

**IN THE MISSOURI COURT OF APPEALS  
WESTERN DISTRICT**

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**Appeal No. WD84816**

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**Cynthia M. Franklin,**

**Respondent,**

**v.**

**Lexington Insurance Company,**

**Appellant.**

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**Appeal from the Circuit Court of Jackson County, Missouri  
The Honorable S. Margene Burnett  
Case Number 1816-CV04397**

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**APPENDIX TO UNITED POLICYHOLDERS' AMICUS CURIAE BRIEF**

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## APPENDIX

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# APPENDIX 1



# Depreciation Basics

Here are three terms that will help you understand how depreciation works in connection with insurance claims. Your insurer may depreciate both your “stuff” and your dwelling.

**Depreciation:** The loss in value from all causes, including age, wear and tear.

**Replacement cost:** The “new” price of what it would cost to actually repair or replace a damaged or destroyed item. Most policies these days are “REPLACEMENT COST” (“RC”) policies because they’re supposed to cover the cost of replacing what you have lost. To collect the full amount you’re entitled to under an RC policy, you have to actually replace the items and send the receipts to the insurer with a demand for the balance they owe you. Insurers don’t volunteer to pay – you insist.

**ACV (Actual Cash Value):** The “old” price of an item as it was pre-loss, sometimes explained as the price a willing buyer would have paid you immediately before the event that caused your loss. Some policies limit payouts to “ACV” and that’s all they pay. If you’ve got an ACV policy, you’ll probably need to argue for less depreciation to be taken on major items, but once the check is cut, that’s all you will get, regardless of what it costs to actually replace what you had.

## THE DEPRECIATION PROCESS

The “normal” contents claim process is: the claimant (with help from an adjuster) prepares a detailed list of every single damaged or destroyed item noting approximate age, value, and replacement cost. The adjuster/insurer depreciates certain items to account for their age and wear and tear, and cuts a check for what’s called “ACTUAL CASH VALUE” (“ACV”) of the entire inventory. (Often the depreciation that the adjuster/insurer applies to your item is excessive). Once you replace items your insurer generally owes you the balance between the ACV and what it actually cost you to replace or repair (subject always to your individual policy’s wording and limits.)

If you replace everything you lost and submit receipts to your insurer with a demand for the balance due, you’ll be fully reimbursed and the excessive depreciation won’t matter. But most people can’t and don’t replace everything they lost, so depreciation does matter.

The most important thing to understand about depreciation is that **it is subjective and you can refuse to accept excessive depreciation**. To recover the full benefits you’re entitled to under your policy, negotiation is the name of the game.

## FAQs

**Q: Why is my insurance adjuster depreciating my contents items when I have a replacement cost policy?**

**A:** Because there is language in your policy that lets them do that. For most items, once you replace and submit proof, they must pay you the difference between the depreciated amount they paid and what you spent.

**Q: You mean I have to pay out of pocket before I get reimbursed?**

A: That's right.

**Q: Why such a complicated process?**

A: The process deters fraud and allows your insurer to pay out less than they really owe. Most people don't end up replacing everything lost so it works to the insurer's advantage.

**Q: What are the rules for how much and which things get depreciated?**

A: Depreciation should be reasonable, not excessive. Depreciation is subjective. [The IRS publishes depreciation guides](#); [United Policyholders publishes a depreciation guide](#), and [industry publications offer depreciation guides](#). The bottom line is you need to resist excessive depreciation by arguing back and providing proof of the value and condition of your lost or damaged items.

**Q: Are there laws or regulations that relate to depreciation?**

A: This varies state by state. California, for example, has the following law:

Fair Claim Settlement Practices Regulations: §2695.9 (f) When the amount claimed is adjusted because of betterment, depreciation, or salvage, all justification for the adjustment shall be contained in the claim file. Any adjustments shall be discernable, measurable, itemized, and specified as to dollar amount, and shall accurately reflect the value of the betterment, depreciation, or salvage. Any adjustments for betterment or depreciation shall reflect a measurable difference in market value attributable to the condition and age of the property and apply only to property normally subject to repair and replacement during the useful life of the property. The basis for any adjustment shall be fully explained to the claimant in writing.

(1) Under a policy, subject to California Insurance Code Section 2071, where the insurer is required to pay the expense of repairing, rebuilding or replacing the property destroyed or damaged with other of like kind and quality, the measure of recovery is determined by the actual cash value of the damaged or destroyed property, as set forth in California Insurance Code Section 2051. Except for the intrinsic labor costs that are included in the cost of manufactured materials or goods, the expense of labor necessary to repair, rebuild or replace covered property is not a component of physical depreciation and shall not be subject to depreciation or betterment.

**Q: How do I resolve a dispute between me and the adjuster/insurer over depreciation?**

A: The same way you resolve any claim-related dispute:

1. Make a specific request for what you feel is a fair resolution and back it up with documentation and your best arguments to support your position.
2. Go up the chain of command at the insurance company, (See UP's tips titled; "Speak UP")
3. File a complaint with your state Insurance Department.
4. If there's enough money at stake, hire professional help. Start at the "[Find Help](#)" section of our website for more information.
5. Mediation and/or Litigation.

**TIPS AND RESOURCES**

**Tip #1: Depreciation is negotiable.** The lower the value an adjuster puts on your property – the less you will be reimbursed by your insurer. There is no agreed-upon schedule or set standard for how much insurers can depreciate your personal property. Insurance adjusters use their own personal views on the value of items plus guidelines on depreciation provided by their employer. It is hard to pin down an adjuster on how they valued your damaged or destroyed items. But these values impact your pocketbook so they are important to challenge if they are unfairly low.

**Tip #2: Age isn't everything. Even if an item was old, it may be in good to excellent condition.**

Be prepared to fight to collect the full value of your possessions, particularly major items, and don't forget to submit receipts and collect full value after you replace items. Although this is no "official" depreciation schedule in common use across the United States, there are resources you can consult. United Policyholders offers a Depreciation Guide that gives you a general idea of the useful life of common household items. Remember – it's only a guide. Your items may be more or less valuable depending on their condition. Another resource is a website designed for insurance company use: [www.claimspages.com](http://www.claimspages.com). This site features a depreciation calculator <http://www.claimspages.com/tools/depreciation>. Again, this is only a tool.

**Tip #3: Negotiate ACV deductions on a case-by-case basis to reflect how worn the items really were.** The furniture in your guest room should be depreciated less than the furniture in your master bedroom because it was used less and was in better shape. – The Replacement Cost and the Actual Cash Value of some items are the same.

**Tip #4: Many items should not be subject to any depreciation.** Examples are: antiques, fine art and jewelry, computer media (CD's, etc.), software, framing, masonry, concrete, insulation, light fixtures. – Some items depreciate faster than others. Examples: electronics, soft furniture, clothes and shoes depreciate faster than hard furniture, washer/dryers, etc.

**Tip #5 If an insurer applies a fixed percentage across all items, challenge them!** Since every item is unique, an insurer must apply a percentage of depreciation specific to each item. This is very time-consuming so some adjusters will try to depreciate all items across the board by a set percentage (30-50% is common) You can either negotiate a much lower percentage (3-5%, for example) or insist that items be depreciated individually.

**Tip #6: Depreciation should be based upon the "Remaining Life Expectancy" of an item – not necessarily the age of the item.** You may have had a guest room in your house with beautiful green shag carpet from 1970. According to the insurer's depreciation schedule, the carpet should have only lasted 5 years. However, in your case, since the room is rarely used, the carpet is in like-new condition. It would be advisable to argue the remaining life expectancy of the carpet is still 5 years and no depreciation should be taken at all. Under the insurer's argument, the carpet wore out 28 years ago and according to their schedule – you would owe them money!

**Tip # 7: Don't accept excessive depreciation of items that are missing or totally destroyed where it's hard to determine the remaining life expectancy.** There have been many cases where items have been stolen and an insurer applies a large percentage – say 75% depreciation on those items. The insurer should be asked how they arrived at their percentage if they did not see the items. How do they know how much life is left in them? Does the insurer really believe that a thief is going to steal an item that only has 25% of its life left? That does not make sense and the insurer should be challenged on that.

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The information presented in this publication is for general informational purposes and is not a substitute for legal advice. If you have a specific legal issue or problem, United Policyholders recommends that you consult with an attorney. Guidance on hiring professional help can be found in the "Find Help" section of [www.uphelp.org](http://www.uphelp.org). United Policyholders does not sell insurance or certify, endorse or warrant any of the insurance products, vendors, or professionals identified on our website.

2/24/22, 8:16 AM

Depreciation Basics - United Policyholders

Source: <https://uphelp.org/claim-guidance-publications/depreciation-basics/>  
Date: February 24, 2022

# APPENDIX 2





## DEPRECIATION OF LABOR

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

December 5, 2014

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

#### ***New Hampshire Subscriber***

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

Two similar cases reached the Oklahoma Supreme Court and were answered within a day of each other in 2002. Both cases involved damage to roofs and an ACV settlement, and both addressed depreciation of labor.

In the first, *Redcorn v. State Farm*, the court said that a "roof is the product of both materials and labor," and so depreciation of labor costs were allowable. But in a dissenting opinion, three justices argued that labor costs should not be depreciated. A roof, they stated, was not a single product consisting of "labor-and-shingles," but was a combination of products (shingles and nails) and a service (labor to install). Labor cannot lose value over time.

One dissenting justice also pointed out that prior to the loss the insured had an installed sixteen-year old roof, and to be indemnified meant he was entitled to the value of the sixteen year old shingles plus the cost of installing them.

The second case before the same court (*Branch v. Farmers Ins.*) also dealt with depreciation of labor. In this instance the court was asked to determine if labor costs for tear-off of a damaged roof could be depreciated, or whether these costs properly should be covered as "debris removal"? In answer to the first question, the court said that labor to install the new roof was a cost the insured was reasonably likely to incur, and so it was rightly included within the meaning of "replacement cost." It followed, then, that labor could be depreciated along with materials.

But having said that, the court noted that homeowners policies contained a separate coverage for debris removal following a covered loss. If a roof were damaged to the extent it had to be replaced, then, said the court, the damaged portion was rubble, or debris. And, if the whole roof had to be torn off to repair or replace the damaged portion, then those torn off pieces must also be considered rubble. Therefore, although the cost of the labor to replace the roof could be depreciated, the cost to remove the debris of the old roof could not.

# APPENDIX 3



**XACTWARE.**  
WHITE PAPER

# Calculating Depreciation for Structural and Personal Property Line Items

5.15.2015

## INTRODUCTION

Xactimate 28 features a powerful depreciation calculator with multiple options to fit your workflow.

There are three options to calculate depreciation: Amount, Percent, or the Age/Condition of the item. When you select Percent or Amount, you can enter the appropriate number in the adjoining field. When you select Age/Condition, you can enter the age in years and select the condition of the item. After this information is entered, Xactimate automatically calculates the depreciation value.

*There are three options to calculate depreciation: Amount, Percent, or the Age/Condition of the item*

## SETTING ESTIMATE-WIDE DEPRECIATION DEFAULTS

To set the depreciation defaults for an estimate, click the Claim Info tab and select Parameters. Depreciation options selected in this window only apply to newly added line items within the estimate. The same options may be set as defaults for all future estimates in User Preferences.

*When you choose to depreciate items by Age/Condition, the calculation is based on information stored in the price list item.*

## DEPRECIATION CALCULATIONS BASED ON AGE/USE

When you choose to depreciate items by Age/Condition, the calculation is based on information stored in the price list item. Each Xactware price list and general quote item contains the item's suggested life expectancy, annual depreciation, and maximum depreciation.

### Determining Average Life Expectancy

Many factors affect the lifespan of a product. For example, the quality of workmanship in the installation or manufacture of the product, how well the product is maintained, weather and climatic conditions (especially for exterior products), and the intensity of use all have an impact on how long a product is used. Providers of life-expectancy data for housing components and personal property either report information using a range from “best case” to “worst case”, or simply provide an “average.” Because the type of data provided by each source can vary, Xactware combines the information into a single average for each line item, and then allows modification to the suggested depreciation through the “Condition” option.

For detailed information about the life expectancy, annual depreciation, and maximum depreciation applied in Xactware price lists, visit the [Xactware Abbreviated Depreciation Information](#) document.

### Determining the Appropriate Condition

The Condition option provides an easy and consistent means to modify the standard suggested depreciation, based solely on the item’s age and condition. When calculating depreciation by age, a simple formula is used that divides the age by the life expectancy. For example, an item that is 10 years old and has an average life expectancy of 20 years, would calculate a suggested average depreciation of 50% ( $10 / 20 = .50$ ). This formula works very well, but assumes a normal or average condition of the item.

Since items are not all used in the same manner or kept in the same condition, Xactware uses standard factors across all items to modify the age calculations described above.

*Depreciation options are subject to a maximum depreciation which will, in most cases, default to 100% unless changed by a user or company.*

| Condition Option | Factor Applied |
|------------------|----------------|
| Average          | 1              |
| Below Average    | 1.4            |
| Above Average    | .6             |
| New              | 0              |
| Replaced         | 0              |

For example, the same item that is 10 years old with a life expectancy of 20 years but has been kept in above average condition would have a depreciation of 30% ( $(10/20)*0.6=0.3$ ).

Depreciation options are subject to a maximum depreciation which will, in most cases, default to 100% unless changed by a user or company.

## AVERAGE LIFE EXPECTANCY DATA SOURCES

### Real Property

Information on life expectancy is obtained from, and used with the express permission of, the National Association of Home Builders (NAHB). NAHB life-expectancy research is documented in their Life Expectancy of Housing Components report. This report was compiled from extensive research with manufacturers, installers, contractors, and home inspectors. It is widely used within the housing industry, and referenced on many sites such as the Housing and Urban Development site ([www.huduser.org](http://www.huduser.org)), The National Institute of Building Services, The Old House Web ([www.oldhouseweb.net](http://www.oldhouseweb.net)), and numerous private home inspection service and insurance agency sites. The report provided by the NAHB is the most comprehensive study available on the life expectancy of housing components.

### Resources Used by the NAHB

The following is a partial list of the resources used by the NAHB in their life-expectancy research:

- Kitchen Cabinet Manufacturers Association
- AFPA Associates of Western Plastics—Laminate Countertops
- Ceramic Tile Institute of America
- Wayne Dalton Corp
- National Wood Window and Door Association
- Raynor Garage Doors
- Brick Institute of America
- Carpet & Rug Institute
- Resilient Floor Covering Institute
- National Wood Flooring Association
- Marble Institute
- Hardwood Plywood Mfrs. Association
- National Terrazzo and Mosaic Association
- Congoleum Corporation
- ACRI Air Conditioning & Refrigeration Institute
- Air Movement & Control Association
- American Gas Association
- American Society of Gas Engineers
- Insulation Contractors Association of America

*NAHB life-expectancy research is documented in their Life Expectancy of Housing Components report. This report was compiled from extensive research with manufacturers, installers, contractors, and home inspectors.*

- North American Insulation Manufacturers Association
- National Stone Association
- American Concrete Pipe Association
- Cast Iron Soil and Pipe Institute
- National Roofing Contractors Association
- Alcoa Building Products
- Association of Wall and Ceiling Industries
- Safety Glazing Certification Council
- Screen Manufacturers Association
- Optimum Window Manufacturing

*Xactware uses the Joint Military Industry Depreciation Guide (JMIDG) for personal property life-expectancy information. The JMIDG has been used for many years by the US military and the private moving industry to place a value on personal property damaged during a move.*

### Personal Property

Xactware uses the Joint Military Industry Depreciation Guide (JMIDG) for personal property life-expectancy information. The JMIDG has been used for many years by the US military and the private moving industry to place a value on personal property damaged during a move.

Xactware incorporates the information published by the GSA as a public resource.

### CONCLUSION

In summary, Xactware's goal is to provide the most complete and up-to-date building cost and personal property replacement data available in the claims industry. It is important to note, however, that the depreciation information stored with each line item is based on average information gathered from various sources. Users should view this information as a suggestion and modify it as needed.

Actual condition of the item should always be taken into account by the estimator to ensure that the appropriate depreciation is applied, whether by a straight percentage, dollar value, or using the age-based calculations provided by Xactware.



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# APPENDIX 4



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### MISSISSIPPI INSURANCE DEPARTMENT BULLETIN 2017-8


#### DEPRECIATION OF LABOR EXPENSES IN PROPERTY LOSS CLAIMS

It is the purpose of this Bulletin to provide the position of the Mississippi Insurance Department regarding the depreciation of labor expenses by an insurer in the adjustment of property loss claims.

There is no statutory law in Mississippi prohibiting the practice of labor depreciation in the adjustment of property loss claims. If such a practice is used, the insurer should clearly provide for the depreciation of labor in the insurance policy. Likewise, if material and/or labor depreciation is applied, the insurer should clearly set out any such depreciation on the claim estimate furnished by the insurer.

This Bulletin shall not apply to automobile physical damage claims.

**ISSUED** this the 4th day of August, 2017.

  
\_\_\_\_\_  
MIKE CHANEY  
COMMISSIONER OF INSURANCE



## MISSISSIPPI INSURANCE DEPARTMENT

**MIKE CHANEY**  
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State Fire Marshal

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MIKE CHANEY  
COMMISSIONER OF INSURANCE

# APPENDIX 5



English (United States)



- Solutions
- Products
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- Resources
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[Company](#) > About Xactware

## About Xactware

Xactware Solutions provides computer software solutions for professionals involved in estimating all phases of building and repair.

In 1986, Xactware opened for business with Xactimate, its flagship estimating system. Xactimate helped contractors and insurance adjusters estimate repairs much faster and more accurately than they ever could before. Since then, Xactimate has evolved into a high-powered package complete with a patented plan-sketching program, and Xactware has become much more than just Xactimate.



Today 22 of the top 25 property insurance companies in the U.S. and 10 of the top 10 Canadian insurers use Xactware property insurance claims tools. Xactware features software solutions for every phase of a building's life: from remodeling to totally replacing a building, from determining the cost of rebuilding a structure to preserving and repairing a home.

Xactware also provides tools to estimate personal property, emergency repairs, and more. Xactware users can work on a desktop, laptop, tablet, smartphone, or "on the cloud" using browser-based solutions. Estimating products are connected to a comprehensive set of tools that includes an assignment network, analytical reports, cost research, project management, and third-party products. The online training center provides users with high-quality training on Xactware solutions and the construction industry.

Xactware reinvests heavily in research and development as well as in the quality of people who develop its products.

Xactware is a [Verisk Analytics company](#).

*\*Based on the A.M. Best Homeowners Multiple Peril ranking.*

### Solutions

- Claims Estimating
- Contents Estimating
- Pack Out
- Weather Analytics
- Claims Management
- Remodeling Estimating
- Property Preservation
- Job Management
- Policyholder Self-Serve
- Construction Training

### Products

- Xactimate
- XactContents
- ContentsTrack
- Benchmark
- Respond
- XactAnalysis
- XactAnalysis SP
- XactRemodel
- XactRemodel GO
- XactPRM
- Property Pres Wizard
- EstimateON
- ClaimXperience
- Restoration Manager
- Inspection Manager
- Punchlist Manager
- Online Training Center

### Resources

- Case Studies
- Consulting Services
- Image Request
- Online Sketch Gallery
- Pricing Data Services
- Property Reports
- Wallpaper
- Webcasts
- Xactware ID

### Training

- Classroom Training
- Virtual Classroom Training
- Self-Paced Training
- Construction Basics
- Workbooks
- User Certification
- Trainer Certification
- Continuing Education

### International

- Belgium (Netherlands)
- Australia
- Canada (francais)
- Canada (English)
- France
- Germany
- Great Britain

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# APPENDIX 6



Shane Smith ▾ My IRMI Online ? (0)

## Expert Commentary

Home » Expert Commentary

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



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



👤 Mike McCracken  
📁 Personal Lines Insurance

🕒 December 2007

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

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

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

## Turning to California

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

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

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

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

## Turning to Kentucky

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

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

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

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

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

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

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

## Overhead and Profit

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

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

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

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

## Turning to Florida

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

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

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

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

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

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

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# APPENDIX 7

**ACTUAL CASH VALUE GUIDELINES**

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**BUILDINGS**

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**PERSONAL PROPERTY**

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

*6/4/83, gift, purchase*

### 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.<sup>6</sup> 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:

|               |   |
|---------------|---|
| <u>Actual</u> | 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.) |
| <u>Cash</u>   | means ready money; currency or coins.   |
| <u>Value</u>  | 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:

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."<sup>8</sup>

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)."

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:

**Reconstruction Cost  
Less Depreciation -  
Partial Losses**

"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.



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."<sup>13</sup>

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

#### APPLICATION OF APPROACHES IN ESTIMATING ACTUAL CASH VALUE

v

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

**Replacement Cost  
v. Reconstruction  
Cost**

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

**Reconstruction Cost  
Less Depreciation**

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

**Replacement Cost  
Less Depreciation**

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

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



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

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

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.

**Fair  
Market/Economic  
Value**

#### 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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