The loss-settlement provision in a homeowner's insurance policy: It matters

A look at claims payments for loss of dwellings and personal property, including calculations for replacement cost, actual-cash-value and depreciation

By Evangeline Grossman

Regardless of the limits of liability shown on the declaration page, every homeowner's insurance policy contains a loss-settlement provision outlining how the claim will be paid subject to various policy conditions. The loss-settlement provision applies to the replacement cost payment for both the dwelling and the personal property. The provision allows the insurance company to delay full payment of the claim by paying only the actual-cash-value of the loss and, in some instances, forego full payment altogether because the insured does not have sufficient funds to repair or replace.

In order to understand how payments are made by the insurance company, one must understand the concepts of replacement cost, actual-cash-value and depreciation. Many property owners believe that because they have purchased a replacement-cost policy the insurance company will pay them up front for the cost to repair or replace their dwelling and personal property. Unfortunately, this assumption is incorrect.

Each time a piece of personal property is not replaced the insurance company saves money and the insured is not made whole.

Rarely do insurance agents explain the distinction between replacement cost and actual-cash-value coverage, nor do they advise policyholders that some items of personal property such as watches and jewelry must be specially written for an additional premium, otherwise coverage is virtually nonexistent. Between depreciation calculations and policy exclusions the method of payment of policy benefits can create problems to the extent an insured has insufficient funds to complete building repairs and repurchase personal property.

Setting adequate homeowner's policy limits

The first line of defense against the Loss-Settlement provision is establishing correct policy limits. The coverage for replacement or repair of a dwelling should be calculated based on

a square-footage price taking into consideration the quality of materials, size of the home, and construction impediments.

The quality of materials is a huge factor in raising the cost of construction. Marble flooring is significantly more expensive than travertine. Lath and plaster is substantially more costly than drywall. Tile roofing is pricier than shake. The list goes on and on.

Construction impediments arise when a home is difficult to access with equipment due to neighbors, vegetation or environmental conditions. A house situated on a hillside may require caissons or have special soil considerations. And, a house in a gated neighborhood or a high-end community such as Beverly Hills, with rules and restrictions for the staging of construction projects, will affect the bottom line. All of these considerations

must be factored into establishing dwelling limits.

The dwelling limit must be set to 100 percent of the cost to repair or replace without factoring in any sort of extended limits or code-upgrade coverage. The extended limits should only be considered a contingency in case of unanticipated costs. The dwelling limit is particularly important because the limits for other structures and personal property are a takeoff from it with other structures being 10 percent and personal property 70 percent. Even if correct policy limits have been set, payment of the claim is contingent on the policy provisions for replacement cost, actual-cash-value and how depreciation is calculated during the pendency of the claim.

Replacement cost

The definition of replacement cost is the actual cost in today's dollars to repair or replace an item back to pre-loss condition. If an identical item is no longer manufactured or cannot be obtained, replacement cost will be the cost of a new item which is similar to the insured article and of like kind and usefulness. Replacement-cost policies, however, contain a loss-settlement provision that governs the payment of benefits. Replacement-cost benefits are paid on an actual-cash-value basis until the entire property is repaired or replaced.

Under California law an insured is "entitled to receive replacement cost only if she actually repaired the damage." (*Stephens & Stephens XII, LLC v. Fireman's Fund Ins. Co* (2014) 231 Cal.App.4th 1131, 1143.) Nonetheless, most policies allow the insured to first recover on an actual-cash-value basis and later claim the replacement-cost value benefits by satisfying the conditions of coverage (e.g., repair or replacement within a specified number of days after the claim is paid.) In addition, replacement-cost coverage does not require the insured to replace the damaged property at the same location. An insured may recover the replacement-cost benefits for damage to her home by purchasing a different home at another location. (*Conway v. Farmer's Home Mut. Ins. Co.* (1994) 26 Cal.App.4th 1185.)

Because actual-cash-value is paid on a replacement-cost policy until the insured satisfies certain conditions, the focus of all homeowner claims becomes how is actual-cash-value calculated and what is the amount of depreciation applied to the loss?

The actual-cash-value calculation for dwellings

Although property policies provide for payment of dwelling losses based on actual-cash-value, they are either conspicuously silent or misstate how actual-cash-value should be measured. For many years, insurers argued that actual-cash-value should be measured by replacement cost less depreciation. That view was rejected by the California Supreme Court. In 1970, the Court held that "actual-cash-value. . . is synonymous with fair market value." (*Jefferson Ins. Co. v. Superior Court* (1970) 3 Cal.3d 398, 402.)

In *Jefferson*, the insured suffered a fire loss to a hotel building that had a fair market value of $65,000. The insurer and the insured both agreed that the amount of the loss was $24,102.05. The insurer, however, refused to pay that sum, contending the property was substantially underinsured according to a provision in the policy requiring that the building be insured to 70 percent of its actual-cash-value. The insurer argued that actual-cash-value, as used in the policy, did not mean fair-market-value, but rather meant the replacement cost and/or repair cost of the building less depreciation. The replacement cost less a reasonable depreciation factor was approximately $170,000.

The insured on the other hand maintained that the building was sufficiently insured, and that actual-cash-value in the policy referred to fair-market-value. The California Supreme Court agreed and ruled that the term actual-cash-value as used in Insurance Code section 2071 is synonymous with "fair market value," i.e., "the price that a willing buyer would pay to a willing seller, neither being under any compulsion to sell or buy." (3 Cal.3d at 402; see also, *Elliano v. Assurance Co. of America* (1975) 45 Cal.App.3d 1170.)

Case law has since confirmed that in the context of building damage claims "actual-cash-value . . . means fair market value not replacement cost less depreciation." (*Cheeks v. California Fair Plan Ass'n* (1998) 61 Cal.App.4th 423, 426.) Despite the law requiring a fair-market-value analysis, claims adjusters regularly calculate actual-cash-value of a dwelling as the cost to repair or replace less depreciation.

Actual-cash-value for personal property

There is a distinction as to how actual-cash-value should be calculated in the context of a dwelling claim versus a personal-property claim. In the case of a personal-property claim actual-cash-value is calculated by determining the replacement cost of the item and then subtracting depreciation (actual-cash-value = replacement-cost-value – depreciation). In determining the amount of depreciation in a personal-property claim the calculation should be based on physical depreciation, not the age of the item.

In April 2016, a state court trial judge, The Honorable Peter Kirwan, ruled that insurers must consider the physical condition of personal property at the time of a loss when determining the property's actual-cash-value. (*The Doan, et al. v. State Farm General Ins. Co.* (Super. Ct. Santa Clara County, April 20, 2016, No. 1:08-cv-129264).

The Doan is a class-action lawsuit against State Farm General Insurance Company alleging that the company's practice for determining actual-cash-value for personal-property losses violates California law. Very different from the analysis for the method of calculating actual-cash-value in a dwelling claim here in the personal-property context State Farm now argued that actual-cash-value

is interchangeable with the fair-market-value of the personal property at the time of the loss. The policyholders argued the opposite – that actual-cash-value is the cost to replace an item with a new item of like kind and quality, less reasonable depreciation determined by the physical condition of the article at the time of loss.

The Court relied on California Insurance Code section 2051 when ruling in favor of the insureds. The Court held: "State Farm's use of its depreciation guide, based on age and average quality of goods . . . does not comply with Section 2051 (b), because the guide fails to consider the condition of the insured's personal property at the time of the injury . . . [The] evidence at trial [showed] that certain items of personal property were depreciated significantly (50 percent -80 percent) without full consideration of their condition at the time of the loss."

Additionally, the Court found that State Farm General Insurance Company violated the California Code of Regulations by not fully explaining in writing the reason for the company's depreciation of personal property. Although *The Doan* is the decision of a trial court and not binding on other courts in the state, the correct standard for determining actual-cash-value of personal property is articulated and the ruling includes the necessary language to combat excessive depreciation in the claims process.

The difference between the actual-cash-value paid and the replacement-cost-value withheld is referred to as the holdback. The insured cannot get the holdback funds pursuant to a replacement-cost policy until repairs are complete. This withholding of money can leave the insured in a position where they can never obtain the replacement-cost benefits because they do not have sufficient funds to repair or replace from the monies paid.

Physical depreciation, not age, is the standard

Insurance companies are required to comply with the provisions of California Insurance Code section 2051 (b), and the regulations promulgated thereunder, in determining actual-cash-value. Insurance Code section 2051 provides that when an open policy (i.e., a policy under which value is not agreed upon up front but instead determined after a loss) "requires payment for actual-cash-value" for a structure's contents, "the measure of the actual-cash-value recovery" is "the amount it would cost the insured to repair, rebuild, or replace the thing lost or injured less a fair and reasonable deduction for physical depreciation based upon its condition at the time of the injury or the policy limit, whichever is less."

Accordingly, section 2051 permits insurers to make a "fair and reasonable" deduction for "physical depreciation" based on the actual "condition" of the item "at the time of the injury." Physical depreciation refers to the physical wearing out of property; it is a measure of actual wear and tear. California Insurance Code section 2051's limitation of "depreciation" to physical depreciation is consistent with longstanding insurance law throughout the country recognizing that depreciation for actual-cash-value purposes is limited to physical depreciation (wear and tear), and does not include other concepts of depreciation that might be used for tax or accounting purposes.

To protect California insureds from arbitrary or improper deductions for depreciation, the California Code of Regulations, Title 10, Chapter 5 section 2695.9(f) states, in pertinent part, "[w]hen the amount claimed is adjusted for betterment, depreciation or salvage, all justification for the adjustment shall be contained in the claim file . . . The basis for the adjustment shall be fully explained to the claimant in writing." 10 Cal. Code Reg. § 2695.9 (f).

Rather than adjust the items in their true pre-loss condition the insured is presented with a spreadsheet listing the replacement cost, amount of depreciation and actual-cash-value with no explanation as to how the numbers were calculated. Universally insurance companies violate section 2695.9(f) as claim files never contain any justifications for the reason a certain percentage of depreciation is applied to each item claimed.

Because the personal property is lost, damaged or destroyed and not available for inspection in its pre-loss condition, insurance companies typically ignore the physical depreciation standard, typecasting everything as average. The computer programs used by the insurance industry calculate a depreciation percentage based on age and type of item rather than the physical condition of the item.

As discussed in *The Doan*, State Farm uses a standard depreciation method based on criteria not permitted by section 2051 and it does not independently justify the depreciation in the claim file as required by section 2695.9(f). Rather than considering the actual condition of the lost or destroyed personal property, State Farm uses a standard estimating system known as the "Depreciation Guide." State Farm's guidelines calculate depreciation based on age and an "average quality" designation; physical condition at the time of the loss is completely ignored. State Farm applies the depreciation values generated by its depreciation guide in settling all personal-property claims in California. State Farm asserts that its depreciation guide is a proprietary, confidential document and that it does not have to provide the document to its insureds or otherwise explain how it calculated depreciation for the loss.

High-end luxury items experience very little physical depreciation

Traditionally, burglars stole watches, jewelry and high-end electronic equipment from homes. Although the electronics are covered by the full personal-property limits, watches and jewelry are limited to $1,500 unless the items are appraised and specially written for an additional premium. Premiums for scheduled items such as watches and jewelry are normally quite high, which deters homeowners from purchasing the coverage, or the homeowner does not understand the coverage needs to be purchased.

In the last several years, however, thieves have started to take high-end clothing, shoes, purses and luggage because there is now a secondary market for their resale. Burglars know their fashion and routinely steal any items made by designers such as Hermes, Luis Vutton and Christian Louboutin. Purses can be worth in excess of $15,000 and shoes can easily cost over $1,000. The full personal-property limits apply to theft of such luxury articles.

In order to limit payouts on these incredibly expensive personal-property claims insurance companies have begun to rely more and more on the application of steep depreciation. California Insurance Code section 2051's limitation of "depreciation" to physical depreciation is completely ignored and the calculation is based on age and the designation of average condition. However, women who collect high-end fashion items store them meticulously in custom-designed closets and they are rarely used. Some pieces even appreciate in value. In this day and age expensive handbags are often more coveted than jewelry as they are instantly recognizable as a status symbol. Although physical depreciation is often de minimis, claim adjusters continue to apply 50 percent - 80 percent depreciation across the board.

Proving the physical condition of personal property

The best methods to prove the physical condition of personal property is through photographs, receipts, evidence of the way the property was kept, and the use of a personal property appraiser.

Although it is often difficult to locate photographs of furniture and electronic equipment, when it comes to purses, shoes and high end clothing there are usually hundreds of photographs, including many maintained on the insured's own cell phone. Further, most photos are taken when the insured is dressed up and looking his or her best, so it is likely that images of high-end luxury articles will be in the shot.

Receipts are actually less helpful to prove the replacement cost of an item than one would think. A receipt shows the age of the item but not its physical condition at the time of the loss. Receipts also show the purchase price but not the current price to replace with like kind and quality.

An under-used method to prove the physical condition of personal property is to show the claims adjuster the manner in which the property was kept. High-end personal property is normally kept in a high-end closet that is often custom made for the insured's storage needs. A simple photograph of the closet and its carefully designed storage capacity speaks volumes about an article's physical condition. Further, there is a large difference in physical condition when a woman has fifty handbags that she rotates versus two or three she carries day in and day out.

And, finally a personal-property appraiser familiar with personal apparel is necessary to assist with going through the list prepared by the insurance company and determining if the replacement cost assigned and the percentage of the depreciation taken is reasonable. A good personal-property appraiser can opine on whether an item actually appreciates in value, can explain the market for resale of luxury goods and will be of assistance to corroborate the physical condition of items based on the consumption level and storage practices of the insured.

Conclusion

If an item is replaced in the time allowed by the policy, the depreciation previously deducted may be paid up to the amount spent to replace the item. The problem for the policyholder lies in the fact that having to pay the out-of-pocket difference between the depreciated amount paid and the actual cost to replace often results in the item not being replaced. Each time a piece of personal property is not replaced the insurance company saves money and the insured is not made whole.


Grossman

Evangeline Fisher Grossman has been a partner at Shernoff Bidart Echeverria, LLP *since 2007. She has handled thousands of insurance bad-faith homeowner's cases and sues on behalf of both individual policyholders and members of class actions. Most recently she has been litigating multiple residential water-loss cases against State Farm, ServiceMaster and Servpro arising out of the insurance company's vendor programs. She was a finalist for Trial Lawyer of the Year for Consumer Attorneys of California in 2014. She is a graduate of Occidental College and Santa Clara Law School. She can be contacted at egrossman@shernoff.com.*