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IN THE SUPREME COURT OF PENNSYLVANIA
EASTERN DISTRICT

NO. 12 EAP 2019
NO. 13 EAP 2019

KONRAD KURACH, APPELLANT
v.
TRUCK INSURANCE EXCHANGE, APPELLEE
and
MARK WINTERSTEIN, et al, APPELLANT
v.
TRUCK INSURANCE EXCHANGE, APPELLEE

BRIEF OF *AMICUS CURIAE* UNITED POLICYHOLDERS IN SUPPORT OF PETITIONERS-APPELLANTS

On Appeal from the Judgment of the Superior Court Filed August 24, 2018, at Nos. 1726 EDA 2017 and 1730 EDA 2017 (reargument denied October 10, 2018) reversing the Order entered on April 21, 2017 and remanding to the Court of Common Pleas, Philadelphia County, Civil Division at Nos. 00339 and 03543 July Term, 2015.

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I. STATEMENT OF INTEREST OF AMICUS CURIAE

Amicus curiae United Policyholders ("UP") submits this brief to support the position of Petitioners-Appellants, Konrad Kurach and Mark Wintersteen ("Petitioners" or "Appellants"), who are insured under property insurance policies issued by Truck Insurance Exchange ("Truck"). UP's efforts can assist both the attorneys and this Court by focusing on public policy considerations surrounding the analysis of whether general contractor overhead and profit ("GCOP") should be excluded in the context of reaching an actual cash value adjustment of a property insurance claim.

UP is a non-profit public interest consumer advocacy organization dedicated to helping preserve the integrity of the insurance system. Since 1991, UP has provided insurance guidance to disaster victims, individuals and businesses and been an advocate for insurance consumers throughout the United States. UP's work is supported by donations, grants, and volunteer labor. UP does not sell insurance or accept funding from insurance companies.

Through its *Advocacy and Action Program*, UP regularly engages with regulators, legislators, academics, journalists and stakeholders on legal and marketplace developments relevant to all policyholders and all lines of insurance. UP's Executive Director is an official consumer representative to the National

Association of Insurance Commissioners. The organization coordinates with and assists insurance regulators in Pennsylvania in solving consumer problems.

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*. During its work in disaster areas, UP has developed extensive knowledge of actual cash value coverage in first-party property insurance policies. UP has a vital interest in seeing that first-party property insurance policies sold to countless policyholders, in Pennsylvania and elsewhere, are interpreted properly and consistently by insurance companies and the courts.

When insurance companies reduce claim payouts by failing to include GCOP, they are failing to meet their duty to indemnify insureds for a necessary cost of restoring insured assets to pre-loss condition. Improper exclusion of GCOP by insurance companies creates shortfalls in repair and rebuilding financing for property owners *and* negatively impacts the local, state and federal government entities that have an interest in communities' successful economic recovery and the restoration of property tax bases. UP's library of publications, tools and guidance includes many publications addressing GCOP. *See, e.g.* "Full and fair insurance payouts foster safe and sound construction" at https://www.uphelp.org/blog/full-

and-fair-insurance-payouts-foster-safe-and-sound-construction; and "What's UP with Overhead and Profit?" at https://www.uphelp.org/pubs/what%E2%80%99s-overhead-and-profit#_ftnref2.

A diverse range of policyholders throughout the U.S. regularly communicate their insurance concerns to UP, which allows UP to submit informed *amicus curiae* briefs to assist state and federal courts in cases involving important insurance principles. UP has filed *amicus curiae* briefs in approximately 450 cases throughout the United States. 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 have been cited with approval by numerous state and federal appellate courts. See: https://www.uphelp.org/resources/amicus-briefs.

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).

II. SUMMARY OF ARGUMENT

Property insurance provides financial security for homeowners and businesses. The question at issue may seem esoteric: whether general contractor overhead and profit ("GCOP") can be excluded when an insurance company pays actual cash value ("ACV") benefits under property insurance policies affording replacement cost coverage. But in practice, ensuring that GCOP is paid with an ACV settlement is critical for ensuring that policyholders receive the full benefit of their coverage. The Superior Court erred in reversing the trial court's ruling that Pennsylvania law requires GCOP to be included in ACV settlements.

Here, Truck Insurance Exchange ("Truck") "determined that the services of a general contractor would likely be necessary to repair the value of the property." (Superior Court Mem. Op. at 5). Nevertheless, Truck excluded GCOP in its calculation of the ACV settlement. (*Id.*) Truck cited language its policies authorizing it to withhold GCOP from ACV payments "unless and until you actually incur and pay such fees and charges, **unless the law of your state requires that such fees and charges be paid with the actual cash value settlement**." (emphasis added). The Superior Court below acknowledged that existing Superior Court precedent, *Gilderman v. State Farm Insurance Company*, 649 A.2d 941 (Pa. Super. 1994), held that GCOP must be included within "actual

cash value," as actual cash value means the actual cost of repair or replacement less depreciation. GCOP is part of replacement cost and does not depreciate, so it is within ACV and is required to be paid as part of the ACV settlement under Pennsylvania law.

The Truck policy explicitly defines "actual cash value" in exactly the way the Superior Court defined the term "actual cash value" in *Gilderman* where State Farm had left the term undefined. From an interpretive perspective, the initial question becomes simple: Does *Gilderman* state "the law of" Pennsylvania that requires GCOP to be paid with the ACV settlement; or would it be so only if, as the Superior Court assumed, the court in *Gilderman* had ruled that "public policy" required that ACV include GCOP? In our view, the answer is simple. Pennsylvania law requires GCOP to be paid with an ACV settlement because, under Pennsylvania law, GCOP is part of ACV, which includes any cost that an insured is reasonably likely to incur in repairing or replacing a covered loss, minus depreciation, and GCOP does not depreciate.

For good reason, courts interpret ambiguities in insurance policies in favor of finding coverage for the policyholder. Insurance policies are often contracts of adhesion, drafted not jointly, but by one party with vastly more economic power. In addition, insurance contracts are aleatory contracts; the policyholder pays

premium up front and the insurance company performs later only if an uncertain event occurs. Because the insurance company has already received performance from the policyholder (payment of premium), there can be an incentive to breach when the insurance company is later called upon to perform. Moreover, the fundamental purpose of insurance is to insure, so doubts in language should be resolved to fulfill the essential contractual purpose of the insurance transaction and the reasonable expectations of the insurance consumer.

In addition to the interpretative question, there is the public policy question raised but not decided by the Superior Court: Does Pennsylvania public policy require that ACV settlements include GCOP? The Superior Court noted only that the plaintiffs had "not identified any case that sets forth a public policy that actual cash settlement value must include GCOP." (Superior Court Mem. Op. at 9). If this court decides that the interpretive question does not resolve the matter in favor of coverage, this Court can and should recognize such a public policy, as it is in accord with existing Pennsylvania precedent (*Gilderman*) and the established customs and practices of the insurance industry. The holdback of GCOP results in policyholders not receiving the full ACV and, due to a lack of resources, it can result in policyholders never being able to access the replacement cost benefits for which they have paid an additional premium.

III. STATEMENT OF FACTS

The parties are addressing the particular facts of this case, so UP will not repeat them here. Determining whether GCOP should be included in the ACV adjustment of a property insurance claim depends on the understanding of unique property insurance concepts and coverages, such as those contained in the Appellants' policies. Therefore, to assist the court, we provide a brief tutorial on some of the key insurance terms.

Actual cash value

Generally, 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). ACV 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. The corollary to this principle is that the ACV approach should

never be employed to underpay a claim by providing less than indemnity. ACV is "replacement cost minus any depreciation (i.e. wear and tear)."[1]

For example, if a policyholder owned a house with a ten-year old roof destroyed by hail, ACV would be the price of providing the policyholder a ten-year old roof 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 before the loss. Historically, insurance companies did not define ACV, but here the policy defines ACV as replacement cost less depreciation. As such, an understanding of what constitutes "replacement cost" is significant.

Replacement Cost

Replacement cost or replacement value is the cost to replace lost or damaged property with new property of comparable quality, at current market value, up to the policy limits. "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

[1] *See* "Homeowners Insurance Guide," Pennsylvania Insurance Department at https://www.insurance.pa.gov/Coverage/Documents/Homeowners/Homeowners%20Insurance%20Guide.pdf.

Appleman on Ins. Law Library Ed. §47.04[2][b] (2016). "Replacement cost coverage, therefore, in contravention of the general rule that an insured cannot profit through insurance, *results in the insured being better off than he or she was prior to the loss, since the insured ends up with a more valuable property*." Allan D. Windt, Insurance Claims and Disputes § 11:35 (6th ed., March 2018 Update) (emphasis added).

Replacement cost coverage is a relatively modern concept in insurance because it exceeds the traditional concept of indemnity, which is to return the insured to the financial position occupied immediately before the loss occurred. The insured will arguably be in a better place financially when older property is replaced with new, but policyholders pay a higher premium for this coverage. 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.

The timing of ACV and replacement cost payments can differ. An insurance company may elect to pay ACV as soon as it determines the replacement cost and depreciation, holding back the depreciation until the policyholder actually repairs or replaces the property. The policy may even put a time limit, sometimes as short as 180 days after payment of the ACV, on when the policyholder must repair or

replace the property in order to receive the full replacement costs. *See Sher v. Allstate Ins. Co.,* 947 F.Supp.2d 370 (S.D.N.Y. 2013). When an insurance company retains amounts for GCOP and pays less in ACV coverage, the policyholder may not have enough funds to rebuild the damaged property within the required time period. In that instance, the coverage could be forfeited and the insurance company *never pays* the replacement cost coverage for which the policyholders contracted and paid.

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; it has depreciated in value.

Overhead and profit

Overhead and profit are costs included in repair estimates. Specifically, overhead includes "fixed costs to run the contractor's business, such as salaries, rent, utilities, and licenses," and profit "is the amount the contractor expects to earn for his services." *Trinidad v. Fla. Peninsula Ins. Co.,* 99 So. 3d 502, 502-03 (Fla. 3d DCA 2011).

IV. ARGUMENT

A. The Law of Pennsylvania Requires That GCOP Be Paid With the Actual Cash Value Settlement.

The policy issued by Truck to Appellants is a replacement cost policy for which Appellants paid an additional premium. The Truck policy has a two-step payment process. Truck is required to pay the ACV necessary to repair the damaged property, withholding a deduction for depreciation until the repairs have been completed. The policy defines "Actual Cash Value" as "the reasonable replacement costs at the time of loss less depreciation for both economic and functional obsolescence." The term "replacement costs" is not defined in the Truck policy, but that is of no moment because it is undisputed that GCOP is properly part of the reasonable replacement costs at the time of loss. Obviously, GCOP is not subject to depreciation for either economic or functional

obsolescence. Therefore, GCOP is within the plain meaning of ACV under the Truck policy.

The policy also includes a "How We Settle Covered Loss" in part:

> (3) . . . However, **actual cash value** settlements will not include estimated general contractor fees or charges for general contractor's services unless and until you actual incur and pay such fees and charges, **unless the law of your State requires that such fees and charges be paid with the actual cash value settlement.**

(Emphasis added). Accordingly, under the policy language, while GCOP is part of the definition of "actual cash value" in the Truck policy, it need not be paid as part of an ACV settlement unless and until GCOP is paid **unless** the law of Pennsylvania requires that GCOP be paid with the ACV settlement.

Pennsylvania law has long required insurance companies to pay GCOP as part of an ACV settlement. In the 1994 case of *Gilderman v. State Farm Insurance Company,* 659 A.2d 941 (Pa. Super. 1994), the insured had a replacement cost policy, but was to receive ACV before any repairs or replacement. The policy limited recovery to the amount actually incurred in repairing or replacing the damaged property. *Id.* at 942–43. The appellate court considered whether State Farm could deduct GCOP from its repair or replacement estimate and offer the insureds an advance check for this lower amount as a payment of ACV. *Id.* at 944. In rejecting State Farm's position, the court noted "there are types of property

damage where a homeowner would use the services of a general contractor[,] ... especially where there is extensive damage to a home requiring the use of more than one trade specialist." *Id.* The court found that, in these instances, an insurance company may not deduct contractor fees from the ACV when such fees are reasonably expected to occur. *Id.* The court extended this rationale to instances when the insured might not actually incur labor costs, i.e., when the insured makes his or her own repairs to a covered loss. *See id.* Thus, the court found State Farm's automatic deduction of contractor fees improper, holding that "repair or replacement costs include any cost that an insured is reasonably likely to incur in repairing or replacing a covered loss," even if the insured may never make the repairs. *Id.*

As further explained in *Mee v. Safeco Insurance Company of America,* 908 A.2d 344 (Pa. Super. 2006), the law of Pennsylvania provides that the actual cash value to be paid by a property insurance company includes all repair and replacement costs (including GCOP), minus depreciation:

> From *Gilderman,* we take the following legal principles: (1) actual cash value includes repair and replacement costs; (2) repair and replacement costs include O & P where use of a general contractor would be reasonably likely; (3) because a homeowner pays higher premiums for repair and replacement coverage, he is entitled to O & P where use of a general contractor would be reasonably likely, even if no contractor is used or no repairs are made.

Mee, 908 A.2d at 350 (footnote omitted). The quoted discussion of *Gilderman* in *Mee* is a succinct summary of Pennsylvania law on the issue.

Here, Judge Djerassi in the Court of Common Pleas applied Pennsylvania law and properly found:

> The approach taken in *Gilderman* and *Mee* is the law today. Insurance companies are required in Pennsylvania to include general contractor overhead and profit in Actual Cash Value payments for losses where repairs would be reasonably likely to require a general contractor. *Gilderman* and *Mee* would reflect the majority of approach across jurisdictions.

(Superior Court Mem. Op. at 11). Accordingly, Judge Djerassi recognized that Pennsylvania law requires that GCOP be paid with an ACV settlement.

Other jurisdictions have adopted the reasoning in *Gilderman* and have ruled that an insurance company may not deduct a contractor's overhead and profit from an ACV payment. *See Mills v. Foremost Ins. Co.,* 511 F.3d 1300, 1305 (11th Cir. 2008) ("[The insureds] contracted for the [ACV] of their loss and their recovery is not tied to actually making the repair or replacement."); *Parkway Assocs., LLC v. Harleysville Mut. Ins. Co.,* 129 F.App'x 955, 962-63 (6th Cir. 2005) ("[ACV] is not calculated based upon what the insured ultimately pays to repair her property"); *Mazzocki v. State Farm Fire & Casualty Corp.,* 1 A.D.3d 9, 766 N.Y.S.2d 719, 722 (2003) (an insurer was "obligated to include profit and overhead in ... [ACV], whenever a general contractor would likely be needed.");

Ghoman v. New Hampshire Insurance Co., 159 F.Supp.2d 928, 934 (N.D. Tex. 2001) (a contractor's overhead and profit fees constituted "'any cost that an insured is reasonably likely to incur in repairing or replacing a covered loss'" and, thus, should be included in the ACV payment.); *Bankers Sec. Ins. Co. v. Brady,* 765 So.2d 870, 872 (Fla. 5th DCA 2000) (stating in dictum that, because insurer paid insured before repair or replacement, insurer could not withhold overhead and profit); *Weidman v. Erie Ins. Group,* 745 N.E.2d 292, 298 (Ind. Ct. App. 2001) (where ACV of loss was set by appraisal, and insurance policy had no provision authorizing insurer to later withhold contractor fees when insured completed own repairs).

Thus, the plain meaning of the policy supports the Court of Common Pleas' ruling that Truck may not withhold GCOP from an ACV settlement because Pennsylvania law requires it to be included. A simple example shows that not including GCOP in an ACV settlement is fundamentally unfair and unreasonable under the policy language at issue. Imagine a situation where there has been no depreciation; for example, when a brand new home is destroyed by fire the day after a homeowner moves in. The replacement cost indisputably includes GCOP. The ACV should equal the replacement cost in this scenario because, as the example assumes, there has been no depreciation and the policy defines ACV as

"the reasonable replacement costs at the time of loss less depreciation for both economic and functional obsolescence." Under Truck's interpretation, however, Truck could pay less for an ACV settlement than for a replacement cost settlement because it could withhold GCOP. That is not a reasonable interpretation of the policy language.

B. Public Policy Requires That GCOP Be Paid With the Actual Cash Value Settlement.

Several state departments of insurance across the country have condemned insurance company efforts to deduct GCOP from replacement cost when calculating ACV. They are important indicia of the standards and practices of the insurance industry. They show that industry usage of the term ACV includes GCOP and that it is improper for an insurance company to withhold GCOP from an ACV settlement. This is in accord with the law and public policy of Pennsylvania.

The Colorado Division of Insurance recently confirmed it would not be repealing a longstanding insurance bulletin requiring that GCOP be part of a calculation to determine ACV in residential insurance policies.[2]

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[2] *See* "Notice of Stakeholder Meeting on Bulletin 5.1" at https://content.govdelivery.com/accounts/CODORA/bulletins/24532eb.

The Colorado bulletin provides, in part:

> **Insurers shall be prohibited from deducting contractors' overhead and profit** in addition to depreciation when policyholders do not repair or replace the structure.
>
> . . .
>
> The position of the Division of Insurance is that the actual cash value of a structure under a replacement cost policy, when the policyholder does not repair or replace the structure, is the full replacement cost with proper deduction for depreciation. **Deduction of contractors' overhead and profit, in addition to depreciation, is not consistent with the definition of actual cash value.** The Division of Insurance will interpret policy provisions containing the foregoing or similar language to prohibit deduction of contractors' overhead and profit, in the calculation of actual cash value, where the dwelling is not repaired or replaced by the policyholder.

See Bulletin B-5.1, *Calculation of actual cash value: Prohibition against deducting contractors' overhead and profit from replacement cost where repairs are not made.* (emphasis added).

Other state insurance departments have issued similar bulletins. In 1992, Florida published an insurance bulletin prohibiting the withholding of overhead and profit, stating in part:

> This authority is specifically applicable to the practice by insurers of imposing a "holdback" of insurance proceeds greater than actual cash value until replacement has taken place. While this practice is appropriate for personal property, this bulletin serves to place insurers on notice that for partial losses on real property, the "holdback" is inconsistent with established precedent.

> The application of a "holdback" to repair of real property can particularly cause hardship to the insured when the actual cash value payment is insufficient to enter into a contract to make repairs. In such an instance, the insured may be forced to seek other funding sources, at his expense, in order to contract for repairs.
>
> Insurers who have been applying "holdbacks" in claims for partial loss on real property should pay the actual amount of the loss. The best indicator of actual loss is the contract for repair entered into by the insured. Once an actual amount of loss is determined by contract, the full loss payment should be made with no hold back applied. This arrangement satisfies the public policy interests both in timely and sufficient claim payments, and in encouraging rebuilding. In instances where a holdback is currently being applied and a repair contract has been executed, the holdback should be released.

Florida Department of Insurance Informational Bulletin No. 92-036, (December 8, 1992). On June 12, 1998, the Texas Insurance Commissioner issued a bulletin, very similar to the one in effect in Colorado, which provides in part:

> Indemnity is the basis and foundation of insurance coverage. The objective is that the insured should neither reap economic gain nor incur a loss if adequately insured. This objective requires that the insured receive a payment equal to that of the covered loss so that the insured will be restored to the same position after the loss as before the loss. The calculation of this payment results in under-compensation if an insurer deducts prospective contractors' overhead and profit and sales tax in determining the actual cash value under a replacement cost policy. Conversely, the inclusion of contractor's overhead and profit and sales tax on building materials does not over-compensate an insured for the amount of the loss because these items represent part of the insured's loss. Generally, the objectives of indemnity will be met if actual cash value is calculated as replacement cost with proper deduction for depreciation. In the rare situation that defies calculation of actual cash value on this basis, such as cases in which the structure has historical significance or the materials cannot

> reasonably be replaced, other factors may be considered. However, there is no situation in which the deduction from replacement cost of depreciation and contractor's overhead and profit and/or sales tax on materials will be the correct measure of the insured's loss.
>
> . . .
>
> ***To deduct costs other than depreciation from the estimated replacement cost of the damaged structure is contrary to historical industry norms and practices***. Historically, insurers have determined actual cash value on the basis of repair or replacement cost less depreciation. Only recently have some insurers deducted contractor's overhead and profit and sales taxes on building materials. There has been no recent change in the language in the promulgated residential property policies to support such a change in determining actual cash value.
>
> The insurers' argument that the cost of contractor's overhead and profit and sales tax on building materials should be excluded from an actual cash value loss settlement because the insured has not incurred these expenses is not persuasive. Using this logic, an insured who opts not to repair or replace damaged property would not incur any of the expenses necessary to repair or replace the damaged property, including the costs of building materials, and would collect nothing under an actual cash value loss settlement. This result would be contrary to the purposes of the subject insurance policy.

Texas Department of Insurance, Commissioner's Bulletin No. B-0045-98, http://www.tdi.texas.gov/bulletins/1998/b-0045-8.html. (emphasis added.) This 1998 Bulletin was reaffirmed as the proper method of property insurance again in 2008. Texas Department of Insurance, Commissioner's Bulletin No. B-0068-08, https://tdi.texas.gov/bulletins/2008/cc70.html.

C. Industry Custom and Practice Has Consistently Included GCOP in ACV Settlements.

This Court has instructed that "[w]herever reasonable, the manifestations of intention of the parties to a promise or agreement are interpreted as consistent with each other and with any relevant course of performance, course of dealing, or usage of trade." *Sunbeam Corp. v. Liberty Mut. Ins. Co.*, 566 Pa. 494, 501, 781 A.2d 1189, 1193 (2001) (quoting Restatement (Second) of Contracts § 202(5)).

The interaction of GCOP with ACV and replacement cost calculations is well established in the insurance industry, and the usage of those terms in the insurance trade confirms that GCOP is included in ACV. In addition to the insurance department bulletins previously referenced, commonly used insurance industry textbooks include GCOP as a component of repair or replacement cost that is not held back or subject to depreciation when making an ACV settlement.

Recovery of GCOP as part of an ACV settlement is an accepted standard and practice in the industry. This was discussed in an *Adjusting Today* article titled "Overhead and Profit: Its Place in a Property Insurance Claim":

> The Property Law Research Bureau ("PLRB"), a recognized resource used by insurers in the interpretation of property insurance policy provisions has taken the position "contractor's overhead and profit are included in ACV, because they are part of replacement costs."

Edward Eshoo, Jr., *Adjusting Today:* "Overhead and Profit: Its Place in a Property Insurance Claim," 5 (October 11, 2007). PLRB concludes that "any estimate of actual cash value should include overhead and profit." *See, id.*, at 6.[3]

The National Underwriter Company publishes under the name Insurance Coverage Law Center ("ICLC"), formerly FC&S, or Fire, Casualty & Surety, a comprehensive library of reference books for insurance professionals. The ICLC also provides online bulletins in which its experts respond to questions from insurance professionals. These bulletins are used by insurance agents and brokers to interpret standard insurance policy provisions. The ICLC addressed its position that contractor's overhead and profit, in addition to depreciation, should not be deducted from an ACV settlement:

> . . Contractors' overhead and profit is included in arriving at a replacement cost figure. Actual cash value is determined by deducting depreciation from the replacement cost figure. The insurer in [Gilderman et al. v. State Farm Ins. Co., 649 A.2d 941 (Pennsylvania 1994)] attempted to deduct depreciation and an additional amount representing contractors' overhead and profit. The court, quite rightly, disagreed with this procedure.

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[3] *Property Loss Adjusting* is a textbook for property claims adjusters published by the Insurance Institute of America for its industry-wide insurance designation and certification programs. It lists several elements as comprising repair or replacement cost: materials, labor and employers' burden, tools and equipment, overhead and profit and miscellaneous direct costs such as permits and taxes. Markham, James. J., *Property Loss Adjusting*, Vol. II, at pp. 5-9.

ICLC Bulletin, *Actual Cash Value and Total Fire Loss* (Nat'l Underwriter Co. November 4, 2009). Likewise, former insurance company attorney and frequent expert witness for insurance companies Barry Zalma explains that "[t]here is no basis for simply withholding profit and overhead as a means of calculating actual cash value." Barry Zalma, *Representing Insureds in a Catastrophe*, 41 Tort Trial & Ins. Prac. L.J. 817, 840 (2006) (emphasis added).

As these authorities recognize, excluding the payment of GCOP would not effectuate the purpose of ACV coverage, which is indemnity, *i.e.*, placing policyholders back in the position they enjoyed before the loss.[4] Of course, ACV coverage can never put the policyholders back in the *precise* position they were in before the loss because if a ten-year old roof is destroyed the only way to return the policyholders back to the exact position they were in before the loss would be to

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[4] Here, Truck's interpretation of the policy under Pennsylvania law provides less coverage than what is contained in the 1943 New York Standard Fire Insurance Policy ("Standard Fire Insurance Policy"), a 165-line form providing coverage for direct loss by fire and lightning, which is used in many states. In Pennsylvania, the statutorily mandated language that must be included in every Standard Fire Insurance Policy is contained in 40 Pa. C.S.A. section 636. That language requires that the measure of an insured's loss be "actual cash value." The rule in Pennsylvania regarding actual cash value coverage "seeks a result which will enable the parties to restore the property to as near the same condition as it was at the time of the fire, or pay for it in cash." *Fedas v. Insurance Co. of Pennsylvania*, 300 Pa. 555, 563-64, 151 A. 285, 288 (Pa. 1930). Thus, Truck's withholding GCOP from Appellants' ACV payment frustrates the purpose of indemnity.

install a ten-year old roof. That is not feasible as you cannot buy and install a used roof, or used roofing material. Therefore, ACV provides a policyholder the cost of a new roof, minus the amount that the roof has deteriorated. Before the loss, the insureds had a ten-year old roof installed on the house. To be made whole, the insurance company must pay enough money to install a ten-year old roof on the insured's house. Whether installing a new roof or a ten-year old roof, the price of GCOP is the same. Another simple example shows how unfair it would be to allow insurance companies, such as Truck, to withhold GCOP from an ACV settlement:

> A retired pilot saves his money for a retirement home and builds it on land he has long owned in Lancaster. The home is built for the cost of $1,000,000. He buys replacement cost insurance for $1,000,000. Two days after the construction is complete, a jet which ran out of fuel crashes into the home, destroys it and a guest of his in the house died. The retired pilot makes a claim for $1,000,000 — the cost to rebuild the structure. The insurance company says it does not have to pay the general contractor overhead and profit until he rebuilds the house. So, they deduct the approximate 20% amount per the estimate and pay him $800,000 as the replacement cost less the contractor's overhead and profit. To add insult to injury, the retired pilot decides he never wants to rebuild at the site because of the emotional incident. In summary, he just paid $1,000,000 for the house, bought insurance for $1,000,000 and the insurance company will only pay an amount less than the agreed replacement cost.

Withholding GCOP prevents making the policyholder whole and frustrates the indemnity purpose of ACV coverage[5].

D. The Law of Pennsylvania Requiring Insurance Policies To Be Interpreted In Favor of Coverage Is Well Supported By Public Policy and Precedent.

If there is any ambiguity in the policy language, that ambiguity must be resolved in favor of the policyholder Appellants. This Court has long held that when multiple reasonable interpretations of an insurance policy are possible, the language must be read in favor of coverage. *See*, *e.g.*, *Prudential Prop. & Cas. Ins. Co. v. Sartno*, 903 A.2d 1170, 1177 (Pa. 2006). This Court's precedent is

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[5] Truck's position of withholding GCOP as part of an ACV settlement may also render coverage potentially illusory, as explained in the example supra, at 23. *See also Jostens, Inc. v. Northfield Ins. Co.*, 527 N.W.2d 116, 118 (Minn. Ct. App. 1995) (the doctrine of illusory coverage is "an independent means to avoid an unreasonable result when a literal reading of a policy unfairly denies coverage."). Further, a policy that requires an insured to pay an extra sum for replacement cost coverage and, in return for the extra sum, fails to provide the insured with the benefits the insured would expect from an ACV policy unreasonably favors the insurance carrier and is therefore unconscionable. *See Standard Venetian Blind Co. v. American Empire Ins. Co.*, 503 Pa. 307, 469 A.2d 566 (1983) ("A court may refuse to enforce a contract or any clause of contract if [the] court as a matter of law deems the contract or any clause of the contract to be unconscionable at the time it was made."). *See Koval v. Liberty Mutual Insurance Company*, 366 Pa.Super. 423-24, 531 A.2d 491 (1987) (explaining Pennsylvania's two-prong test in determining unconscionability: first, one of the parties must have lacked a meaningful choice whether to accept the provision and, second, the provision must unreasonably favor the other party to the contract.)

uniformly adopted across the country. It is critical to the enforcement of insurance policies, which are imbued with the public interest.

As explained in an article written by Professor Henderson of the University of Arizona College of Law:

> [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 differs 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).

Insurance is far from the market ideals of complete information and no transaction costs. Opportunistic breaches are especially likely because of the aleatory nature of those contracts, with the insurance company's performance coming long after the policyholder has performed. *See* Mark Pennington, *Punitive Damages for Breach of Contract: A Core Sample from the Decisions of the Last Ten Years*, 42 ARK. L. REV. 31, 54 (1989); *see also Communale v. Traders & Gen. Ins. Co.*, 328 P.2d 198, 200-02 (Cal. 1958). Thus, insurance is special:

> 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. . .
>
> . . . 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, *supra* at 13-14.

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").

The ambiguity doctrine has deep roots. In *American Surety Co. of N.Y. v. Pauly*, 170 U.S. 133, 144 (1898), the United States Supreme Court held that ambiguities in insurance policy language must be construed against the insurance company, because (even then) the ambiguity doctrine was "a well established rule

in the law of insurance." As explained and applied by this Court, any reasonable interpretation of insurance policy language favoring the policyholder should be adopted, even if there are other reasonable interpretations. *Prudential Prop. & Cas. Ins. Co. v. Sartno*, 903 A.2d 1170, 1177 (Pa. 2006). As the party who selects the language used in the insurance policy, the insurance company must be clear and specific in its use. *Sartno*, 903 A.2d at 1178. *See also Safran v. Mut. Life Ins. Co. of New York,* 210 Pa. Super. 408, 413, 234 A.2d 1, 4 (1967) (Pennsylvania courts adhere to the rule of liberal construction in construing insurance contracts); *Limandri v. Allstate Ins. Co.,* No. CV 16-2960, 2019 WL 1429666 (E.D. Pa. Mar. 29, 2019) (when a provision in an insurance policy is ambiguous under Pennsylvania law, the policy should be construed in favor of the insured to further the contract's prime purpose of indemnification, as the insurer drafts the policy, and controls coverage); *Toffler Assocs., Inc. v. Hartford Fire Ins. Co.,* 651 F. Supp. 2d 332, 343 (E.D. Pa. 2009) (the test to be applied in determining whether there is an ambiguity in a policy is not what the insurer intended it to mean, but what a reasonable person in the position of an insured would understand the words to mean).

V. CONCLUSION

UP recognizes and appreciates the extremely important role insurance plays in modern society. Profitable and financially stable insurance companies promote a healthy society, allowing risks 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. The inclusion of GCOP in ACV payments is a well-established and important standard and practice in the insurance industry. Pennsylvania courts and various insurance commissioners have all acknowledged that GCOP is properly a part of an ACV settlement. UP respectfully requests that the Court reverse the decision of the panel of the Superior Court and find that GCOP is owed under the Truck policy as part of an ACV settlement in Pennsylvania.

Dated: July 29, 2019

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

Pursuant to Pennsylvania Rules of Appellate Procedure 531 and 2135, the length of this amicus curiae brief is 6,736 words, in compliance with the word count limit of 7,000 words.

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I hereby certify that I am this day serving the foregoing document upon the persons listed below via the PACFile system, which service satisfies the requirements of Pa.R.A.P. 121. To the extent the PACFile system is unable to serve any of the persons listed below, such persons will be served via first class U.S. Mail.

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ADDENDUM

1. Edward Eshoo, Jr., *Adjusting Today*: "Overhead and Profit: Its Place in a Property Insurance Claim" (October 11, 2007)

2. Florida Department of Insurance Informational Bulletin No. 92-036, (December 8, 1992)

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

ADJUSTING TODAY

Adjusters International Disaster Recovery Consulting

EDITOR'S NOTE

In the property insurance claim, there is occasional room for debate between policyholders and their insurers. Questions may arise about what to repair or replace, or there can be uncertainty over the fairest and most reasonable methodology used to calculate actual cash value (ACV).

There might also be discussions over which expenses contribute to an ACV estimate — labor, materials and one that readers of our feature article might find particularly interesting and useful — general contractor overhead and profit (GCO&P).

In this issue of Adjusting Today, *attorney and first-party property insurance expert Edward Eshoo Jr. takes on those insurers that "... withhold, exclude, deduct or fail to include the costs of general contractor overhead and profit, GCO&P, in their calculation of the repair or replacement cost ..."*

Citing compelling case law, state insurance commissioner bulletins, and accepted insurance industry practices, Eshoo brings us an insightful discussion of the various conditions and circumstances that support the inclusion of GCO&P in the cost to repair or replace.

We hope you find this information helpful.

Sheila E. Salvatore
Editor

Overhead & Profit:
Its Place in a Property Insurance Claim

By Edward Eshoo Jr.

An interesting discussion is now taking place in the insurance industry over general contractor overhead and profit and its rightful place in the property insurance claim.

The terms "repair cost" or "replacement cost" are not clearly defined in the typical property insurance policy. Nevertheless, no reasonable property insurer would dispute that labor and materials are elements comprising repair or replacement cost. But what about general contractor overhead and profit? Before answering this question, it helps to have a clearer understanding of the role of the general contractor and exactly what falls into the category of general contractor overhead and profit.

A general contractor oversees the entire construction project, a role that includes, among other responsibilities, hiring the required trades (carpentry, masonry, plumbing, electrical, etc.); sequencing, coordinating and supervising their work; researching zoning requirements; and obtaining necessary permits. Overhead expenses represent those costs incurred by a general contractor to operate its business, but are not attributable to any one specific job.

Some examples of overhead expenses are:

- general and administrative expenses
- office rent and utilities
- office supplies
- salaries and benefits for office personnel
- depreciation on office equipment
- licenses
- advertising

Every general contractor is entitled to a profit, which is defined as the difference between the cost of goods and the price for which they are sold. Overhead and profit, which vary significantly in the construction industry from general contractor to general contractor, is expressed as a percentage of the total construction cost. The overhead and profit percentage commonly utilized in the insurance industry is 20 percent of the estimated repair or replacement cost.

While most property insurers provide replacement cost coverage, rarely are they contractually obligated to pay more than actual cash value ("ACV") as of the time of the loss unless and until the damaged or destroyed structure is actually repaired or replaced. Since the term is usually undefined in the typical property insurance policy, courts have developed three primary rules to measure ACV.

Some courts apply a "market value" rule: the difference between the market value of the property before and after a loss. This rule applies the criterion of what a willing buyer would pay and what a willing seller would accept for the property on a cash sale in a free and open market.

Other courts apply a "broad evidence" rule, in which consideration is given to every fact and circumstance that logically tends to establish a correct estimate of the value of the property, such as: its original cost; its replacement or reproduction cost; its market value; income derived from its use; its age and condition; its obsolescence, both structural and functional; depreciation and deterioration to which it has been subjected; and the opinion of value given by qualified expert valuation witnesses.

A number of courts have rejected both the "market value" and the "broad evidence" rules, instead applying a "replacement cost less depreciation" rule. Under this rule, depreciation is deducted from the estimated cost to repair or to replace damaged or destroyed property to determine its ACV.

Depreciation in an insurance context, which is different than depreciation in an accounting context, is considered the decrease in the actual value of property based on its physical condition, age, use, and other factors that affect the remaining usefulness of the property.

Although there is no express provision in the typical property

Determining ACV

Some courts apply a **"market value"** rule, which is the difference in a free and open market between the market value of the property before and after a loss.

Other courts apply a **"broad evidence"** rule, which considers every logical fact and circumstance in establishing a correct estimate of the property's value. These could include original cost, replacement cost, market value, age and condition.

A number of courts have rejected both of these rules and instead are applying a **"replacement cost less depreciation"** rule. Under this rule, depreciation is deducted from the estimated cost to repair or to replace damaged or destroyed property in order to determine its ACV.

insurance policy authorizing them to do so, some insurers withhold, exclude, deduct or fail to include the costs of GCO&P in their calculation of the repair or replacement cost used to arrive at an ACV estimate and settlement of a claim based on the replacement cost less depreciation rule.

These insurers take the position that the overhead and profit costs of a general contractor are not components of repair or replacement cost unless and until they are actually incurred. They maintain that an insured could receive what amounts to a windfall if permitted to recover a repair or replacement cost that may never actually be incurred.

> ***"Every general contractor is entitled to a profit, which is defined as the difference between the cost of goods and the price for which they are sold. Overhead and profit … is expressed as a percentage of the total construction cost."***

However, opposing points of view from respectable insurance industry professionals have been circulating for some time now. Recent case law and two separate state insurance commissioner bulletins, along with long-accepted customs and practices in the insurance industry, conclusively establish that GCO&P should be included in the cost of repair or replacement in order to arrive at an ACV estimate and settlement.

Majority View: Payment Required if Use is Likely

The majority of courts that have considered the issue have concluded that payment of GCO&P is required where the use of a general contractor is reasonably likely in repairing or replacing a covered loss, *even if no general contractor is used or no repair or replacement is made*. The nature and extent of the damage and the number of trades needed to make the repairs are key factors in determining whether use of a general contractor is reasonably likely. This requires some consideration of the degree to which coordination and supervision of trades are required.

A number of cases that went before the courts involved replacement cost policies. However, the policies expressly provided that until the damaged or destroyed property was actually repaired or replaced, the insurer's obligation was limited to an ACV payment. Under the policies in those cases, the insurer also was obligated to make an ACV payment to policyholders irrespective of whether they actually repaired or replaced the damaged or destroyed property. Accordingly, the issue in those cases was the amount the insurer agreed to pay to its insured prior to actual repair or replacement. It agreed to pay ACV, which the courts in those cases decided meant "repair or replacement cost less depreciation."

In the 1994 case of *Gilderman v. State Farm Ins. Co.*, the court stated, "the real inquiry is what is included in repair or replacement costs," which it answered as "any costs that an insured would be expected reasonably to incur in repairing or replacing the covered loss."

"The nature and extent of the damage and the number of trades needed to make repairs are key factors in determining whether use of a general contractor is reasonably likely."

In the more recent case of *Lukes v. American Family Mutual Ins. Co.*, the court observed, "The policy at issue in this case does insure the Plaintiff in 'the amounts it *would cost* to repair or replace covered property with material of like kind and quality ... .' Note that the policy does *not* say, 'the amount which it *did* cost to repair or replace ... .' Thus, the Court rejects the Defendant's argument that it does not have to pay sales tax unless and until the Plaintiff actually replaces the contents."

In its ruling in *Tritschler v. Allstate Ins. Co.*, the court offered some additional perspective on the issue. It wrote that "actual cash value is an estimate of the needed repairs; the determination of actual cash value is not based upon what the insured actually pays to repair or replace the damaged property. Therefore, the amount an insured ultimately spends to make needed repairs, if any, is irrelevant." Finally, as the court concluded in *Mee v. Safeco Ins. Co. of America*, it can hardly be said "that an insured reaps a windfall by obtaining payment of actual cash value determined in a fair and reasonable manner when that is precisely what the insurer has agreed to pay under its policy in advance of actual repair or replacement. No windfall occurs where insureds receive benefits for which they have paid and to which they are entitled, even if repair or replacement costs are not incurred."

Minority View: Payment Not Required Unless Incurred

A minority of courts have rationalized that overhead and profit are "non-damage" factors that have no relation to the value of the damage. In their dim view, these represent only the cost or expense that would be incurred if repair or replacement were involved.

That rationale has been roundly criticized in at least four cases. The "majority view" courts have explained that the estimate of the ACV is just that — an estimate. Certainly, the insured has not incurred the cost of contractor's overhead and profit at this point or, for that matter, the cost of labor or materials. Logically speaking, it makes no more sense to exclude one on the grounds that it is a "non-damage factor" and not the other.

But even more importantly, by applying the "minority view" logic, an insured who opts not to repair or to replace the damaged property would not incur any expenses, including the cost of building materials. As such, the insured would collect nothing under an ACV settlement, thereby rendering coverage illusory.

The two "minority view decisions" — *Karl v. State Farm Fire and Casualty Co.*, and *Snellen v. State Farm Fire and Casualty* — also were based on an application of the "broad evidence" rule, for which there is no single measure of ACV.

As the *Karl* court reasoned, the broad evidence rule is "fatal to the position that, as a matter of law, general contractor's overhead and profit must always be included as part of the ACV in each instance where a general contractor could be necessary to actually complete the repairs."

State Insurance Commissioner Rulings

Quite impressively, the Texas Department of Insurance took action and squarely addressed the propriety of State Farm deducting contractor's overhead and profit from replacement cost when calculating ACV.

In a bulletin issued June 12, 1998, the Commissioner of Insurance strongly articulated the position of the Texas Department of Insurance relative to such practice: "The deduction of prospective contractors' overhead and profit and sales tax in determining the actual cash value under a replacement cost policy is improper, is not a reasonable interpretation of the policy language, and is unfair to insureds."

The Colorado Division of Insurance lent support to that position when it fired off a missive declaring its own stance on the issue. In a June 4, 1998, letter to a State Farm representative, the Colorado Division of Insurance wrote: "Based on the provisions in the policy, and the legal definitions of 'replacement cost,' 'actual cash value,' and 'depreciation' there do not appear to be grounds for State Farm to have refused to pay the 'overhead and profit' which is part of the replacement cost of the property. The 'actual cash value' of the property allows for a deduction for 'depreciation,' but under no legal definition, nor policy definition, is there a provision for a separate deduction for overhead and profit."

Industry Custom and Practice

Textbooks commonly used in the insurance industry include contractor overhead and profit as a component of repair or replacement cost. *Property Loss Adjusting* is a textbook for property claims adjusters published by the Insurance Institute of America for use in its industry-wide insurance designation and certification programs. It lists the following elements as comprising repair or replacement cost:

- materials
- labor and employers' burden
- tools and equipment
- overhead and profit
- miscellaneous direct costs such as permits and taxes

Widely accepted construction estimating publications like *Marshall & Swift/Boeckh*, *RS Means*, and *Sweets* that are used in the insurance industry in estimating the replacement cost of commercial buildings and residential dwellings, define replacement cost to include labor, materials, and contractor's overhead and profit.

To add even further validation, the Property Loss Research Bureau (PLRB), a recognized resource used by insurers in the interpretation of property insurance policy provisions, has taken the position that "contractor's overhead and profit are included in ACV, because they are part of replacement cost." The PLRB concludes that "any estimate of actual cash value should include overhead and profit."

Other industry groups are taking similar positions. *The Fire, Casualty*

> ***"The majority of courts that have considered the issue have concluded that payment of GCO&P is required where the use of a general contractor is reasonably likely in repairing or replacing a covered loss, even if no general contractor is used or no repair or replacement is made."***

& Surety Bulletins (FC&S), a National Underwriter Publication used by insurance professionals in the interpretation of property insurance policy provisions, is one notable example. In response to a question describing the practice of not including the costs of GCO&P as part of an ACV payment, an FC&S editor explained:

"Both [general contractor overhead and profit as well as subcontractor overhead and profit] are to be used in calculating final replacement cost, since they are obviously a part of the function of repairing or replacing the building, and it is from this that the actual cash value settlement is derived."

An FC&S editor applied this same rationale in response to another question about an insurer's refusal to include architect's fees in its replacement cost payment: "When the home was new, the replacement cost on the first policy included the architect's fees, because they were surely included in the purchase price. Rebuilding is no different. The replacement cost of a home includes everything that goes into it — not just the building materials. The architect's fees should be paid as part of replacement cost."

Why GCO&P Always Should Be Included

Arguably, there is no basis for an insurer ever to exclude the costs of GCO&P from the replacement cost calculation that is used in arriving at an ACV estimate and settlement based on the replacement cost less depreciation rule, even if the insured is not reasonably likely to incur such costs.

One reason is that many insurers include the cost of specialty contractor and subcontractor overhead and profit as well as sales tax in its replacement cost and ACV calculations, even if the contractor is not used and even if building materials are not purchased. As a result, many insurers pay for replacement costs policyholders never incur: those being the theoretical expenses of specialty contractors or subcontractors and sales taxes.

Once again it goes back to the simple premise that it is illogical for insurers to include some, but to exclude other, "contingent" expenses in its replacement cost calculation. In *Gilderman*, it was ruled that "All repair or replacement costs are, in theory, 'contingent' prior to being incurred." Likewise, in *Mazzocki*, the court stated, "A replacement cost estimate is equally hypothetical or contingent as to all materials, labor and contractor services."

Additionally, there is no real meaningful distinction between general contractor overhead and profit and that of the specialty contractor/subcontractor. Overhead is overhead and profit is profit.

Furthermore, many insurers include both general and specialty contractor/subcontractor overhead and profit when estimating the replacement cost that determines the limit of liability upon which a policyholder's premiums are based.

As the Texas Department of Insurance so aptly stated in its bulletin, "if the insurer in determining actual cash value excludes costs that are included in the determination of liability limits, on which the insured's premium is based, the insurer reaps an illegal windfall because the insurer receives premium on insurable values for which loss may never be paid."

Let's also not forget that, as a cardinal rule of insurance contract interpretation and construction, if a provision in an insurance policy is subject to more than one reasonable interpretation, then it is ambiguous and must be construed against the insurer and in favor of the insured.

The reasons for this rule are two-fold:

- The intent of an insured in purchasing an insurance policy is to obtain coverage and, therefore, any ambiguity that may jeopardize such coverage should be construed consistent with the insured's intent.

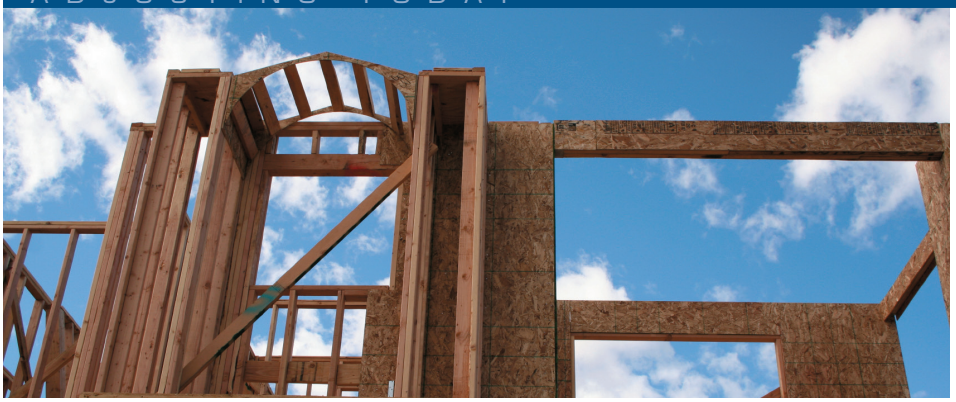
- The insurer is the drafter of the policy and could have drafted the ambiguous provision clearly and specifically.

"Arguably, there is no basis for an insurer ever to exclude the costs of GCO&P from the replacement cost calculation that is used in arriving at an ACV estimate and settlement based on the replacement cost less depreciation rule, even if the insured is not reasonably likely to incur such costs."

Following this analysis, it is a reasonable interpretation of the standard provisions in the typical property insurance policy that the costs of GCO&P should be included in every loss estimated and settled based on the "replacement cost less depreciation" rule. So in accordance with this rule of insurance contract interpretation and construction — a rule designed to protect the insured's reasonable expectation of coverage in a situation in which the insurer-draftsman controls the language of the policy — a court would be required to construe the policy strictly against the insurer and in favor of the insured.

But as insurance industry professionals, let's evaluate this issue in its purest sense. The most fundamental of insurance principles is the principle of indemnity. The role of insurance is to put insureds back into the same position they enjoyed before the occurrence of an insured event.

Now, just as various parts of a property contain building materials whose value cannot be excluded from ACV regardless of whether they are replaced, each part of that property also contains at least some portion of the original general contractor



overhead and profit associated with its construction.

Because some of that value is left at the time of the loss, the loss of that value is, in fact, part of the damage suffered by the insured. A claims practice of excluding, deducting or withholding the costs of GCO&P in these calculations clearly violates the principle of indemnity. Specifically, insureds are not being compensated for the value included in that portion of the general contractor overhead and profit when the property was first constructed.

Conclusion

The inclusion of GCO&P in ACV payments is pervasive and traditional to the insurance industry. Numerous courts of law, the Texas and Colorado departments of insurance and widely accepted insurance publications all acknowledge this fact. They clearly recognize the need to include these expenses in situations where the insured is reasonably likely to incur such costs in repairing or replacing their loss.

Although many insurers routinely pay for GCO&P if more than three trade categories of specialty contractors/subcontractors are needed, a strong argument can be made for including the costs of CGO&P in *every* loss when the replacement cost less depreciation rule is used. At the very least, insureds should receive some compensation for the time spent and the expense incurred while acting as their own general contractor in losses where the services of a general contractor normally would not be utilized.

Edward Eshoo Jr. Esq.

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FLORIDA NOTICES AND BULLETINS

December 8, 1992

SUBJECT: INSURANCE

INFORMATIONAL BULLETIN 92-036
ALL INSURERS WRITING PROPERTY INSURANCE COVERAGE IN THIS STATE

HOLDBACKS PROHIBITED ON REAL PROPERTY PARTIAL LOSSES

December 08, 1992

The payment of a partial loss on real property must be handled in a manner consistent with existing statutes and case law.

Section 627.702(2) Florida Statutes, while specifying only fire and lightning losses, is instructive in discerning legislative intent in applying the Valued Policy Law to partial losses on real estate resulting from Hurricane Andrew. This statute provides that the insured is entitled to the "actual amount of such loss", not to exceed the amount of insurance specified in the policy as to such property.

The Florida Supreme Court, in Sperling v. Liberty Mutual So2d 297 (Fla 1973), held that the "actual amount of such loss" is the cost of placing the building in as nearly as possible the same condition that it was before the loss, without allowing depreciation for the materials used.

This authority is specifically applicable to the practice by insurers of imposing a "holdback" of insurance proceeds greater than actual cash value until replacement has taken place. While this practice is appropriate for personal property, this bulletin serves to place insurers on notice that for partial losses on real property, the "holdback" is inconsistent with established precedent.

The application of a "holdback" to repair of real property can particularly cause hardship to the insured when the actual cash value payment is insufficient to enter into a contract to make repairs. In such an instance, the insured may be forced to seek other funding sources, at his expense, in order to contract for repairs.

Insurers who have been applying "holdbacks" in claims for partial loss on real property should pay the actual amount of the loss. The best indicator of actual loss is the contract for repair entered into by the insured. Once an actual amount of loss is determined by contract, the full loss payment should be made with no hold back applied. This arrangement satisfies the public policy interests both in timely and sufficient claim payments, and in encouraging rebuilding. In instances where a holdback is currently being applied and a repair contract has been executed, the holdback should be released.

Should you have any questions regarding this Bulletin, please contact Dan Sumner, Assistant General Counsel at (904) 922-3103, extension 4904.

3

ACTUAL CASH VALUE GUIDELINES

BUILDINGS

PERSONAL PROPERTY

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

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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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