

A primer on fire-insurance coverage in California

The issues consumers will face as they try to rebuild their homes and lives

By Jeffrey I. Ehrlich

As I write this article, the Palisades and Eaton fires remain substantially uncontained and more than 200,000 people are under evacuation orders. Given the unprecedented destruction caused by these fires, when thousands of homeowners are allowed to return to their neighborhoods, they will find that their houses have been destroyed. This article is a primer on a variety of the insurance issues they will face as they try to rebuild their homes and their lives.

Perhaps the single bright spot, albeit a dim one, is that coverage for their losses is unlikely to be in dispute. Unlike hurricane-caused losses, where insurers sometimes claim that the cause of the damage was an excluded peril, like flooding, coverage for fire is built into all California homeowners' policies. These policies are, in fact, "fire policies" under section 102, subdivision (a) of the Insurance Code, which provides that "[f]ire insurance includes ... [i]nsurance against loss by fire, lightning, windstorm, tornado, or earthquake."

Section 2070 of the Insurance Code requires that all fire policies be written on the "standard form," which is set forth in Insurance Code section 2071. The insuring clause of the standard form requires the policy to "insure ... against all loss by fire [and] lightning." (*Ibid.*) Insurers may issue policies that have terms that do not include the terms mandated by the standard form, but if they do, those provisions must be substantially equivalent to or more advantageous to policyholders than the terms mandated by the standard form. (*Ibid.*)

Since coverage is unlikely to be in dispute, there are two topics that will be of paramount importance, the policy's loss-settlement provisions and its coverage for "additional living expenses" or "ALE."

Additional Living Expenses (ALE)

ALE coverage is intended to provide the policyholder with coverage for the costs of additional living expenses, such as food and lodging, which are incurred because the insured dwelling has been rendered uninhabitable because of a covered peril. Coverage for ALE is not mandated by the standard form. But it is very common in homeowners policies. If the policy provides ALE coverage, and the loss is incurred by a declared state of emergency (as the fires in Los Angeles are), then the ALE coverage must be for not less than 24 months but is subject to the policy provisions.

If the policyholder requests an extension of up to 12 additional months because of delays beyond the policyholder's control in the reconstruction process, including construction-permit delays, lack of needed construction materials, or lack of available contractors, the insurer must grant the extension. (Ins. Code, § 2060, subd. (b)(1).) And "additional extensions of six months shall be provided to policyholders for good cause." (*Ibid.*)

Loss settlement

The "loss settlement" provisions of the policy deal with how the insurer determines how much to pay the policyholder after a covered loss. They are typically found in the "conditions" section of the policy. The two most common types of loss-settlement methods in fire policies are "actual cash value" (ACV) and "replacement-cost value" (RCV). These terms are specifically defined in Insurance Code sections 2051 and 2051.5.

Section 2051 provides that for a policy that provides for payment of ACV (which is what the standard form provides) the measure of ACV "shall be 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."

Section 2051.5, subdivision (b)(1) states that, for a policy that provides RCV coverage, "the measure of indemnity is the amount that it would cost the insured to repair, rebuild, or replace the thing lost or injured, without a deduction for physical depreciation, or the policy limit, whichever is less."

Section 2051.5 subdivision (b)(2) provides that, if an RCV policy requires the policyholder to repair, rebuild, or replace the damaged property as a condition of collecting the full replacement cost (and most RCV policies do), then the insurer must pay the ACV as though the policy was an ACV policy. Then, after the property is rebuilt, repaired, or replaced, the insured can submit a claim for the difference between the ACV and the RCV, up to the policy limits.

Note: This means that, at least in theory, a policyholder must pay out of pocket for the difference between ACV and RCV before collecting that difference

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after the repair or replacement is completed. Some insurers, however, will advance those funds if requested. And some banks have been willing to lend against the expected insurance payments.

In cases where the cause of the loss is part of an officially declared state of emergency, under Government Code section 8558, the insurer may not impose a time limit to complete the repair, replacement, or rebuilding of less than 36 months. And these deadlines are subject to one or more extensions of six months for the same reasons that ALE can be extended. (Ins. Code, § 2051.5, subd. (b)(2).)

Where there has been a total loss to the insured dwelling, the policyholder may use the policy proceeds, up to the amount of RCV (but not more than policy limits) to rebuild at a new location or to purchase an existing home at a new location. (Ins. Code, § 2051.5, subd. (c)(1).)

If the policyholder chooses to rebuild in a new location, the amount owed under the policy "shall be the amount that would have been recoverable had the insured dwelling been rebuilt at its original location." (*Id*., subd. (c)(2).) And under this option, the insurer may not deduct from the amount owed to the policyholder the value of the land at the new location. (*Ibid*.)

Appraisal

The standard form provides that, if the insurer and the policyholder cannot agree on the value of the ACV or of the loss, then either party may make a written demand for the dispute to be resolved by appraisal. (Ins. Code, § 2071.) Appraisal is a form of arbitration. (See *Devonwood Condominium Ass'n v. Farmers Ins. Exch*. (2008) 162 Cal.App.4th 1498, 1505.) As provided in the standard form, when an appraisal is used to value a loss, each side will appoint an appraiser, and the two appraisers will then collectively select an umpire. (Ins. Code, § 2071.) The appraisal process is limited to determining the *value* of the loss, or of items claimed to have been damaged; it cannot be used to determine disputed issues of coverage under the policy, or other issues such as causation. (*Lee v. California Capital Ins. Co*. (2015) 237 Cal.App.4th 1154, 1166.)

When the policyholder's loss is the result of a "government declared disaster" under the Government Code, then either party may request appraisal, but appraisal cannot be compelled over the other party's objection.

Policy limits/under-insurance

As noted above, the policy limit generally provides the upper limit on the amount that the insurer will pay under an RCV policy to repair, replace, or rebuild the damaged dwelling. In the past, to make their product more attractive to shoppers, insurers would offer "guaranteed replacement cost" coverage. As its name suggests, this type of coverage would pay RCV regardless of the actual amount necessary to repair, replace, or rebuild the damaged property. In effect, it had no policy limit. This type of coverage has not been sold by insurers in California for many years.

Instead, many insurers offer something called "extended replacement cost" coverage. Extended replacement-cost coverage provides indemnity up to a specified percentage (e.g., 10%) or specific dollar amount above the policy limit.

Older cases have held that it is *not* the insurer's responsibility to determine the correct amount of coverage for the policyholder. For example, in *Everett v. State Farm Gen. Ins. Co*. (2008) 162 Cal.App.4th 649, 660-661, the court explained:

> Insurance Code sections 10101 and 10102 do not require State Farm to set policy limits that equal the cost to replace the property. Nor is State Farm duty bound to set policy limits for insureds. It is up to the insured to determine whether he or she has sufficient coverage for his or her needs. In fact, the California Residential Property Insurance Disclosure statement provides that it is the insured's burden to obtain sufficient coverage: "To be eligible to recover extended replacement cost coverage, you must insure the dwelling to its full replacement cost at the time the policy is issued, with possible periodic increases in the amount of coverage to adjust for inflation...." Additionally, the insured "must notify the insurance company about any alterations that increase the value of the insured dwelling by a certain amount...."
>
> Each year that Everett had her insurance with State Farm, State Farm sent renewal certificates. These certificates reminded Everett that the replacement cost figure identified by State Farm was merely an estimate, and that it was her responsibility to determine whether her property was adequately insured. Thus, contrary to Everett's contention that it was State Farm's duty to maintain policy limits equal to replacement cost, Everett bore such duty.

As explained below, given recent changes in the Insurance Code, this analysis may no longer be accurate. But first, a word about the disclosure referenced in the *Everett* decision. In 2010, the Legislature started to require insurers who insure residential property to issue a mandatory disclosure to the policyholder every other year, upon renewal of the policy. (Ins. Code, § 10102.) The disclosure explains the type of coverage provided by the policy. The stated goal of the disclosure was to alert policyholders to the need to maintain policy limits that were adequate to ensure that they could rebuild their dwelling after a disaster.

The Legislature has updated the disclosure several times since 2010. The current disclosure includes the following information:

> INFORMATION YOU SHOULD KNOW ABOUT RESIDENTIAL DWELLING INSURANCE
>
> AVOID BEING UNDERINSURED: Insuring your home for less than its replacement cost may result in your

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having to pay thousands of dollars out of your own pocket to rebuild your home if it is completely destroyed. Contact your agent, broker, or insurance company immediately if you believe your policy limits may be inadequate.

THE RESIDENTIAL DWELLING COVERAGE LIMIT: The coverage limit on the dwelling structure should be high enough so you can rebuild your home if it is completely destroyed.

Please note:

The cost to rebuild your home is almost always different from the market value.

• Dwelling coverage limits do not cover the value of your land.

The estimate to rebuild your home should be based on construction costs in your area and should be adjusted to account for the features of your home. These features include, but are not limited to, the square footage, type of foundation, number of stories, and the quality of the materials used for items such as flooring, countertops, windows, cabinetry, lighting, and plumbing.

The cost to rebuild your home should be adjusted each year to account for inflation.

Coverage limits for contents, separate structures, additional living expenses, and debris removal are usually based on a percentage of the limit for the dwelling. If your dwelling limit is too low, these coverage limits may also be too low.

You are encouraged to obtain a current estimate of the cost to rebuild your home from your insurance agent, broker, or insurance company or an independent appraisal from a local contractor, architect, or real estate appraiser. If you do obtain an estimate of replacement value and wish to change your policy limits, contact your insurance company. While not a guarantee, a current estimate can help protect you against being underinsured.

DEMAND SURGE: After a widespread disaster, the cost of construction can increase dramatically as a result of the unusually high demand for contractors, building supplies, and construction labor. This effect is known as demand surge. Demand surge can increase the cost of rebuilding your home. Consider increasing your coverage limits or purchasing Extended Replacement Cost coverage to prepare for this possibility.

CHANGES TO PROPERTY: Changes to your property may increase its replacement cost. These changes may include the building of additions, customizing your kitchen or bathrooms, or otherwise remodeling your home. Failure to advise your insurance company of any significant changes to your property may result in your home being underinsured.

(Ins. Code, § 10102.)

All of this is valuable information, but in practice, few policyholders read it, and those who do are usually unable to accurately assess whether their policy limits are sufficient to allow them to rebuild. And even if they do pick limits that would be adequate when they purchase the policy, as the disclosure explains, after a major disaster when hundreds or thousands of homes are destroyed, the resulting demand for competent contractors and construction materials will drive the prices so high that even well-insured policyholders may not have sufficient limits.

In past litigation arising from fire disasters, a frequently litigated issue was whether the insurer or insurance agent could be held responsible, generally on a negligence theory, for setting the limits too low. For the most part, those efforts proved unsuccessful.

But the outcome of this issue in future cases may differ based on relatively recent changes to the Insurance Code, which were designed to try to avoid underinsurance. For example, in 2018, the Legislature added section 10103.4 to the Insurance Code. It requires insurers who provide RCV coverage, with certain exceptions, to provide an estimate of the replacement cost that complies with certain specified requirements in Title 10 of the California Code of Regulations. This estimate must be provided every other year, when the insurer offers to renew the policy. (Ins. Code, § 10103.4, subd. (a).)

It is important to note, however, that subdivision (d) of section 10103.4 states, "This section is not intended to change existing law with respect to the duty of the policyholder or applicant to select the coverage limits for a policy of residential property insurance."

The regulations referenced in section 10103.4 include 10 CCR § 2695.183, titled "Standards for Estimates of Replacement Value." The regulation requires that an insurer's estimate of RCV must include the expenses that would reasonably be incurred to rebuild the insured structure(s) in its entirety, including, at least:

(1) Cost of labor, building materials and supplies;
(2) Overhead and profit;
(3) Cost of demolition and debris removal;
(4) Cost of permits and architect's plans; and
(5) Consideration of components and features of the insured structure, including at least the following:
(A) Type of foundation;
(B) Type of frame;
(C) Roofing materials and type of roof;
(D) Siding materials and type of siding;
(E) Whether the structure is located on a slope;
(F) The square footage of the living space;
(G) Geographic location of property;
(H) Number of stories and any nonstandard wall heights;
(I) Materials used in, and generic types of, interior features and finishes, such as, where applicable, the type of heating and air conditioning system, walls, flooring, ceiling, fireplaces, kitchen, and bath(s);
(J) Age of the structure or the year it was built; and

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(K) Size and type of attached garage.

In addition, the estimate must be based on the cost to rebuild the single property being evaluated, as opposed to the cost of building multiple or tract dwellings. (*Id.*, § 2695.183(b).)

Critically, the insurer must, no less frequently than once a year, "take reasonable steps to verify that the sources and methods used to generate the estimate of replacement cost are kept current to reflect changes in the costs of reconstruction and rebuilding, including changes in labor, building materials, and supplies, based upon the geographic location of the insured structure. The estimate of replacement cost shall be created using such reasonably current sources and methods." (*Id.*, § 2695.183(e).)

If the insurer requires its broker-agents to use a specific source or tool to use to prepare RCV estimates, the insurer must prescribe complete written procedures to be followed by the broker-agent when using the sources or tools; must provide the broker-agent with training and written materials necessary for the broker-agent to properly use the tools or sources in conformity with the insurer's prescribed procedures; and "the insurer, and not the broker-agent, shall be responsible for any noncompliance with this Section 2695.183 that results from the failure of the estimate to satisfy [these prescribed] requirements unless that noncompliance results from failure by the broker-agent to follow the insurer's prescribed written procedures when using the source or tool." (*Id.*, § 2695.183(k).)

As with the statute it supports, the regulation contains a disclaimer: "No provision of this article shall be construed as requiring a licensee to estimate replacement cost or to set or recommend a policy limit to an applicant or insured. No provision of this article shall be construed as requiring a licensee to advise the applicant or insured as to the sufficiency of an estimate of replacement cost." (*Id.*, § 2695.183(m).)

Given the extent of the destruction caused by the Palisades and Eaton fires, which appear to have wiped entire communities off the map, it is likely that the *demand surg*e will be particularly high. Based on my experience in litigating prior wildfire cases, it is likely that most policyholders will be underinsured. I would expect that policyholders will argue that these provisions require the insurers to take reasonable steps to ensure that the RCV estimates they provide are adequate to prevent any significant under-insurance. And the insurers will point to the disclaimers to argue that the ultimate responsibility for setting the policy limit falls on the policyholder. I think it's too early to hazard a guess on how this issue will shake out.

For those who were not impacted by the fires, it would likely be a good idea to call your insurer and increase your limits substantially.



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