

Commissioner's Bulletin # B-0045-98

June 12, 1998

To: ALL PROPERTY AND CASUALTY INSURANCE COMPANIES

Re: Calculation of Actual Cash Value Under the Texas Standard Homeowner's Policy - Form B

The Department has learned that one or more insurers have interpreted language in the Texas Standard Homeowner's Policy - Form B to permit the deduction of contractor's overhead and profit, in addition to depreciation, from replacement cost in calculating actual cash value. This interpretation has generated two class action lawsuits and inquiries to the Department regarding the Department's position on this matter. The insurers are interpreting the following Loss Settlement provision of the Texas Homeowners Policy - Form B:

We will pay only the actual cash value of the damaged building structure(s) until repair or replacement is completed.

The purpose of this bulletin is to state the Department's position that actual cash value of a structure under a replacement cost policy, when the insurer does not repair or replace the structure, is the replacement cost with proper deduction for depreciation. The deduction of prospective contractors' overhead and profit and sales tax in determining the actual cash value under a replacement cost policy is improper, is not a reasonable interpretation of the policy language, and is unfair to insureds.

The Department's position is based on the following:

-- Indemnity is the basis and foundation of insurance coverage. The objective is that the insured should neither reap economic gain nor incur a loss if adequately insured. This objective requires that the insured receive a payment equal to that of the covered loss so that the insured will be restored to the same position after the loss as before the loss. The calculation of this payment results in under-compensation if an insurer deducts prospective contractors' overhead and profit and sales tax in determining the actual cash value under a replacement cost policy. Conversely, the inclusion of contractor's overhead and profit and sales tax on building materials does not over-compensate an insured for the amount of the loss because these items represent part of the insured's loss. Generally, the objectives of indemnity will be met if actual cash value is calculated as replacement cost with proper deduction for depreciation. In the rare situation that defies calculation of actual value on this basis, such as cases in which the structure has historical significance or the materials cannot reasonably be replaced, other factors may be considered. However, there is no situation in which the deduction from replacement cost of depreciation and contractor's overhead and profit and/or sales tax on materials will be the correct measure of the insured's loss.

--Premiums charged must not be excessive for the risks to which they apply. Under a replacement cost policy, the liability limits of the policy and the premium paid by the insured are determined on the basis of the replacement cost of the structure. The value of contractor's overhead and profit, as well as sales tax on building materials, has been included in the limit of liability for which the insured has paid premium. If the insurer in determining actual cash value excludes costs that are included in the determination of liability limits, on which the insured's premium is based, the insurer reaps an illegal windfall because the insurer receives premium on insurable values for which loss may never be paid.

--To deduct costs other than depreciation from the estimated replacement cost of the damaged structure is contrary to historical industry norms and practices. Historically, insurers have determined actual cash value on the basis of repair or replacement cost less depreciation. Only recently have some insurers deducted contractor's overhead and profit and sales taxes on building materials. There has been no recent change in the language in the promulgated residential property policies to support such a change in determining actual cash value.

--The insurers' argument that the cost of contractor's overhead and profit and sales tax on building materials should be excluded from an actual cash value loss settlement because the insured has not incurred these expenses is not persuasive. Using this logic, an insured who opts not to repair or replace damaged property would not incur any of the expenses necessary to repair or replace the damaged property, including the costs of building materials, and would collect nothing under an actual cash value loss settlement. This result would be contrary to the purposes of the subject insurance policy.

The scope of this bulletin is limited to the calculation of actual cash value for dwelling coverage in replacement value policies by use of the practice described herein. This bulletin is not intended to, and does not, express any opinion of the Department as to the calculation of actual cash value in other contexts, such as personal property, or measures of the actual value of such property to the owners of such property.

The Department has concluded that an insurer providing property coverage under replacement cost residential policies that allow for the adjustment of covered losses to structures on an actual cash value basis may not calculate actual cash value on the basis of replacement cost with proper deduction for depreciation, less contractor's overhead and profit, nor may the insurer deduct sales tax on building materials. Any insurer that determines actual cash value on this basis may be subject to disciplinary action for violations of the Texas Insurance Code, including unfair claims practices pursuant to Article 21.21 § 4(10)(a) and Article 21.21-2.

Elton Bomer
Commissioner Of Insurance

