generally subject also to negotiation between insured and insurer.

It provides indemnity to the insured on total losses and on most partial losses. The exceptions are to be found in isolated court decisions. (See Partial Losses - Depreciation)

The courts have been fairly consistent and clear on insisting that an old building may not be valued at replacement cost new and that deductions for physical depreciation are to be made.

> "The actual cash value of the property at the time of loss is not ordinarily the same as the cost of replacing the property with new property with like kind or quality. As to a building, it is the cost of a new building of the same material and dimensions of the one destroyed, less the amount the destroyed building had deteriorated by use. Boise Assn. of Creditmen v. U.S. Fire Insurance Co. 44 Idaho 249, 256 P. 523 (1927)."

Reconstruction Cost Less Depreciation - Partial Losses

The right to take depreciation into account in the estimation of a partial loss was, to a great extent, taken for granted before the 1943 Standard Policy eliminated the parenthetical expression "ascertained with proper deductions for depreciation" after the word "value". Since 1943 there has been an increase in the decisions of courts refusing to take depreciation. A widely cited case is Farber v. Perkiomen Mutual Insurance Company, 370 Pa. 480, 88 At. 2d 776 (1952), where the Supreme Court of Pennsylvania so held. The judge observed:

> "As already stated, if the defendants (insurers) wish to bring about a different result under circumstances similar to those present here, they will have to change the terms of their policies in order to achieve this end."

This case involved the so-called rule of consistency; i.e. applying the same percentage of depreciation on the loss side as on the value side where the policy contained a coinsurance clause. The court held the loss was not subject to depreciation, but the value was. The insurers contended that loss and value should be depreciated the same percentage.

In another case involving a coinsurance clause, the court held the parties bound by the appraisal agreement which allowed 20 percent depreciation on the loss side but 45
percent on the value side. The Court, however, plainly stated that in the absence of the appraisal agreement, the Court would allow no depreciation on the loss side. Lazaroff v. Northwestern National Insurance Company, 121 N.Y.S. 2d 122; aff'd 218 App. Div. 672 (1952).

A similar view was taken by the court in Glen Falls Insurance Co. v. Gulf Breeze Cottages Inc. 850, 38 S. 2d 828 (1949) where 50 percent depreciation was allowed in determining value but no depreciation was allowed on the loss.

An important case handed down by a New York court supports no depreciation and contains the following statement by the judge:

> "Testimony on behalf of the plaintiffs is that even if allowance were made for new material, the value of the building after repairing it would be no more than it was prior to the fire, and I have reached a conclusion to that effect — moreover, I find that with the use of new materials the plaintiff would have no better building than they had prior to the fire, and in fact, the proof is that the building would lack certain materials and facilities which were a part of the building when the fire occurred." Andrews v. Empire Cooperative Fire Insurance Company, 103 N.Y.S. 2d 177 (1951).

This statement seems to emphasize more than most cases, the reaching out by the court to close the gap between indemnification and betterment.

There are very few cases in which the courts have ruled that depreciation must be taken on partial losses. Of the half dozen or so, most lack a discussion that would justify the deduction, and most involve situations where a deduction for depreciation is so apparent that to rule otherwise would be grossly unjust.[9]

A second approach to estimate "actual cash value" is the "fair market value" approach, a term usually defined as:

Fair Market Value

> "The price at which property would change hands between a willing buyer and a willing seller, each having a reasonable knowledge of all pertinent facts and neither being under compulsion to buy or sell."

Appraising is not an exact science and the element of opinion plays a major role. Therefore, the estimating of fair market value can generate wide divergence of opinion among appraisers. In spite of the often quoted definition above, it is seldom that situations for estimating fair market value involve a completely willing buyer and completely willing seller, each having equal negotiating ability.

Appraisers of market value include in their calculation (1) the cost approach, (2) the market data approach and (3) the income or capitalization approach. These various approaches are valued, correlated and weighted to arrive at a final estimate.

(1) The cost approach takes into account reconstruction cost* less depreciation, i.e. physical deterioration, functional and economic obsolescence.

(2) The market approach compares the property to sales and listings of similar properties in the same or similar areas.

(3) The income or capitalization approach measures present worth of expected future net income derived from the property. It estimates vacancy, gross income, expenses and other charges. Net income is capitalized to estimate probable value as an investment.

The "market value" approach is considered the rule in California. See Jefferson Insurance Co. of New York v. Superior Court 475 P. 2d 880 (1970). The California Supreme Court, construing its standard fire insurance policy, held that:

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*Note reconstruction cost, not replacement cost. See Replacement Cost v. Reconstruction Cost for explanation of the distinction.

damage; depreciation.

(13) Obsolescence.
(14) Present use of building and its profitability.
(15) Alternate building uses.
(16) Present neighborhood characteristics; long-range community plans for the area where building is located; urban renewal prospects; new roadway plans.
(17) Insured's intention to demolish building.
(18) Vacancy, abandonment.
(19) Excessive tax arrears.
(20) Original cost of construction.
(21) Inflationary or deflationary trends.

This list, of course, is not intended to include all elements. Each person's claim is as unique as a fingerprint and new elements of ACV always crop up."[13]

Seventeen of these 21 elements or factors relate directly to and have an influence on the market value of a building. Four of them, 1, 12, 20 and 21, relate to and have an influence on the replacement/reproduction cost less depreciation value of a building. If we include or associate economic value with market value, the Broad Evidence Rule offers the only two realistic approaches for estimating the actual cash value of any building whether it be a new one, one of recent construction, one of functional or economic obsolescence, an abandoned building or one about to be demolished. The two approaches are (1) Market/Economic value, (2) Replacement/Reconstruction value less depreciation. Implicit in both of these approaches is the Rule that every fact and circumstance tending to the formation of a correct estimate of the value must be given due consideration.

APPLICATION OF APPROACHES IN ESTIMATING ACTUAL CASH VALUE

V

Insurance underwriters and claim personnel are regularly faced with the problem of estimating the actual cash value of buildings. The underwriter is concerned that buildings are neither over-insured nor under-insured. The claims person's interest is that, in the event of loss, the insured is properly and adequately indemnified within the terms and provisions of the policy. Insureds and producers are likewise concerned.

Replacement Cost v. Reconstruction Cost

Throughout this study of actual cash value the term replacement/reconstruction cost has been used rather than the word replacement or the word reconstruction, except where the individual words could be used correctly. In both the real estate and the property insurance fields a distinction is necessary between replacement and reconstruction costs. Replacement is held to mean: To provide another functionally equivalent building, though it need not necessarily be an identical building. Reconstruction means: To restore a building to exactly the same design, size and dimensions as it was originally using materials identical as to kind and quality.

Reconstruction Cost Less Depreciation

Whenever reconstruction cost less depreciation meets and satisfies a given set of circumstances, one need go no further in arriving at the actual cash value. As stated earlier, this approach works satisfactorily for the majority of buildings throughout the country. It deals solely with the building as a unit without concern for the value of the land to which it is attached. The actual cash value arrived at will, in most cases, provide indemnity to the insured should the building be damaged or destroyed, if the original estimate was reliable and kept current.

Replacement Cost Less Depreciation

In many rural areas it is very common to find large, older, private dwellings that have become architecturally, sometimes structurally, obsolete. The framing is usually the full "nominal" sizes, i.e. 2"x4" instead of the present-day 1.5"x3.5" and 2"x10" instead of 1.5"x9.25"; many have parquet flooring; non-stock size and type windows and doors; fancy molded casings, baseboards and other trim of oak and chestnut - no longer available; ornamental plaster on wood lath, and ceilings that are nine and ten feet high. The roofing is often heavy slate shingles; there is a box gutter and wide overhanging, ornamental (gingerbread) cornice, and sometimes wood columns in front. It is not unusual to see three or four brick chimneys, with fireplaces in several rooms, most or all closed up after some form of central heat was installed.

When a building like the one described is functioning satisfactorily as a private, single family residence, a practical approach to the actual cash value, and one consistent with the Broad Evidence Rule, is to estimate the replacement cost as defined herein, that is, the cost of a building functionally equivalent though not identical. In most situations this approach will indemnify the insured in the event the building is damaged or destroyed. Any attempt to measure the actual cash value of buildings of this kind on the basis of the reconstruction cost would result in an amount many times the market value and far in excess of the true value to the insured.

There are many occasions when it is practicable to apply a similar approach to the actual cash value of older buildings that are occupied for commercial, manufacturing and residential (multiple family dwellings) purposes but which have been subject to major architectural, structural and plan obsolescence. Replacement with a building that is functionally equivalent and has the same capacity and utility for the occupants or tenants, usually will indemnify the insured physically and economically. Reconstruction cost less physical depreciation would produce excessive insurance requirements — something neither the insured nor insurer desire.

To use market value as the sole and exclusive measure of actual cash value of the buildings that fall into this classification would, in all probability, result in an insufficient amount of insurance to enable the insureds to repair a substantial partial loss and preclude replacing the building in event of a total loss. It would not indemnify the insureds. This is not to deny that, in these cases, there can be and often is a fine line between the application of replacement cost and market value for measuring actual cash value.

Fair Market/Economic Value

Replacement cost and reconstruction cost approaches to actual cash value, as outlined above, are understood easier than the fair market/economic approach. They are also easier to apply because the process closely follows standard and traditional methods for estimating building construction costs. Builders and appraisers, accustomed to the cost per square foot and cubic foot, and the detailed stick-by-stick and brick-by-brick methods of estimating, are very much at home with these two approaches.

Guidelines For Identifying Buildings in this Classification

While the term market value in itself is readily understood by definition, there is a divergence of opinion as to when and how it is to be used, on what kind of property it is to be used, and to what extent it affects the actual cash value of the property. This raises serious problems for both insured and insurer when trying to establish a proper amount of insurance to be carried. Looking to the Broad Evidence Rule for answers, as it was first enunciated and the numerous elements that have since appeared in court decisions where the Rule has been used, it is quite clear, that buildings that have come within the range of the Rule are those whose actual cash values are closer to fair market value than to replacement/reconstruction cost less depreciation. When the insurance is not adequate to comply with the provisions of a coinsurance clause, and a partial loss occurs, the insured would prefer that the fair market value of the building be the sole measure of its actual cash value, and thus avoid a penalty. When the

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"Actual Cash Value", 1978, by E. L. Lecomte, President, National Committee on Property Insurance. A talk before the Independent Insurance Agents of Rhode Island.

"Appraisal of Substandard Risks in the Adjustment of Fire Insurance Losses", 1967, by John C. Hagensick, C.P.C.U., Fire Loss Manager, Reserve Insurance Co., Chicago. A paper delivered before the American Society of Appraisers at the International Conference in Detroit, Mich.

"Relating Loss to Value When Dealing With Building Losses Under the Coinsurance
Clause — An Attorney's Point of View", 1958, by Herbert W. Hirsh, Attorney, Clausen, Hirsh, Miller & Gorman. A talk before the Western Loss Association, Delevan, Wisc.

"Actual Cash Value — The Broad Evidence Rule", 1968, by Norman A. Miller and
Stephen D. Marcus, Attorneys, Clausen, Hirsh, Miller & Gorman. A talk before the Property Loss Research Bureau, Chicago.

"Actual Cash Value", 1971 through 1978, F.C.& S. Bulletins, Fire and Marine Section, Misc. Fire. Ac-1 to Ac-8; also "Valued Policy Laws", Csfg-1 to Csfg-6.

"Actual Cash Value: The Magic Words — What Do They Mean?" by Osborne J. Dykes, Attorney, Fulbright & Jaworski, Houston, Tex.

"Actual Cash Value" Phillip G. Simkins, Firemans Fund Insurance Co., 1979.

"Some Thoughts on Actual Cash Value — Buildings", 1962, by George D. Vail, Jr., Vice President, Corroon & Reynolds Group, New York City. An article appearing in the Independent Adjuster Magazine.

"What Is Value?", 1974, published in "The Valuation Consultant", Marshall & Swift publication.

"Adjustment of Property Losses", 4th edition, 1978, by Paul I. Thomas & Prentiss B. Reed, published by McGraw-Hill Book Company, New York, N.Y.

"Depreciation as Factor In Determining Actual Cash Value For Partial Loss Under Insurance Policy", 8 A.L.R. 4th 533 1981, by Wendy Evans Lehmann, J.D.

OHIO DEPARTMENT OF INSURANCE

MARKET CONDUCT EXAMINATION OF

SANDY & BEAVER VALLEY FARMERS MUTUAL INSURANCE COMPANY

NAIC #10270

As Of

June 30, 2011

ODI
Ohio Department of Insurance
John R. Kasich, Governor
Mary Taylor, Lt. Governor/Director

50 West Town Street
Third Floor – Suite 300
Columbus, OH 43215-4186
(614) 644-2658
www.insurance.ohio.gov

Honorable Mary Taylor
Lt. Governor/Director
Ohio Department of Insurance
50 W. Town St. Ste. 300
Columbus, OH 43215

Lt. Governor/Director:

Pursuant to your instructions and in accordance with the powers vested under Title 39 of the Ohio Revised and Administrative Codes, a target market conduct examination was conducted on the Ohio business of:

Sandy and Beaver Valley Farmers Mutual Insurance Company
NAIC Company Code 10270

The examination was conducted at the Company's home office located at:
108 North Market Street Lisbon, OH 44432

and at the offices of the Ohio Department of Insurance located at:
50 W. Town St. Ste. 300
Columbus, OH 43215

Respectively submitted,

Lynette A. Baker

Lynette A. Baker, CFE, MCM
Chief, Market Conduct Division

May 21, 2012
Date

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COMPANY OPERATIONS

Sandy and Beaver Valley Farmers Mutual Insurance Company is a mutual protective organization organized under Ohio Revised Code ("ORC") section 3939.01. The Company writes commercial lines farmowners property damage coverage, and personal lines homeowners, church, rental, mobile home, and low value dwelling property damage coverage policies in Ohio. Liability coverage is offered by Grinnell Mutual Reinsurance Company.

The Company markets its business through approximately 200 independent agencies. As of December 31, 2011 the Company has over 14,000 policyholders and reported direct written Ohio premiums of $6,574,530. It has been in business since 1879.

As of 2011 the Company officers were:

James Sanor	President
Ned Ellis	Vice President
Leroy Sanor	Treasurer

SCOPE OF EXAMINATION

The examination of Sandy and Beaver Valley Farmers Mutual Insurance Company ("Company") covered the period from July 1, 2010 through June 30, 2011. The examiners conducted file reviews and interviews of company management.

The examination was conducted in accordance with the standards and procedures established by the National Association of Insurance Commissioners ("NAIC") and Ohio's applicable statutes and regulations. The examination included the following areas of the Company's operations:

- Paid Claims
- Denied Claims
- Consumer Complaints
- New Business Underwriting
- Endorsements

This report is a report by tests.

METHODOLOGY

The examination was conducted through reviews of the claims and underwriting files for the Company's property insurance products. The examiners also interviewed Company officers, and made requests for additional information.

Tests designed to measure the Company's level of compliance with Ohio's statutes and regulations, were applied to the files. All tests are described and the results displayed in this report.

All tests are expressed as a "yes/no" question. A "yes" response indicates compliance and a "no" response indicates a failure to comply. The results of each test applied to a sample are reported separately.

The examiners used the NAIC standards of:

7% error ratio on claim tests (93% compliance rate) and

10% error ratio on all other tests (90% compliance rate)

to determine whether or not an apparent pattern or practice of non-compliance existed for any given test. Except as otherwise noted, all tests were conducted on a random sample, taken from a given population of new business or claims records.

In an instance where errors were noted, the examiners described the apparent error and asked the Company for a written response. The Company responded that it concurred with all of the examiner's findings.

The Company's response and the examiner's recommendations, as applicable, are included in this report.

PERSONAL LINES PAID CLAIMS

Timely Initial Contact

Standard: The initial contact by the Company with the claimant is within the required time frame.

Test: Did the Company make timely contact (within 15 days of receipt of loss notice) with claimants following the report of a claim per Ohio Administrative Code ("OAC") 3901-1-54(F)(2)?

Test Methodology:

- The definition of "initial contact" included telephone notice of the claim to the Company or its agent, from the insured, third party claimant, and/or legal representative.
- The examiners considered any initial contact to a first notice of loss where more than fifteen (15) days elapsed to be an exception.

- The examiners considered any instance where initial contact to a first notice of loss was not documented to be an exception.
- The sample consisted of personal lines paid homeowners and fire and extended coverage claims.

Findings:

Population	Sample	Yes	No	Standard	Compliance
1031	50	47	3	93%	94%

The standard of compliance is 93%. The Company's handling practices were above this standard.

Examiner Comments:
Two of the exceptions resulted from missing file documentation. The examiners were unable to determine when the Company first contacted the respective claimants. The third exception resulted from the Company taking more than fifteen days (15) to contact the claimant.

Timely Settlement

Standard: Claims are resolved in a timely manner.

> **Test:** Did the Company make timely payments (10 days after acceptance) to first party claimants per OAC 3901-1-54(G)(6)?

Test Methodology:

- The examiners considered claim payments made more than ten (10) calendar days after the amount was known and agreed to be exceptions.
- The sample consisted of personal lines paid homeowners and fire and extended coverage claims.

Findings:

Population	Sample	Yes	No	Standard	Compliance
1031	50	49	1	93%	98%

The standard of compliance is 93%. The Company's handling practices were above this standard.

Fair Settlement

Standard: Claims are properly handled in accordance with policy provisions and applicable statutes and rules.

> **Test:** Did the Company calculate the settlement amount in a manner that conforms to OAC 3901-1-54(I)?

Test Methodology:

- The examiners considered claim files not containing the actual estimate used to pay the loss to be exceptions.

- In order to be consistent with the industry practice of not depreciating labor, the examiners considered the depreciation of labor to be an exception.
- The sample consisted of personal lines paid homeowners and fire and extended coverage claims.

Findings:

Population	Sample	Yes	No	Standard	Compliance
1031	50	50	0	93%	100%

The standard of compliance is 93%. The Company's handling practices were above this standard.

Treasurer Certificate and Demolition Fund

Standard: Claims are properly handled in accordance with policy provisions and applicable statutes and rules.

Test 1: If the loss exceeds $5000, did the company claim settlement practices conform to ORC 3929.86?

Test 2: If the loss exceeds 60% of the aggregate limits, did the Company make an escrow payment as required by ORC 3929.86?

Test Methodology:

- The examiners considered applicable claim files without documentation of Company research into the need for, or evidence of, a county treasurer certificate or payment to a demolition fund to be exceptions.
- The sample consisted of personal lines paid homeowners and fire and extended coverage claims.

Findings:

Population	Sample	Yes	No	Standard	Compliance
1031	50	50	0	93%	100%

The standard of compliance is 93%. The Company's handling practices were above this standard.

FARMOWNERS PAID CLAIMS

Timely Initial Contact

Standard: The initial contact by the Company with the claimant is within the required time frame.

> **Test:** Did the Company make timely contact (within 15 days of receipt of loss notice) with claimants following the report of a claim per OAC 3901-1-54(F)(2)?

Test Methodology:

- The definition of "initial contact" included telephone notice of the claim to the Company or its agent, from the insured, third party claimant, and/or legal representative.
- The examiners considered any initial contact to a first notice of loss where more than fifteen (15) days elapsed to be an exception.
- The examiners considered any instance where initial contact to a first notice of loss was not documented to be an exception.
- The sample consisted of commercial lines paid farmowners claims.

Findings:

Population	Sample	Yes	No	Standard	Compliance
351	25	21	4	93%	84%

The standard of compliance is 93%. The Company's handling practices were below this standard.

Examiner Comments:
The four exceptions resulted from missing file documentation. The examiners were unable to determine when the Company first contacted the respective claimants.

Timely Settlement

Standard: Claims are resolved in a timely manner.

> **Test:** Did the Company make timely payments (10 days after acceptance) to first party claimants per OAC 3901-1-54(G)(6)?

Test Methodology:

- The examiners considered claim payments made more than ten (10) calendar days after the amount was known and agreed to be exceptions.
- The sample consisted of commercial lines paid farmowners claims.

Findings:

Population	Sample	Yes	No	Standard	Compliance
351	25	22	3	93%	88%

The standard of compliance is 93%. The Company's handling practices were below this standard.

Examiner Comments:
Two of the exceptions resulted from the Company not issuing payment to the claimants within ten days (10) of the amount being known and agreed to by the claimant. The third exception resulted from missing file documentation. The examiners were unable to determine when the Company first contacted the claimant.

Fair Settlement

Standard: Claims are properly handled in accordance with policy provisions and applicable statutes and rules.

Test: Did the Company calculate the settlement amount in a manner that conforms to OAC 3901-1-54(I)?

Test Methodology:

- The examiners considered claim files not containing the actual estimate used to pay the loss to be exceptions.
- In order to be consistent with the industry practice of not depreciating labor, the examiners considered the depreciation of labor to be an exception.
- The sample consisted of commercial lines paid farmowners claims.

Findings:

Population	Sample	Yes	No	Standard	Compliance
351	25	23	2	93%	92%

The standard of compliance is 93%. The Company's handling practices were below this standard.

Examiner Comments:
One exception resulted from the depreciation of painting labor. The other exception resulted from the estimate, used to pay the claim, not being in the file.

Treasurer Certificate and Demolition Fund

Standard: Claims are properly handled in accordance with policy provisions and applicable statutes and rules.

Test 1: If the loss exceeds $5000, did the company claim settlement practices conform to ORC 3929.86?

Test 2: If the loss exceeds 60% of the aggregate limits, did the Company make an escrow payment as required by ORC 3929.86?

Test Methodology:

- The examiners considered applicable claim files without documentation of Company research into the need for, or evidence of, a county treasurer certificate or payment to a demolition fund to be exceptions.
- The sample consisted of commercial lines paid farmowners claims.

Findings:

Population	Sample	Yes	No	Standard	Compliance
351	25	24	1	93%	96%

The standard of compliance is 93%. The Company's handling practices were above this standard.

DENIED CLAIMS

Sampling Methodology:

- The sample included personal and commercial lines denied claims. These claims were not separated by coverage type due to the population size.
- The examiners removed and replaced sample claims that were closed without payment, and not formally denied, until a sample of fifty (50) was identified and reviewed. Forty-four (44) records were removed and replaced for this reason.

Timely Initial Contact

Standard: The initial contact by the Company with the claimant is within the required time frame.

Test: Did the Company make timely contact (within 15 days of receipt of loss notice) with claimants following the report of a claim per OAC 3901-1-54(F)(2)?

Test Methodology:

- "Initial contact" included telephone notice to the Company of a loss from the insured, third party claimant, and/or legal representative.
- The examiners considered failure to contact a claimant within fifteen (15) days from the date of notice of the claim, when the Company had sufficient information to contact that claimant, to be an exception.

Findings:

Population	Sample	Yes	No	Standard	Compliance
587	50	47	3	93%	94%

The standard of compliance is 93%. The Company's handling practices were above this standard.

Examiner Comments:
Two of the exceptions resulted from the Company not making contact with the claimant within fifteen (15) days. The other exception resulted from missing file documentation. The examiners were unable to determine when the Company first contacted the claimant.

Provisions, Conditions, Exclusions, and Disclosures

Standard: Claims are properly handled in accordance with policy provisions and applicable statutes and rules.

> **Test:** If the claim was denied on the grounds of a specific policy provision, condition, or exclusion, did the claim file include documentation that the denial notice contained reference to such provision, condition, or exclusion as required by OAC 3901-1-54(G)(2)?

Test Methodology:

- The examiners considered Company failure to include in its denial a specific reference to the provision, condition, or exclusion that was the basis for the claim denial, to be exceptions.

Findings:

Population	Sample	Yes	No	Standard	Compliance
587	50	36	14	93%	72%

The standard of compliance is 93%. The Company's handling practices were below this standard.

Examiner Comments:
Thirteen (13) of the exceptions resulted from the Company denial letters not specifying the policy provisions wherein the respective losses were excluded. The other exception resulted from the denial letter not being found in the file.

Continuing Investigation Notification

Standard: Claims are properly handled in accordance with policy provisions and applicable statutes and rules.

> **Test:** Was the denial determined within twenty-one (21) days of receipt of properly executed proof of loss, and if not, was notice sent to the insured within the 21 day period and was claimant notified of status of investigation and the estimated time required for continuing the investigation at least every forty-five (45) days thereafter as required by OAC 3901-1-54(G)(1)?

Test Methodology:

- The examiners considered claim files without documentation of written or verbal communication of the need for additional time to investigate, from the Company to the claimant, dated or logged within twenty-one (21) days of receipt of the proof of loss, to be exceptions.
- The examiners considered claim files without notice of continuing investigation letters from the Company to the claimant, stating the need for further time to investigate the claim, every forty-five (45) days, to be exceptions.

Findings:

Population	Sample	Yes	No	Standard	Compliance
587	50	44	6	93%	88%

The standard of compliance is 93%. The Company's handling practices were below this standard.

Examiner Comments:
Four of the exceptions resulted from the Company's continuing investigation letters to the respective claimants not being found in the files. Two of the exceptions resulted from there being no indication of an inspection of investigation found in the files.

MULTI-LINE NEW BUSINESS UNDERWRITING

Underwriting Practices

Standard: The Company's underwriting practices are not unfairly discriminatory.

Test: Are all applicants underwritten by the same underwriting standards and rules as required by ORC 3901.21(M)?

Test Methodology:

- The examiners considered instances of incorrect building locations, construction years, construction types, public protection classes, product offerings, premium credits, and deductibles to be exceptions.
- The sample consisted of personal lines homeowners and fire and extended coverage policies and commercial lines farmowners applications submitted during the examination period.

Findings:

Population	Sample	Yes	No	Standard	Compliance
8061	100	100	0	90%	100%

The standard of compliance is 90%. The Company's handling practices were above this standard.

MULTI-LINE ENDORSEMENTS

Endorsements

Standard: All endorsements are filed with the Department.

Test: Did the Company file with the Department any endorsements added to the policy subsequent to a claim being filed as required by ORC 3939.01(A)?

Test Methodology:

- The examiners considered exclusionary endorsements added to policies, mid-term and after a loss to be exceptions.
- The sample consisted of personal lines homeowners and fire and extended coverage policies and commercial lines farmowners claims caused by wind and/or hail submitted during the examination period.

Findings:

Population	Sample	Yes	No	Standard	Compliance
747	50	50	0	90%	100%

The standard of compliance is 93%. The Company's handling practices were above this standard.

CONSUMER COMPLAINTS

Complaints

Standard: The Company shall adopt and implement reasonable standards for the proper handling of written communications, primarily expressing grievances, received by the Company from insureds and claimants.

Test: Has the Company adopted and implemented reasonable standards for handling written communications, primarily expressing grievances, including procedures to make a complete investigation of a complaint and respond as required by OAC 3901-1-07(C)(15)?

Test Methodology:
Prior to the on-site portion of the examination, the examiners reviewed Company complaints for the period 1/1/09-6/30/11.

Findings:
The Company does not have formal written procedures for the handling of consumer complaints. The examiners interviewed Company President, Jim Sanor. Mr. Sanor advised that he reviews and responds to complaints personally, either via phone or written correspondence. He indicated that he does not differentiate in his treatment of complaints directly from the consumer versus from the Department of Insurance. These procedures appear sufficient to deal with the volume of complaints a Company of this size might conceivably receive.

EXAMINER RECOMMENDATIONS

- The Company should work to improve the quality, quantity, and consistency of its claim adjuster notes and other documentation so claim processing activity can be reconstructed.

- Dated logs of all adjuster work activities and copies of all documents should be included in every claim file. In some files the examiners were unable to determine when, or if, contact with the claimant had occurred and/or when the claim adjuster began an investigation.

- The Company should ensure that all claim payments are issued/mailed to the claimant within ten (10) calendar days of the settlement amount being known and agreed to by parties.

- The Company should ensure that all files contain the claim acknowledgement, continuing investigation, and closing investigation letters to the insured, when applicable,

- During interviews with the examiners, the Company indicated that its procedure was not to depreciate labor. The Company should ensure that independent adjuster estimates do not include labor depreciation, in order to maintain consistency between claimant settlements and adherance to Company policies and procedures.

- The Company should ensure that denial letters reference the specific, applicable, exclusionary policy lanauage that led to the denial.

EXECUTIVE SUMMARY

PERSONAL LINES PAID CLAIMS		
Areas of Review	**Compliance Standard**	**Compliance Rate**
Timely initial contact	93%	94%
Timely settlement	93%	98%
Fair settlement	93%	100%
Treasurer certificate and demolition fund	93%	100%

FARMOWNERS PAID CLAIMS		
Areas of Review	**Compliance Standard**	**Compliance Rate**
Timely initial contact	93%	84%
Timely settlement	93%	88%
Fair settlement	93%	92%
Treasurer certificate and demolition fund	93%	96%

DENIED CLAIMS		
Areas of Review	**Compliance Standard**	**Compliance Rate**
Timely initial contact	93%	94%
Provisions, conditions, exclusions, and disclosures	93%	72%
Proper denial and continuing investigation notification	93%	88%

NEW BUSINESS UNDERWRITING		
Areas of Review	**Compliance Standard**	**Compliance Rate**
Underwriting practices	90%	100%

ENDORSEMENTS		
Areas of Review	**Compliance Standard**	**Compliance Rate**
Endorsements	90%	100%

This concludes the report of the Market Conduct Examination of Sandy & Beaver Valley Farmers Mutual Insurance Company. The examiners, Ben Hauck, Rodney Beetch, John Pollock, and Molly Porto would like to acknowledge the assistance and cooperation provided by the management and the employees of the Company.

Ben Hauck

May 21, 2012

Date

Ben Hauck, AINS, MCM
Examiner-in-Charge

INTRODUCTION TO CLAIMS

Robert J. Prahl, CPCU
Assistant Vice President—Claims
State Auto Insurance

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Insurance Institute of America
720 Providence Road, Malvern, Pennsylvania 19355-0770

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War Loss caused by war, insurrection, or revolution, because of its catastrophic nature, traditionally is excluded from insurance policy coverage.

Nuclear Hazard This means any nuclear reaction, radiation, or radioactive contamination. Nuclear hazard exclusions, in one form or another, were added to insurance policies when the nuclear exposure was first recognized because of its catastrophic consequences. Note the exception to the exclusion for direct loss by fire resulting from the nuclear hazard. Insurance pools or associations are available to cover, in part, the nuclear hazard.

As an aside, after the 1979 nuclear accident at Three Mile Island near Harrisburg, PA, there was considerable controversy among insurers over whether theft or vandalism at some of the insured homes was covered. These acts of vandalism or theft were committed after insureds had evacuated their homes due to the danger of nuclear contamination. Some insurers took the position that this was a loss caused *indirectly* by nuclear hazard, and since policy language excluded both loss caused directly and indirectly, technically there was no coverage. Many insurers, apparently for practical and public relations considerations, elected to pay for such losses despite the seemingly clear exclusion. It must be emphasized, however, that the second sentence of the lead-in language to Section I—Exclusions, concerning the applicability of the exclusions regardless of any other cause or event contributing concurrently or in any sequence to the loss, was not included in the policy in 1979. Had that language been present in 1979, it may have given insurers added support for invoking the nuclear hazard exclusion to deny such theft losses.

The remaining exclusions for intentional loss, weather conditions, acts or decisions, and faulty planning, design, construction, and so on are recent additions to the homeowners policy. The purpose of the intentional loss exclusion is to eliminate coverage for damage caused deliberately by *an* insured. If one spouse burns the house down to collect the insurance proceeds, for example, and the insurer develops evidence to substantiate this, it may, in some jurisdictions, deny the entire claim. The strength of this exclusion will be tempered somewhat by the manner in which local courts interpret it.

The last three exclusions (weather conditions, acts or decisions, faulty construction, and so on) were considered necessary to counter the doctrine of concurrent causation. Although it appears that these exclusions will help insurers to resist providing coverage for losses that were never intended to be covered, as of this writing the exclusions have not undergone the ultimate test of their meaning—that of court interpretation.

Details of Property Loss Adjusting

Scoping the Loss

When a dwelling or building is damaged by an insured peril, the objective of the claim person assigned to handle the loss is to determine the *scope* or extent of the damage. In most moderate to substantial losses and in some smaller losses as well, the appropriate first step is to *scope the loss*. As explained earlier, to scope a loss means simply to determine the extent of the damage by using a sketch or diagram

to identify the area involved and the personal property contained therein which has been damaged. Frequently, photos of the damage will accompany the scope sheet. Exhibits 3-6 and 3-7 illustrate scope sheets concerning a fire loss to a two-story dwelling. The fire originated in the lower level when Christmas packages stored near the furnace ignited. The extent of the fire damage on the lower level is noted in the sketch. Loss on the second or main level was confined almost totally to smoke damage except for minor fire damage in the floor and wall off the kitchen. The fire in the lower level found its way through a lower level duct space and extended into the main level floor. Exhibit 3-8 shows a Scope of Loss Worksheet developed by the Property Loss Research Bureau for its member companies.

Basic Estimating

Ideally, the claim person responsible for handling structural property damage should be capable of estimating routine or moderate building losses. If not sufficiently knowledgeable or skilled to actually prepare an estimate of the damages, the claim person should be able to check or scrutinize an estimate submitted by a building contractor for accuracy. This may entail obtaining local labor rates and material prices. It also may include calling in an independent appraiser or adjuster to verify the cost of repairs.

To estimate means to approximate the loss. Although there are various methods used to estimate losses, all estimating includes five major elements.

1. *Specifications.* These describe the work to be done and the amount and quality of material to be used. The appropriate time and place to take the specifications is immediately after the loss at the scene of the damage. The adjuster scopes the loss as he or she walks through the area, taking measurements of rooms and, if possible, noting the type and quality of material used. It is obviously important that measurements be taken carefully because incorrect measurements can seriously distort the final figures. Depending upon the severity of the loss, the adjuster should take specific notes as to what is observed regarding the extent of damages, room dimensions, personal property damaged, and so on. If a disagreement over the extent of loss arises, the notes will be helpful in locating the sources of disagreement.
2. *Materials.* This refers specifically to the quantity and price of building materials identified in the specifications. It is important that materials be described in detail because there are many different types, grades, and qualities, and the price can be substantial.
3. *Labor.* There is much room for variation in estimating or approximating the length of time needed to complete repairs. This is because the circumstances and effects of each loss may vary considerably. For example, the time involved in cleaning up and removing debris before new materials can be installed will vary from loss to loss. Other factors which affect labor times and rates include weather conditions, quality of workers, building laws or ordinances, union regulations, and physical conditions associated with the job such as access, interference of tenants or pedestrians, and so on. Local wage scales should be used in preparing the estimate.

4. *Overhead.* This refers to general expenses that cannot be charged to any particular job or operation. While contractors conduct their businesses in different ways, the following expense items are ordinarily included in overhead charges:
   - rent, heat, light and power expense for offices and shops
   - general insurance premiums
   - workers compensation insurance
   - social security and unemployment taxes
   - general telephone expense
   - travel expense
   - plans and building permits
   - supervision
   - office and shop payroll

   Overhead does not include the labor or material for a particular job. It is estimated as a percentage of the cost of material and labor and is usually about 10 percent.
5. *Profit.* Profit is usually estimated as a percentage of the overall job cost. Adjusters need to scrutinize contractors' estimates to make sure overhead and profit are not already included or hidden in the estimate and then added again at the end of the estimate as a separate item. Overhead and profit are figured as a percentage of the cost of material and labor—usually 20 or 21 percent if combined.

Occasionally, most often in cases of minor damage but in some moderate size losses as well, an insured will make his own repairs. In such cases, the question arises whether the insured is entitled to overhead and profit. Although insurers will make an allowance for what they consider a reasonable labor rate when the insured performs his own repair work, generally speaking, they are reluctant to consider overhead and profit. The major reason for the reluctance is the view held by most insurers that the insured ordinarily does not incur overhead expenses. To permit recovery of such charges would violate the *principle of indemnity* which declares that the insured should recover the actual loss sustained, but no more. For the same reason, insurers believe that an insured should not be entitled to a percentage of the overall cost of the job in the form of profit.

Despite this general view, some insurers believe that recovery of overhead expenses should be allowed when the insured can prove such expenses have been or will be incurred. The time involved in getting advice and discussing the repair job with lumber yard or home improvement personnel, and the money spent on gasoline in driving to and from the home improvement center and in picking up supplies, could reasonably be considered overhead expenses.

There also may be instances where an insured may have every intention of making his own repairs only to find that the job is bigger than anticipated. In such cases, the insured is forced to call in a contractor to complete the job. Most insurers would agree that overhead and profit then become allowable charges since the contractor is entitled to recover these charges as a percentage of the overall job cost.

Some state insurance departments may prohibit insurers from taking deductions for overhead and profit when repairs are made by the insured. Adjusters need to be aware of such rulings as well as their company position regarding acceptance

of overhead and profit when an insured makes the repairs.

Another consideration, especially in cases of substantial loss to commercial buildings, is *architects' fees*. Whether such fees will be allowed in residential property losses in the absence of a law or policy provision that addresses this issue depends on what is reasonable under the circumstances. If, in the adjuster's opinion, circumstances warrant the use of an architect, the expense will most likely be covered.

Pricing Methods After the damaged property has been inspected and all measurements and specifications have been calculated, the final step to complete the estimate is known as *pricing*. *Pricing* refers to figuring the cost of materials required to complete the job and estimating the number of hours and cost of labor necessary to install the material. Costs of material delivered to the job are based on local prices. Labor costs are based on current local wage scales for the building trades involved. Three common methods of pricing estimates are: (1) *unit cost*, (2) *material and labor*, and (3) *lump sum*.

The *unit cost* is the combined cost of the material and labor needed to install a unit of material. If, for example, a roofer can lay 235 lb. of asphalt shingles on a roof at the average rate of one square (100 square feet or 10' x 10') every two hours, he would estimate the cost of doing the roof as follows:

One square shingles @ $40.00	=	$40.00 (approx.)
Two hours labor @ $15.00/hour	=	$30.00
Cost per square	=	$70.00

If the roof requires 20 squares, the cost of material and labor is $1,400 (20 squares multiplied by $70).

Under the *material and labor* method, the material cost is calculated for each item and shown in a separate column on the estimate under the heading "material cost." Labor for each item is determined and the cost is indicated in a column entitled "labor cost." A third column shows the total cost of both material and labor.

Material Cost		
20 squares at $40 per square	=	$800
Labor Cost		
2 hours per square x 20 squares = 40 man-hours x $15 per hour	=	$600
Cost of Material and Labor	=	$1,400

This is, of course, a simple example which is designed merely to introduce readers to the general concept of pricing estimates. The examples do not include the cost of nails or consideration of whether tear out of previous layers of roofing is necessary or if felt is to be laid underneath the roof shingles. It is also important to mention that the cost of a roofing job will vary according to the type of structure involved. A very steep roof with a number of valleys usually produces higher costs than a roof that is of a normal pitch. Understandably, extra labor time is necessary because of the many valleys and corners of the roof, and extra expenses will also be incurred if scaffolding is necessary. (Exhibit 3-9 shows a repair estimate form which

may be used in developing a building damage estimate.)

The *lump sum* estimate may show a total figure for the entire repair work or be subdivided with a series of figures being shown for several operations. Experienced adjusters usually do not accept lump sum estimates except on small losses involving minor repairs. Insurers are entitled to know precisely what they are paying for and lump sum estimates are generally difficult, if not impossible, to analyze.

As an aid to adjusters in estimating property losses, there are various construction estimating guides available. Some use the unit cost method, others use the material and labor method, while still others apply a combination of these methods. The guides can assist adjusters in determining prices and in checking estimates submitted by contractors.

A typical repair/replacement guide might show the following for repair or replacement of vinyl siding:

	Material Cost (per square)	Repair/ Replacement Time (per square)	Removal Time (per square)
Vinyl Siding	$90	3 hours	1.25 hours

An adjuster using this guide has most of the necessary information to determine the repair cost of a square (100 square feet) of vinyl siding. The adjuster still needs to determine the local hourly labor rate. Assuming that the hourly labor rate is $20, the approximate cost of removing a square of damaged siding and replacing it with new vinyl siding is $175:

$90	Material
85	Labor (4.25 hours at $20 per hour)
$175	Material and Labor Cost (this does not include the cost of incidentals such as nails, corners, and trim pieces)

Keep in mind also that the cost of material may vary from locality to locality and that repair guides are just that. If you can get a better price than that shown in the guide, you should use that price.

Computer Estimating

Estimating by computer has become fairly popular in recent years, primarily because it allows for an increase in productivity. Typically, an adjuster with access to a computer estimating system appraises the damage or conducts the inspection in the conventional manner. During the inspection, the adjuster makes appropriate entries on the scope sheet. When the inspection is complete, the adjuster, or claim clerical assistant, enters the information (specifications) into the computer. The computer performs the detail work of researching and checking prices and making calculations, and prints out a neat and mathematically correct estimate. The computer contains its own data base with rates and prices for labor and materials. Since the detail work of actually preparing the estimate is accomplished by computer, the adjuster has more time to devote to the more productive tasks of estimating and adjusting losses.

It must be emphasized that the computer is *not* a substitute for a knowledge-

Exhibit 3-9
Building Repair Estimate

BUILDING REPAIR ESTIMATE

Claim Number

Insured

Location of Property

Type of Loss	Loss Date	Type of Buildings

Replacement Value	Actual Cash Value	Estimator	Date of Estimate

When completing the data below, try to develop and use "Unit Prices" - Otherwise, estimate "Material Cost" and "Labor Cost" separately.

DESCRIPTION OF WORK REQUIRED (Identify Materials - Show Room or Area Measurement)	Quantity	Unit Price (When used)	Material Cost	Labor Cost	Total Cost

able adjuster with estimating skills. In other words, a person lacking knowledge and experience in estimating cannot prepare a valid estimate simply by using the computer. Estimating requires judgment, and computers lack this important attribute. The computer serves as a valuable aid to the estimating process, but it is virtually useless without an adjuster who possesses estimating skills.

Measure of Damages in Structural Property Losses

When we speak of the *measure of damages*, we mean the basis upon which the loss, or the extent of loss, is evaluated. Dwelling and building losses are evaluated on an *actual cash value* or *replacement cost* basis. Specifically, whichever method is used to adjust a loss depends upon the particular insurance policy in effect. Some policies refer to "actual cash value" as the measure of damages while others provide the greater protection of "replacement cost" coverage. The standard homeowners policy, for example, is written on a replacement cost basis with regard to *dwelling* losses. (Personal property losses are adjusted on an actual cash value basis.) The meaning of these terms obviously is important to claim people because they determine the amount that will be paid on a loss.

Determining actual cash value is not necessarily a simple task. Although the phrase is found in many property insurance policies, it is not defined in those policies. In fact, the origin of the phrase "actual cash value" is probably a mystery to most, if not all, modern day insurance practitioners. As is the case with the word "fire," we must look to the various state courts for interpretation of the words "actual cash value."

It can be said with a moderate degree of assurance that the generally accepted meaning of actual cash value is "replacement cost new less depreciation." *Depreciation* is the reduction in value of tangible property. There are two kinds of depreciation: *physical* depreciation and *economic* depreciation. Physical depreciation refers to wear and tear, deterioration, decay, and so on, which occur with use and are inevitable over time. Economic depreciation, or *obsolescence*, means a reduction in value due to changes in technology, style, or perhaps composition of the neighborhood of a "rust belt" city whose principal industry has gone bankrupt. Widespread unemployment may have resulted in a change in the composition of the neighborhood to the point where there are no longer any incentives or funds available to maintain the building properly. It needs to be emphasized that the courts are not uniform in holding that obsolescence can be considered as a depreciable item. Be sure that you understand the situation in your state.

Since most property depreciates with age and use, this formula of "replacement cost new less depreciation" ordinarily meets with general acceptance, although alternative approaches to determining actual value are being used with increasing frequency. The concept of "replacement cost new less depreciation," however, is quite compatible with the *principle of indemnity* which holds that ideologically insurance should reimburse the insured for the actual loss sustained, *but no more*. Expressed simply, to indemnify means to put the insured back in the situation he or she enjoyed prior to the loss.

If, for example, the insured's twenty-five-year-old building burns down and the insurance proceeds make it possible to construct a new building with the same

kind and quality of materials, the insured clearly enjoys a better position after loss than before. Quite frankly, the insured has profited from the loss. However, if the policy is written on an actual cash value basis, appropriate depreciation would be deducted from the cost of the new building so as to avoid the situation where the insured receives a profit or "betterment."

Perhaps an example will help to clarify the meaning of actual cash value. Assume a building has a life expectancy of 100 years and is 25 years old when it is destroyed by a tornado. Since it has already realized one fourth of its life expectancy, the depreciation would amount to 25 percent.

Taking this a step further, let's say that 25 years ago this building was purchased for $50,000, but would cost $400,000 to replace today. What is the actual cash value of the building?

Applying the formula replacement cost new less depreciation equals actual cash value gives:

$400,000	Replacement cost new
-100,000	Depreciation (25% x $400,000)
$300,000	Actual cash value

Depreciation has been deducted from the cost of constructing a new building since the insured did not own a new building immediately prior to the loss; he owned a 25-year-old building.

On a partial loss to a structure, depreciation is based on the life span of each item in the building that is damaged. A four-year-old hail-damaged roof with a life expectancy of 20 years, for example, which costs $5,000 to replace, would be depreciated 20 percent (1/5 of $5,000 or $1,000) even though the dwelling may be 65 years old.

In discussing losses with insureds, many adjusters find it preferable to speak in terms of "betterment" rather than "depreciation." By focusing on "betterment," the claim person simply takes a positive approach to explaining the concept of depreciation, and it usually is more acceptable to the insured. "Betterment" results when the insured is better off financially after a loss because *new* has replaced the *old*. The difference in value provides the insured with a betterment or profit which represents the amount of depreciation that must be deducted from the cost of the new building or item. By applying the principle of indemnity where applicable, adjusters may avoid paying for "betterment."

Traditionally, actual cash value has been determined by three methods or approaches. They are: (1) *replacement cost new less depreciation*, (2) *market value*, and (3) *the broad evidence rule*.

The *replacement cost less depreciation* method has already been explained. In essence, it takes the cost of a new building of the same size and material as the one destroyed and subtracts from this the amount the destroyed building has deteriorated by use. While this approach results in fairly accurate evaluations when relatively new structures are involved, focusing on replacement cost has shortcomings with respect to older buildings or those that may be subject to obsolescence. An older building in a deteriorating neighborhood, for example, may be worth little on the real estate market but may cost hundreds of thousands of dollars to replace with

similar material. When the replacement cost of a building as well as the amount of insurance exceed the building's market value, moral hazard is created in that the insured stands to gain financially in the event of a loss. Insurers, of course, try to avoid this situation through selective underwriting.

As a result of these shortcomings, *market value* occasionally has been substituted for replacement cost less depreciation as a means of determining actual cash value. *Market value* generally means the price fairly agreed upon by an owner willing to sell and a purchaser desiring to buy, neither of whom is under any pressure to act. In a minority of states, actual cash value is synonymous with market value.

The *broad evidence rule* simply requires that all evidence available regarding the value of property, particularly fair market value and replacement cost less depreciation, be considered in establishing actual cash value. In short, many factors may be considered as guides in arriving at actual cash value. In recent years, there has been a trend among the courts in various states toward adoption of the broad evidence rule.

Adjusters use one of these methods, depending upon the state in which they handle claims, to determine actual cash value. As indicated earlier, determining actual cash value is sometimes a difficult task, and disagreements between adjusters and insureds over the amount of the loss occasionally occur. In the majority of cases, these disputes are negotiated and adjusted accordingly, perhaps with assistance from independent experts or appraisers. Where negotiations fail, the *Appraisal* procedures outlined in the policy may be utilized to effect adjustment.

Either party may demand an appraisal. Each party chooses a competent appraiser. Each appraiser then separately estimates the damage and if they agree on the amount, the loss is adjusted on that basis. If the appraisers do not agree, their differences are submitted to an umpire who establishes the amount of the loss by agreeing with either appraiser.

Coinsurance

It is well established that most losses are partial in that they do not result in the total destruction of the structures involved. For the insureds who recognize this, there may be a tendency to play the odds and limit the amount of insurance purchased. Why pay the premium for full coverage when chances are you may never need the full amount? Of course, when the property is pledged for security for a mortgage loan, a higher amount of insurance is usually required, but even then there is some latitude in estimating the value of the property in question. Since most losses are partial, individuals who purchase full coverage ordinarily would pay an inordinately higher rate than those playing the odds and limiting the amount of their insurance. Therefore, insureds with full coverage would pay an inequitable premium. In addition, a policy that does not include a coinsurance clause may, in a case of substantial underinsurance, end up paying its full limit when only a small part of the building is destroyed.

In an effort to avoid this inequity and to encourage insureds to carry a reasonable amount of insurance in relation to the actual cash value of their property, a *coinsurance* requirement is incorporated in many property insurance policies. The