No. 18-5104

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

SUSAN HICKS and DON WILLIAMS,

Plaintiffs-Appellees,

v.

STATE FARM FIRE AND CASUALTY COMPANY,

Defendant-Appellant.

On Appeal from the United States District Court
for the Eastern District of Kentucky, Ashland Division
Case No. 0:14-cv-00053-HRW

Reply Brief of Defendant-Appellant State Farm Fire and Casualty Company

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INTRODUCTION

This appeal involves the proper calculation of the "actual cash value" ("ACV") of Kentucky structures insured under "replacement cost" policies, a question decided differently by two district courts in this Circuit. *Compare Bailey v. State Farm Fire & Cas. Co.*, No. 14-53-HRW, 2015 WL 1401640, *5-8 (E.D. Ky. Mar. 25, 2015), *with Brown v. Travelers Cas. Ins. Co. of Am.*, No. 15-50-ART, 2016 WL 1644342, *2-5 (E.D. Ky. Apr. 25, 2016). Under replacement cost policies, an insurer does not owe the full cost to repair a damaged structure until *after* repair or replacement is complete. Before repair, the insurer only owes ACV. *See* discussion *infra* at 27-28.

By regulation, ACV in Kentucky is the "replacement cost of property at the time of the loss less depreciation, if any." 806 KY. ADMIN. REGS. 12:095(9)(2) (1992) (the "ACV Regulation"). Defendant-Appellant State Farm Fire and Casualty Company ("State Farm") has demonstrated why the Kentucky Supreme Court would hold that *all* components of replacement cost are subject to depreciation under the ACV Regulation. *See* S.F. Br. 16-46.[1] For the same reasons, the replacement cost

[1] For ease of reference, the Brief of Defendant-Appellant State Farm Fire and Casualty Company, Dkt. 16, is referred to herein as "State Farm's Brief" or "S.F. Br."

policies State Farm issued to Plaintiffs-Appellees Susan Hicks and Don Williams ("Plaintiffs") likewise provide for that depreciation. *See id.*

Plaintiffs' Response[2] asserts that the ACV Regulation cannot be read to allow insurers to depreciate the labor component of replacement cost ("labor depreciation"). *See* Pl. Br. 16-19. But Plaintiffs overstate the "data points" they rely on, incorrectly urge the Court to adopt a deferential standard of review, misinterpret Kentucky authority on the principle of indemnity, and misapply Kentucky's standards for construing statutes and contracts.

For the reasons set forth in State Farm's opening brief, its argument below, and the Associations' Amicus Brief,[3] State Farm respectfully requests reversal of the district court's order denying State Farm's motion to dismiss.

ARGUMENT

I. The Relaxed Standard of Review Plaintiffs Propose is Improper.

After initially conceding that *de novo* review applies here (Pl. Br. 12), Plaintiffs shift course and urge that affirmance is warranted so long as "the district

[2] The Brief of Plaintiffs-Appellees Susan Hicks and Don Williams, Dkt. 25, is referred to herein as "Plaintiffs' Brief" or "Pl. Br."

[3] The Brief of Amici Curiae American Insurance Association, National Association of Mutual Insurance Companies, and Property Casualty Insurers Association of America in Support of the Position of State Farm Fire and Casualty Company and in Support of Reversal, Dkt. 24, is referred to herein as the "Associations' Amicus Brief" or "Ass'n Br."

judge reached a permissible conclusion predicting state law." *Id.* at 7, 12. That is error, for the United States Supreme Court has instructed unequivocally that "*no form of appellate deference is acceptable*" on appeal from a district court's determination of state law. *Salve Regina Coll. v. Russell*, 499 U.S. 225, 231, 238 (1991) (emphasis supplied); *Am. Home Assur. Co. v. Hughes*, 310 F.3d 947, 949 n.3 (6th Cir. 2002). Plaintiffs' cited authorities pre-date *Salve Regina* and should not be followed. *See* Pl. Br. 7, 12 (citing *Bailey v. V&O Press*, 770 F.2d 601, 606-07 (6th Cir. 1985); *Parham v. Hardaway*, 555 F.2d 139, 140 (6th Cir. 1977)).

II. The Kentucky Supreme Court's Declination of the Certified Question in *Brown* is Irrelevant Here.

Plaintiffs state that "the most significant data point" favoring their position on appeal is that the Kentucky Supreme Court supposedly signaled its approval of Judge Wilhoit's interpretation of "actual cash value." *See* Pl. Br. 21. This purported "signal" supposedly was sent in *Brown*, when the Kentucky Supreme Court declined to accept the "labor depreciation" question Judge Thapar certified for review. *Id.* at 21-26. Because the declination post-dated Judge Wilhoit's denial of State Farm's motion to dismiss here, Plaintiffs erroneously claim it "has much the same predictive

value" as a state high court's decision to decline review of a state appellate decision. *Id.* at 25.[4]

In fact, the predictive value of the Kentucky Supreme Court's non-action in *Brown* is zero. The Kentucky Supreme Court's acceptance of certified questions is discretionary. KY. R. CIV. P. 76.37(1). And Kentucky Supreme Court Rule 1.030 establishes that denials of discretionary review "*shall not be taken* as indicating its approval of the opinion or order sought to be reviewed, and *shall not be cited* as connoting such approval." KY. S. CT. R. 1.030(8)(b) (emphases supplied).[5] Nor are such declinations among the "data points" this Court considers when reviewing a district court's prediction of state law. *See, e.g.*, *Kurczi v. Eli Lilly & Co.*, 113 F.3d 1426, 1429 (6th Cir. 1997) (listing appropriate data points); *Elfelt v. United States*, 47 F. App'x 386, 388, 390-94 (6th Cir. 2002) (applying *de novo* review and reversing district court's prediction of state law after certified question was declined). The Kentucky Supreme Court's inaction in *Brown* does not favor or disfavor either party.

[4] The analogy is inapt. A federal court's prediction of state law does not bind state courts. *See Ohio ex rel. Skaggs v. Brunner*, 549 F.3d 468, 472 (6th Cir. 2008). State appellate decisions, in contrast, do bind state courts.

[5] The same rule applies when the United States Supreme Court declines review. *See United States v. Carver*, 260 U.S. 428, 490 (1923) (denial of a writ of certiorari "imports no expression of opinion upon the merits of the case").

III. The Kentucky Supreme Court Would Reject Plaintiffs' "Reproduction Cost" Formulation of Indemnity for Actual Cash Value.

Plaintiffs concede that the purpose of insurance is to achieve indemnity. Pl. Br. 19. For ACV in Kentucky, an insured is indemnified by payment of the monetary value of a structure "'as it stood upon the ground on the day that it was destroyed.'" *Brown*, 2016 WL 1644342, at *5 (quoting *Aetna Ins. Co. v. Johnson*, 74 Ky. 587, 591 (1874)).[6] Plaintiffs, however, now contend that for ACV, Kentucky insurers must pay the full cost for workers to *rebuild* damaged property using aged and deteriorated building materials. *E.g.*, Pl. Br. 14, 16, 19, 33-34.

As set forth below, the Kentucky Supreme Court would not adopt Plaintiffs' view. The purpose of ACV is to pay the market value of the insured's property, not the cost to *restore* the property to its pre-loss physical condition.

[6] Guidelines published by the National Committee on Property Insurance similarly demonstrate that the common meaning of actual cash value is the property's "WORTH IN MONEY AT THE PRESENT MOMENT." Br. of *Amicus Curiae* United Policyholders in Support of Plaintiffs-Appellees and Supporting Affirmance of the District Court's Memorandum Opinion and Order ("UP Br."), Dkt. 28, at PageID #13, 45 (quoting *Actual Cash Value Guidelines: Buildings, Personal Property*, National Committee on Property Insurance 5 (1982)) (emphasis in original).

A. "Replacement Cost Less Depreciation" is Intended to Calculate Market Value.

Plaintiffs admit that their proposed "cost of reproducing used property"[7] formulation of ACV requires insurers to pay *more* than the market value of damaged property. *See, e.g.*, Pl. Br. 15-16, 18, 28-34, 44. They contend this properly reflects Kentucky's *intent* that ACV exceed market value. *Id.* Plaintiffs err.

Regardless of whether Kentucky recognizes different "concepts" of value in other settings, the value concept Kentucky selected for ACV is "replacement cost" less "depreciation." 806 KY. ADMIN. REGS. 12:095(9)(2)(a). And Plaintiffs' authorities establish that for decades, the Kentucky Supreme Court has recognized "replacement cost less depreciation" as a method to calculate market value. *See Commonwealth v. R.J. Corman R.R. Co./Memphis Line*, 116 S.W.3d 488, 491, 495 (Ky. 2003); *Commonwealth v. Congregation Anshei S'fard*, 390 S.W.2d 454, 455 (Ky. 1965) (replacement cost less depreciation is one of the three recognized methods to calculate market value of real estate); *Fayette Cty. Bd. of Supervisors v. O'Rear*, 275 S.W.2d 577, 579 (Ky. 1954) (for tax assessment the "reproduction cost

[7] For reasons they do not explain, Plaintiffs frequently substitute "reproduction cost" for "replacement cost" when discussing the ACV Regulation. *See, e.g.*, Pl. Br. 16. That attempted substitution conflicts with the ACV Regulation and should be ignored.

new, less depreciation" reasonably approximates the "fair voluntary sale price" or market value of property).

The text of the ACV Regulation further confirms Kentucky's intent that ACV pays market value. *See* 806 KY. ADMIN. REGS. 12:095(9)(2)(b). If "replacement cost" less "depreciation" generates a value disproportionately higher than an insured's property interest, such as where the property has "nominal or no economic value," the ACV Regulation allows alternative computation to prevent overpayment. *Id.* Part 9(2)(b) thus operates much like the "broad evidence rule" Kentucky followed before adopting the ACV Regulation. *See Snellen v. State Farm Fire & Cas. Co.*, 675 F. Supp. 1064, 1068 (W.D. Ky. 1987) (under the broad evidence rule, Kentucky determined the actual cash value of property "'as is', considering its condition at the time of the loss," and deemed it "logical" to calculate ACV by "subtracting depreciation from full replacement cost"); *see also* Pl. Br. 29-30 (acknowledging Kentucky's prior application of the broad evidence rule).

Finally, Plaintiffs have not cited authorities showing "consistent support" for the idea that ACV in Kentucky is the cost to rebuild property with used building materials. *See* Pl. Br. 10, 28. In *Great American Insurance Co. v. Crume*, the court ruled that under a partial loss statute requiring payment for the "actual loss of the party insured," the amount due was "the reasonable cost *of restoring or repairing any damage or injury … to as good condition*" as before the loss." 99 S.W.2d 742,

743 (Ky. 1936) (citing 762a-22, Ky. Stats.) (emphasis supplied). Plaintiffs' second "historical" authority similarly addresses a restoration measure for tortious damage to real estate, which is "the cost of *restoring the property* to substantially the same condition it was in before the accident." *Ky. Util. Co. v. Consol. Tel. Co.*, 252 S.W.2d 437, 440-41 (Ky. 1952). Kentucky plainly could have, but *chose not to*, adopt a "restoration" standard for ACV. Instead, it defined ACV as "replacement cost" less "depreciation," a measure of market value.

B. Extensive Authorities Establish Why the Kentucky Supreme Court Would Hold That "Labor Depreciation" Serves Indemnity.

As set forth in State Farm's opening Brief (*see* S.F. Br. 26, 32-33 & n.16), there is extensive caselaw explaining that including the full cost of labor to rebuild damaged property as part of ACV *overstates* the property's pre-loss value and is *contrary* to the purpose of indemnity. For example, as stated in the Oklahoma Supreme Court's seminal decision in *Redcorn v. State Farm Fire and Casualty Company*:

> A roof does not have a separate market value from the building it covers. . . . [Plaintiff] insured a roof surface, not two components, material and labor. He did not pay for a hybrid policy of actual cash value for roofing materials and replacement costs for labor. To construe the policy in such a manner would unjustly enrich the policy holder.

55 P.3d 1017, 1020-21 (Okla. 2002).

The Eighth Circuit Court of Appeals' reasoning in *In re State Farm Fire and Casualty Co.*, 872 F.3d 567 (8th Cir. 2017) ("*LaBrier*"), provides additional guidance, explaining that at the ACV stage, "the insured bears the share of the loss resulting from" pre-loss deterioration of property, and "a 'depreciation' deduction is the most common" method to reflect that reduction in value. *Id.* at 574. The issue when determining ACV thus is whether "depreciating what a contractor will charge to replace the partial loss is a reasonable method of estimating 'the difference in value of the property immediately before and immediately after the loss.'" *Id.* at 576. The Eighth Circuit held that applying such depreciation is "an eminently practical and reasonable method" to measure actual cash value. *Id.* at 577. Indeed, the Eighth Circuit recognized that a "more precise estimate of [ACV] would depreciate *the full original* cost of the asset to account for its decline in value over time," so depreciating all components of replacement cost not only is reasonable, it favors the insured. *Id.* at 576 (emphasis in original).

Redcorn and *LaBrier* do not stand alone. Like analysis has been applied to approve "labor depreciation" in well-reasoned decisions from the Nebraska Supreme Court, the Minnesota Supreme Court, and the Tenth Circuit Court of Appeals, among others. *See, e.g.*, *Henn v. Am. Family Mut. Ins. Co.*, 894 N.W.2d 179, 190 (Neb. 2017) ("We hold that payment of the full amount of labor would amount to a prepayment of benefits to which the insured is not yet entitled"; depreciating "both

materials and labor, does not underindemnify the insured."); *Wilcox v. State Farm Fire & Cas. Co.*, 874 N.W.2d 780, 785 (Minn. 2016) (same); *Graves v. Am. Family Mut. Ins. Co.*, 686 F. App'x 536, 540 (10th Cir. 2017) (same); *Basham v. United Servs. Auto. Assoc.*, No. 16-cv-03057-RBJ, 2017 WL 3217768, at *3 (D. Colo July 28, 2017) (same) .

Plaintiffs argue that State Farm's authorities are inapt because they apply the law of states recognizing that ACV should approximate market value. *See* Pl. Br. 28-34. Plaintiffs' distinction fails, however, for Kentucky shares that understanding. *See supra* at 6-8. Thus, the Kentucky Supreme Court likely would deem State Farm's cited authorities highly persuasive.

C. The Kentucky Supreme Court Would Not Follow Plaintiffs' Cited Authorities.

The few cases that have deemed Plaintiffs' view of ACV to be reasonable are unpersuasive. *See* S.F. Br. 37-41. They do not apply reasoning that the Kentucky Supreme Court is likely to adopt.

1. The Decisions in *Bailey* and *Brown*.

Plaintiffs briefly address the district court's ruling here that ACV includes the full cost of labor to repair damaged property. *See* Pl. Br. 19. They acknowledge that the district court applied *Crume*'s standard of "indemnification," which calls for *restoration* of property rather than the "replacement cost" less "depreciation" formula in the ACV Regulation. *Id.* Further, an Arkansas Supreme Court decision

that the district court below found persuasive, and which accepted a "labor depreciation" theory like Plaintiffs' here, has since been superseded by statute. *See* S.F. Br. 37-38.

Addressing *Brown*, Plaintiffs incorrectly assert that there is no material conflict between Judge Thapar's ruling and Judge Wilhoit's order here. *See* Pl. Br. 8, 20. In fact, Judge Thapar ruled that the "*ordinary meaning* of 'depreciation' allows an insurer to depreciate the value of labor *that has merged with a finished good*," but not where such a "merging" has not occurred. *Brown*, 2016 1644342, *3 (emphases supplied). He denied dismissal in *Brown* because he *could not yet determine* whether the insured's damaged property – the "walls, the floor, and the ceilings" – *was or was not* of the type for which labor had merged into a "finished good." *Id.* at *3-5. Judge Thapar thus disagreed with Judge Wilhoit's ruling that "labor depreciation" is necessarily improper.[8] *See id.*

2. The Kentucky State Trial Court Decisions.

The Kentucky state court "labor depreciation" rulings Plaintiffs cite likewise lack predictive value.[9] Such decisions are potentially helpful only to the extent their

[8] Neither *Brown* nor *Bailey* contains an express finding of contractual ambiguity. *See* S.F. Br. 18.

[9] *See* Pl. Br. 9-10, citing *Traditional Bank v. Rocky Osborne, et al.*, Case No. 15-CI-90044, slip op. at 2 (Ky. Cir. Ct. May 24, 2016); *Jones v. Auto Club Prop. Cas. Ins. Co.*, Case No. 15-CI-0956, slip op. at 2-3 (Ky. Cir. Ct. May 24, 2016).)

"reasoning and conclusions [are] persuasive." *Bailey v. V& O Press Co.*, 770 F.2d at 604 (citing *Wolf v. Gardner*, 386 F.2d 295, 297 (6th Cir. 1967)). Plaintiffs' cited orders do not disclose those courts' analysis.

In *Traditional Bank*, the trial court denied State Farm's motion to dismiss in an order reciting, without explanation, a finding that State Farm was contractually obligated to calculate ACV without applying "labor depreciation." *See* Pl. Br. at PageID #60, ¶ 2. *Traditional Bank* later was settled on an individual basis, without a ruling on the merits. *See id.* at PageID #77. *Jones* likewise did not result in a judgment on the merits. There, the trial court in denied a motion to dismiss a "labor depreciation" complaint after concluding that Kentucky law on that issue was *unsettled*. *Id.* at PageID #65. The *Jones* court did not attempt to predict how the Kentucky Supreme Court would decide the question of "labor depreciation." *Id.*

3. Plaintiffs' Out-Of-State Authorities.

Plaintiffs cite several out-of-state cases in which insurance policies that did not define "actual cash value" were deemed ambiguous, and the court then deemed it reasonable to construe "actual cash value" to prohibit "labor depreciation." *See* Pl. Br. 34-37 and n.15. One of those orders was a default judgment and has since

been vacated.[10] The remainder do not present reasoning the Kentucky Supreme Court is likely to adopt.

As demonstrated above, it is well-established in Kentucky that ACV payments should reflect the market value of property. *See* discussion *supra* at 6-8. Under that view of "indemnity" for ACV, the Kentucky Supreme Court is unlikely to deem the cost to rebuild damaged property with used materials to be a reasonable interpretation of either "actual cash value" or the "replacement cost" less "depreciation" formula adopted in the ACV Regulation. *Id.*

Moreover, the ambiguity analysis applied in Plaintiffs' authorities cannot be applied under Kentucky law. As shown below, Kentucky law holds that contract terms defined by law are not ambiguous, and adverse construction is not applied against insurers when regulations are interpreted. *Infra* at 23-27. None of Plaintiffs' cited authorities applied those principles.[11]

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[10] *See McKenzie v. Farmers Ins. Exch.*, 260 F. Supp. 3d 1150 (D.S.D. 2017), *vacated*, No. 17-4011, 2018 WL 801597 (D.S.D. Feb. 8, 2018).

[11] *See Arnold v. State Farm Fire & Cas. Co.*, 268 F.Supp.3d 1297, 1305, 1312 (S.D. Ala. 2017) (deeming policy ambiguous though "actual cash value" was defined by state law); *Sproull v. State Farm Fire & Cas. Co.*, No. 16-L-1341, slip op. at 2-6 (Ill. Cir. Ct. Feb. 26, 2018) (same); *Titan Exteriors, Inc. v. Certain Underwriters at Lloyd's*, No. 1:17-cv-178-GHD-DAS, 2018 WL 1057139, at *5 (N.D. Miss. Feb. 26, 2018) (deeming policy ambiguous though parties agreed on definition of ACV under state law); *Lains v. Am. Fam. Mut. Ins. Co.*, No. C14-1982-JCC, 2016 WL 4533075, at *2 (W.D. Wash. Feb. 9, 2016) (deeming policy ambiguous without reference to state law); *Adams v. Cameron Mut. Ins. Co.*, 430 S.W.3d 675, 679 (Ark. 2013) (deeming policy ambiguous where "actual cash value was not defined by law or in

Finally, the decisions in *Arnold* and *Sproull* both conflict with other authority applying Alabama and Illinois law, respectively, and *rejecting* Plaintiffs' view that insurers cannot depreciate labor costs. In Alabama, the court in *Ware v. Metropolitan Property & Casualty Insurance Co.* ruled that a policy mirroring the state's regulatory definition of ACV as "replacement cost" less "depreciation" unambiguously authorized depreciation of *all* components of replacement cost. 220 F. Supp. 3d 1288, 1291 (M.D. Ala. 2016). That directly conflicts with the ambiguity analysis applied in *Arnold*, 268 F. Supp. 3d at 1305-06. Similarly, in Illinois, the court in *Gee v. State Farm Fire & Casualty Co.* found it *unreasonable* to interpret "replacement cost less depreciation" as prohibiting depreciation of the sales tax component of replacement cost when calculating the ACV of personal property. No. 11-cv-250, 2013 WL 8284483, *2-3 (N.D. Ill. Sept. 23, 2013). That conflicts with the ambiguity analysis applied in *Sproull*, slip op. at 2-6. As stated in its opening brief, State Farm respectfully submits that *Ware* and *Gee* are better reasoned. *See* S.F. Br. 38-40.

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the policy); *Ingram v. Liberty Ins. Co.*, No. 16CVH06-5538, slip op. at 6 (Ohio Cir. Ct., March 13, 2018) (ruling that whether insurer could apply "labor depreciation" when calculating ACV was a question for the jury).

4. The Supposed "Industry Practice" Documents.

Plaintiffs finally cite to a handful of out-of-state regulatory materials as "authorities" showing that applying "labor depreciation" is contrary to a supposed "traditional industry practice." *See* Pl. Br. 39 n.16. The materials are neither relevant nor helpful.

The issue presented here is whether "labor depreciation" is permitted in Kentucky *now*. The ACV Regulation and Kentucky precedent support the conclusion that "labor depreciation" is permitted. *See supra* at 5-8; *infra* at 18-21. And the regulatory materials this Court should consider are those issued by the Kentucky Department of Insurance (the "KDOI"). The KDOI promulgated the ACV Regulation, and the plain text of that Regulation authorizes "labor depreciation." *See infra* at 18-19. Moreover, the KDOI has posted guidance for consumers that *specifically applies* "labor depreciation" when illustrating how insureds should expect to be paid for ACV:

> If your policy provides ACV coverage on your roof and your shingles are 12 years old, they may be rated with a life expectancy of 20 years depending on material. If the cost of replacing your roof is $14,000, *your insurer will apply 60 percent (12/20) depreciation* and pay the ACV of $5,600 less your deductible."

Consumer Awareness Announcement: Wind & Hail Deductibles, KY. DEP'T OF INS. (Aug. 2012), http://insurance.ky.gov/documents/windhaildeductannounce081512.pdf

(last visited Apr. 26, 2018). This reflects that current practice in Kentucky, as permitted under the ACV Regulation and by the KDOI, is to depreciate labor.

Moreover, even if past practice had some relevance here, the traditional practice has been to *apply* "labor depreciation" when calculating ACV. That is shown by both parties' amici. The Associations' Amicus Brief cites "[e]arly-20th century insurance adjusting manuals confirm[ing] that depreciation was applied at that time … as a percentage of the replacement cost, not based on the cost of the materials only." Ass'n Br. 12-13, *see also id.* at 3-4. And United Policyholders has provided decades-old industry guidance clearly explaining that for "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)." Robert J. Prahl, Introduction to Claims 88 (1st ed. 1988) (excerpted in UP Br. at PageID #79).

Plaintiffs' materials do not counter the amici. They cite a Vermont Bulletin that does not mention traditional practice. *See Ins. Bulletin No. 184*, VT. DEP'T OF FIN. & PROF'L REGULATION, DEP'T OF INS. (May 2015), http://www.dfr.vermont.gov/sites/default/files/Bulletin_184.pdf (last visited April 25, 2018). They cite an Ohio market conduct report showing a *lack* of uniform industry practice, as the examined insurer was cited for failing to ensure that

independent adjusters *followed* the insurer's internal policy against applying "labor depreciation." *See Market Conduct Examination of Sandy & Beaver Valley Farmers Mutual Insurance Co. as of June 30, 2011*, OHIO DEP'T OF INS., at 10 (May 21, 2012), https://www.insurance.ohio.gov/Company/MC/Sandy%20and%20Beaver%20Valley%20Exam%20Report.pdf (last visited April 25, 2018) ("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 . . . and adherence to Company policies and procedures."). And the stray references to "industry practice" by the drafters of the Ohio report and a report from California are made without citation to any authority. *See id.* at 6; *Market Conduct Examination of Allstate Ins. Co.*, CAL. DEP'T OF INS., at 16 (1998), http://mail.consumerwatchdog.org/insurance/rp/rp000619.pdf (last visited April 25, 2018). No proper support has been provided to demonstrate a prior industry or trade practice, in Kentucky or elsewhere, to calculate ACV without "labor depreciation."

D. Property Valuation Methods in Other Contexts Support Application of "Labor Depreciation" for ACV.

That labor is depreciated in other valuation contexts further supports the prediction that the Kentucky Supreme Court would hold that all components of replacement cost are to be depreciated under Kentucky's ACV Regulation. *Id.* Plaintiffs concede that federal admiralty courts "have historically used straight-line depreciation of total replacement costs to value damaged property." Pl. Br. 44. They

also concede that in the tax context, both Kentucky and federal law treat labor costs as a depreciable component of the basis for damaged property. *Id.* at 42-43. And though Plaintiffs argue that the tax context "has nothing to do with the valuation of assets" (*id.* at 43), the Internal Revenue Service ("IRS") has stated that depreciation for tax purposes is intended to provide an annual allowance recognizing the reduced value of property, including structures, due to "*wear and tear, deterioration, or obsolescence of the property.*" *A Brief Overview of Depreciation,* Internal Revenue Service, https://www.irs.gov/businesses/small-businesses-self-employed/a-brief-overview-of-depreciation (last visited April 25, 2018) (emphasis supplied).[12]

IV. The Kentucky Supreme Court Would Hold That the ACV Regulation Allows Depreciation of All Components of Replacement Cost.

A. The ACV Regulation Unambiguously Provides that Total Replacement Cost is Depreciated When Calculating ACV.

Plaintiffs' "labor depreciation" theory further fails because it is wholly inconsistent with the plain language of the ACV regulation itself. The ACV Regulation directs that ACV generally is calculated as "replacement cost of the property at the time of the loss less depreciation, if any." 806 KY. ADMIN. REGS. 12:095(9)(2)(a). The text of the ACV Regulation does not exempt any components

[12] The Court may take judicial notice of this statement published on the IRS's website because it is a public record and because the IRS's website is a source whose accuracy cannot reasonably be questioned. *See* S.F. Br. 22 n.9.

of replacement cost from depreciation. *Id.* It clearly provides for an insurer to depreciate the total cost of replacement as a whole. *See* S.F. Br. 24.

Several courts have construed insurance policy language framed in a manner essentially identical to the ACV Regulation and found that the language unambiguously provided for "labor depreciation" to be applied. For example, in *Ware*, the plaintiff's policy provided that ACV was the cost to repair less an "allowance for physical deterioration and depreciation including obsolescence." 220 F. Supp. 3d at 1291 (citation omitted). The court concluded that the policy unambiguously allowed "labor depreciation":

> When the entire definition is read together, it is clear that an allowance for depreciation is to be deducted from the *entire* estimated cost of repairing the covered property. It logically follows that the depreciation allowance includes depreciation of the full estimated cost of repair, which obviously includes materials and labor. *Nothing in the policy suggests that only the materials component of that cost of repair should be depreciated or that the repair labor cost should be ignored when determining depreciation.*

Id. (emphases supplied) (applying Alabama law).

A like result was reached in *Basham*, 2017 WL 3217768, at *1-2 (applying Colorado law). There again, the court interpreted an insurance policy providing that ACV was the cost to repair or replace covered property "'subject to a deduction for deterioration, depreciation and obsolescence.'" *Id.* at *1 (citation omitted). The court held that because labor and materials were both included as components of

replacement cost, "*both* the cost of materials *and* the cost of labor" were subject to depreciation. *Id.* at *2 (emphasis supplied).

Basham, *Ware*, and other similar cases fully support the conclusion that "labor depreciation" is proper under the ACV Regulation. *See*, *e.g.*, *Papurello v. State Farm Fire & Cas. Co.*, 144 F. Supp. 3d 746, 768, 770-71 (W.D. Pa. 2015) (holding that "the only reasonable interpretation" of ACV "is replacement cost less depreciation," with depreciation applied to the entire estimated replacement cost).[13]

Further, State Farm has shown that the plain meaning of the word "depreciation" clearly contemplates that *all* components of an asset's cost are subject to depreciation. *See* S.F. Br. 25-29. The ordinary meaning of "depreciation" is a decline in value of property. *Id.* And the Eighth and Tenth Circuits have both concluded that "depreciation," by its plain meaning, applies to *both* material costs and labor costs incurred for an asset. *LaBrier*, 872 F.3d at 574; *Graves*, 686 F. App'x at 540.

Plaintiffs attempt to undermine *Graves* by asserting that "the Tenth Circuit … simply followed a decision of [another court]." Pl. Br. 29; *see also id.* at 32. But the Tenth Circuit in *Graves* independently analyzed the "plain and ordinary meaning

[13] While the foregoing decisions interpreted contracts, Kentucky courts interpret contracts *and* statutes according to their plain language. *See* discussion *infra* at 24.

of 'depreciation," concluding that "a reasonably prudent insured" would not expect the insurer to apply the "unorthodox depreciation method" that the insured advocated. *Graves*, 686 F. App'x at 540.

Plaintiffs' attempt to distinguish *LaBrier* is equally unsuccessful. They note that *LaBrier* considered the meaning of "depreciation" in a state where ACV was defined as the "fair market value" of property. *See* Pl. Br. 32. The Eighth Circuit's analysis, however, referenced "depreciation" in the context of "replacement cost less depreciation," and ACV in Kentucky similarly should equate to market value. *LaBrier*, 872 F.3d at 574. Moreover, the Eighth Circuit recognized that each of the ten different depreciation methods identified in Black's Law Dictionary deducts depreciation "from the initial *full cost* of the damaged asset, because that was the insured investment." *Id.* (emphasis supplied).

Finally, Plaintiffs do not address State Farm's prior citation to long-standing Kentucky precedent recognizing that property depreciates as a whole, and that depreciation is properly applied to the *total* value of such property. *See* S.F. Br. 26-27 & n.14. The Kentucky Supreme Court's understanding of the term "depreciation" in the insurance context is a significant "data point" weighing against Plaintiffs' position.

B. Plaintiffs' Interpretation of the ACV Regulation Improperly Fails to Give Meaning to the Regulation's Full Text.

Plaintiffs concede that when ACV is calculated with "labor depreciation" applied, as State Farm proposes, the resulting value matches the "economic" or market value of damaged property. As illustrated in State Farm's opening brief, if one assumes damage to property with a 16-year-old roof with four years of remaining useful life on the date of loss, and a $10,000 cost for repair ($6,000 for labor and $4,000 for materials), the ACV of the property would be $2,000 if calculated *with* "labor depreciation," and $6,800 – nearly 70% of its full value – if the cost for labor is *not* depreciated. S.F. Br. 30.

Plaintiffs contend that State Farm's approach must fail because it gives no meaning to part 9(2)(b) of the ACV Regulation, which allows deviation from the "replacement cost" less "depreciation" formula "if the insured's interest is limited because the property has nominal or no economic value, or a value disproportionate to replacement cost less depreciation." 806 KY. ADMIN. REGS. 12:095(9)(2)(b).

But State Farm's approach *does* give meaning to part 9(2)(b). Assume that a long-vacant, multi-structure hospital sustains fire damage, as occurred in *American States Insurance Co. v. Mo-Lex, Inc.*, 427 S.W.2d 236 (Ky. 1968). The estimated cost to repair the property is $400,000, but even after depreciation is applied to reflect age and deterioration, the calculated ACV is more than the property's economic value due to obsolescence. *Id.* at 239-40. In *Mo-Lex*, consideration of

that fact was allowed under the broad evidence rule. *Id*. at 238-40. Today, it would be allowed under part 9(2)(b) of the Regulation.

In contrast, *Plaintiffs'* formula leaves no role for part 9(2)(b). Plaintiffs' "reproduction of used property" calculation is *designed* to calculate values exceeding the "economic" or market value of property as a rule, and they contend that such excess is *proper*. *See, e.g.*, Pl. Br. 15-16, 18, 28-34, 44. When would a payment ever be *too* disproportionate to economic value under their approach? Plaintiffs do not say.

C. The ACV Regulation Cannot Be Construed Adversely to State Farm.

To the extent that Plaintiffs complain that the "replacement cost" less "depreciation" formula is confusing in any manner, they err in contending that they are entitled to have the KDOI-drafted ACV Regulation construed in their favor.

Adverse construction is a *contractual* interpretation tool justified on the basis that the drafter of a contract should be bound by the language it chooses. State Farm plainly is not the "drafter" of the ACV Regulation, and applying adverse construction thus is improper. *See, e.g., Nabor v. Occidental Life Ins. Co. of Cal.*, 396 N.E.2d 1267, 1270 (Ill. App. Ct. 1979) (insurer is not the "drafter" of statutory language and adverse construction of statutory language is improper); *Terra Indust., Inc. v. Commonwealth Ins. Co. of Am.*, 981 F. Supp. 581, 590-91 (N.D. Iowa 1997) (same).

Instead, Kentucky's rules of *statutory* construction apply to the ACV Regulation. S.F. Br. 21. Those rules require application of the Regulation according to its plain language, and any uncertainty as to the meaning of the Regulation is to be resolved by reference to the KDOI's intent as its drafter. *See id.* at 21-22. As discussed above, the KDOI's intent with the ACV Regulation is clear – "labor depreciation" is proper for ACV calculations in Kentucky. *See supra* at 15-16. The ACV Regulation accordingly must be applied as the KDOI has interpreted and applied it.

V. The Kentucky Supreme Court Would Not Find Plaintiffs' Policies Ambiguous.

A. The Term "Actual Cash Value" is Unambiguous.

The only term *in Plaintiffs' policies* that Plaintiffs challenge as ambiguous is "actual cash value." Pl. Br. 37-40 and n.15. Plaintiffs contend that it is a "cardinal principle[]" that courts apply "liberal[]" construction of policy language in favor of the insured. Pl. Br. 38. And they assert that policy *exclusions* are to be strictly construed against insurers and are ineffective if they are not clearly stated. *Id.* Plaintiffs' analysis overlooks that in Kentucky, insurance policies are to be interpreted according to their terms, and *no* rule of adverse construction can be applied to favor an insured *unless* the insured first can demonstrate a policy ambiguity. *Pryor v. Colony Ins.*, 414 S.W.3d 424, 430-31 (Ky. Ct. App. 2013) ("[A] nonexistent ambiguity should not be used to resolve a policy against a company").

State Farm has cited authority clearly holding that when Kentucky law supplies the definition of a term used in a contract, the contractual term is *not* ambiguous. *See* S.F. Br. at 16-20. There is no exception to that rule for insureds or insurance policies – rather, all parties to all contracts are deemed to know the law. *Id.* at 18. Plaintiffs argue that State Farm cannot invoke this rule because it did not cite the ACV Regulation in its policy. *See* Pl. Br. at 41. But the sole case they cite does not support them.

The Kentucky Supreme Court in *v. Shelter Mutual Insurance Company* did *not* hold – as Plaintiffs' suggest – that an insurer must specifically reference a statute or regulation that supplies the definition for terms in its policy. *See* 367 S.W.3d 585, 593 (Ky. 2012). The policy in *Bidwell* expressly invoked "the financial responsibility law," but did not clearly reference how that provision would apply to the insured's coverage. *Id.* at 589-92. The court ruled that the statutory reference the insurer drafted was insufficiently clear, *not* that policies using terms defined by law must include statutory citations. *Id.* at 593.

Plaintiffs' attempt to show ambiguity further fails because they *agree* with State Farm that "actual cash value" *must* be calculated in accordance with Kentucky's ACV Regulation. *See, e.g.*, Pl. Br. 3, 13, 20. Plaintiffs' ambiguity analysis thus relies on exactly the type of "nonexistent ambiguity" that Kentucky rejects. *See Pryor*, 414 S.W.3d at 430-31.

Moreover, Plaintiffs cannot demonstrate that their proposed interpretation of "replacement cost less depreciation" is reasonable. As demonstrated above, their formulation requires payments exceeding market value, which conflicts with Kentucky law and the ACV Regulation. *See* discussion *supra*. And Plaintiffs' construction of ACV further posits a situation that never happens in the real world – insureds hiring workers to repair their homes with used nails, decayed shingles, and other deteriorated building materials. *See* UP Br. 16 ("[Y]ou cannot buy and install a used roof, or used roofing material"). Such "fanciful" interpretations of policy language are insufficient to demonstrate a real ambiguity. *See, e.g.*, *True v. Raines*, 99 S.W.3d 439, 443 (Ky. 2003) ("Only actual ambiguities, not fanciful ones, will trigger application of" the reasonable expectations doctrine).

B. The ACV Language in Plaintiffs' Policies is Not an Exclusion Subject to Adverse Construction.

Plaintiffs' authorities applying strict construction against insurers when construing policy exclusions or limitations on coverage also are inapt. First, each applied adverse construction based on a policy ambiguity, which Plaintiffs cannot show here. *See St. Paul Fire & Marine Ins. Co. v. Powell-Walton-Milward, Inc.*, 870 S.W.2d 223, 225 (Ky. 1994) (construing policy exclusion in insured's favor where it was susceptible of more than one meaning); *Eyler v. Nationwide Mut. Fire Ins. Co.*, 824 S.W.2d 855, 859 (Ky. 1992) (same); *Bidwell*, 367 S.W.3d at 589-93 (Ky. 2012) (similar). Second, each involved a coverage *exclusion* (*i.e.*, the insurer

denied the claim or argued that its liability was limited). Here, State Farm *accepted* coverage of Plaintiffs' losses and issued ACV payments to them, and no policy exclusion is being applied.

C. Ambiguity is Not Established by the Differing Results in *Brown* and *Bailey*.

Nor do the differing conclusions regarding "labor depreciation" reached here and in *Brown* demonstrate ambiguity in Plaintiffs' policies, as they wrongly contend. *See* Pl. Br. at 21, 38, 40. Plaintiffs cite *Auto-Owners Ins. Co. v. Goode*, 294 S.W.3d 32, 37 (Ky. Ct. App. 2009), but the court there independently analyzed whether an ambiguity was present. A contract may be found unambiguous *despite* conflicting decisions on that issue. *See Cincinnati Ins. Co. v. Motorists Mut. Ins. Co.*, 306 S.W.3d 69, 73, 79 (Ky. 2011) (finding policy provision unambiguous despite the existence of conflicting decisions on that question); *see also* Ass'n Br. 15 n.3.

D. The Two-Step Loss Settlement Provision in Plaintiffs' Policies Further Forecloses Plaintiffs' Interpretation of ACV.

As Plaintiffs concede, their policies provide that State Farm owes payment of replacement cost only after an insured completes repair or replacement of his or her damaged property. Pl. Br. 3. That further precludes acceptance of Plaintiffs' interpretation of "actual cash value," which would require up-front payment of labor costs *before* repair.

In a footnote, Plaintiffs assert that their policy interpretation preserves a proper distinction between the ACV and replacement cost benefits because their "step one" payment still allows depreciation of the cost of materials. *See* Pl. Br. 42 n.17. But half-honoring the distinction between ACV and replacement cost benefits is not sufficient. Until repair is complete, it is the *insured* who bears the portion of a loss attributable to the depreciated value of insured property. *See LaBrier*, 872 F.3d at 575; S.F. Br. 33-36. As the Court in *Papurello* succinctly stated when analyzing policies identical to Plaintiffs', the two-step loss settlement language in the policies "*compels the … conclusion*" that the cost for labor to replace damaged property is not owed with an ACV payment. *Papurello*, 144 F. Supp. 3d at 770 (emphasis supplied).

CONCLUSION

For all the reasons set forth above and in its Opening Brief, State Farm Fire and Casualty Company respectfully requests that the Court reverse the district court's order denying State Farm's motion to dismiss.

Dated: April 26, 2018

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CERTIFICATE OF COMPLIANCE

Pursuant to Federal Rule of Appellate Procedure 32(a)(7)(C) and Sixth Circuit Rule 32(a) and (b), I hereby certify that according to the word count of the word-processing system used to prepare the brief, this Reply Brief of Appellant contains 6,428 words, exclusive of the corporate disclosure statement, table of contents, table of authorities, statement with respect to oral argument, designation of relevant district court documents, and certificates of counsel.

Dated: April 26, 2018

/s/ *Heidi Dalenberg*
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CERTIFICATE OF SERVICE

I hereby certify that on April 26, 2018, I filed a copy of the foregoing REPLY BRIEF OF APPELLANT electronically using the Court's CM/ECF system, which will automatically generate notice of this filing to all counsel of record. Parties may access this filing using the Court's CM/ECF system.

Dated: April 26, 2018

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