ADJUSTING TODAY

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EDITOR'S NOTE

In the property insurance claim, there is occasional room for debate between policyholders and their insurers. Questions may arise about what to repair or replace, or there can be uncertainty over the fairest and most reasonable methodology used to calculate actual cash value (ACV).

There might also be discussions over which expenses contribute to an ACV estimate — labor, materials and one that readers of our feature article might find particularly interesting and useful — general contractor overhead and profit (GCO&P).

In this issue of Adjusting Today, *attorney and first-party property insurance expert Edward Eshoo Jr. takes on those insurers that "... withhold, exclude, deduct or fail to include the costs of general contractor overhead and profit, GCO&P, in their calculation of the repair or replacement cost ..."*

Citing compelling case law, state insurance commissioner bulletins, and accepted insurance industry practices, Eshoo brings us an insightful discussion of the various conditions and circumstances that support the inclusion of GCO&P in the cost to repair or replace.

We hope you find this information helpful.

Sheila E. Salvatore
Editor

Overhead & Profit:
Its Place in a Property Insurance Claim

By Edward Eshoo Jr.

An interesting discussion is now taking place in the insurance industry over general contractor overhead and profit and its rightful place in the property insurance claim.

The terms "repair cost" or "replacement cost" are not clearly defined in the typical property insurance policy. Nevertheless, no reasonable property insurer would dispute that labor and materials are elements comprising repair or replacement cost. But what about general contractor overhead and profit? Before answering this question, it helps to have a clearer understanding of the role of the general contractor and exactly what falls into the category of general contractor overhead and profit.

A general contractor oversees the entire construction project, a role that includes, among other responsibilities, hiring the required trades (carpentry, masonry, plumbing, electrical, etc.); sequencing, coordinating and supervising their work; researching zoning requirements; and obtaining necessary permits. Overhead expenses represent those costs incurred by a general contractor to operate its business, but are not attributable to any one specific job.

Some examples of overhead expenses are:

- general and administrative expenses
- office rent and utilities
- office supplies
- salaries and benefits for office personnel
- depreciation on office equipment
- licenses
- advertising

Every general contractor is entitled to a profit, which is defined as the difference between the cost of goods and the price for which they are sold. Overhead and profit, which vary significantly in the construction industry from general contractor to general contractor, is expressed as a percentage of the total construction cost. The overhead and profit percentage commonly utilized in the insurance industry is 20 percent of the estimated repair or replacement cost.

While most property insurers provide replacement cost coverage, rarely are they contractually obligated to pay more than actual cash value ("ACV") as of the time of the loss unless and until the damaged or destroyed structure is actually repaired or replaced. Since the term is usually undefined in the typical property insurance policy, courts have developed three primary rules to measure ACV.

Some courts apply a "market value" rule: the difference between the market value of the property before and after a loss. This rule applies the criterion of what a willing buyer would pay and what a willing seller would accept for the property on a cash sale in a free and open market.

Other courts apply a "broad evidence" rule, in which consideration is given to every fact and circumstance that logically tends to establish a correct estimate of the value of the property, such as: its original cost; its replacement or reproduction cost; its market value; income derived from its use; its age and condition; its obsolescence, both structural and functional; depreciation and deterioration to which it has been subjected; and the opinion of value given by qualified expert valuation witnesses.

A number of courts have rejected both the "market value" and the "broad evidence" rules, instead applying a "replacement cost less depreciation" rule. Under this rule, depreciation is deducted from the estimated cost to repair or to replace damaged or destroyed property to determine its ACV.

Depreciation in an insurance context, which is different than depreciation in an accounting context, is considered the decrease in the actual value of property based on its physical condition, age, use, and other factors that affect the remaining usefulness of the property.

Although there is no express provision in the typical property

Determining ACV

Some courts apply a **"market value"** rule, which is the difference in a free and open market between the market value of the property before and after a loss.

Other courts apply a **"broad evidence"** rule, which considers every logical fact and circumstance in establishing a correct estimate of the property's value. These could include original cost, replacement cost, market value, age and condition.

A number of courts have rejected both of these rules and instead are applying a **"replacement cost less depreciation"** rule. Under this rule, depreciation is deducted from the estimated cost to repair or to replace damaged or destroyed property in order to determine its ACV.

insurance policy authorizing them to do so, some insurers withhold, exclude, deduct or fail to include the costs of GCO&P in their calculation of the repair or replacement cost used to arrive at an ACV estimate and settlement of a claim based on the replacement cost less depreciation rule.

These insurers take the position that the overhead and profit costs of a general contractor are not components of repair or replacement cost unless and until they are actually incurred. They maintain that an insured could receive what amounts to a windfall if permitted to recover a repair or replacement cost that may never actually be incurred.

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However, opposing points of view from respectable insurance industry professionals have been circulating for some time now. Recent case law and two separate state insurance commissioner bulletins, along with long-accepted customs and practices in the insurance industry, conclusively establish that GCO&P should be included in the cost of repair or replacement in order to arrive at an ACV estimate and settlement.

Majority View: Payment Required if Use is Likely

The majority of courts that have considered the issue have concluded that payment of GCO&P is required where the use of a general contractor is reasonably likely in repairing or replacing a covered loss, *even if no general contractor is used or no repair or replacement is made*. The nature and extent of the damage and the number of trades needed to make the repairs are key factors in determining whether use of a general contractor is reasonably likely. This requires some consideration of the degree to which coordination and supervision of trades are required.

A number of cases that went before the courts involved replacement cost policies. However, the policies expressly provided that until the damaged or destroyed property was actually repaired or replaced, the insurer's obligation was limited to an ACV payment. Under the policies in those cases, the insurer also was obligated to make an ACV payment to policyholders irrespective of whether they actually repaired or replaced the damaged or destroyed property. Accordingly, the issue in those cases was the amount the insurer agreed to pay to its insured prior to actual repair or replacement. It agreed to pay ACV, which the courts in those cases decided meant "repair or replacement cost less depreciation."

In the 1994 case of *Gilderman v. State Farm Ins. Co.*, the court stated, "the real inquiry is what is included in repair or replacement costs," which it answered as "any costs that an insured would be expected reasonably to incur in repairing or replacing the covered loss."

"The nature and extent of the damage and the number of trades needed to make repairs are key factors in determining whether use of a general contractor is reasonably likely."

In the more recent case of *Lukes v. American Family Mutual Ins. Co.*, the court observed, "The policy at issue in this case does insure the Plaintiff in 'the amounts it *would cost* to repair or replace covered property with material of like kind and quality ... .' Note that the policy does *not* say, 'the amount which it *did* cost to repair or replace ... .' Thus, the Court rejects the Defendant's argument that it does not have to pay sales tax unless and until the Plaintiff actually replaces the contents."

In its ruling in *Tritschler v. Allstate Ins. Co.*, the court offered some additional perspective on the issue. It wrote that "actual cash value is an estimate of the needed repairs; the determination of actual cash value is not based upon what the insured actually pays to repair or replace the damaged property. Therefore, the amount an insured ultimately spends to make needed repairs, if any, is irrelevant." Finally, as the court concluded in *Mee v. Safeco Ins. Co. of America*, it can hardly be said "that an insured reaps a windfall by obtaining payment of actual cash value determined in a fair and reasonable manner when that is precisely what the insurer has agreed to pay under its policy in advance of actual repair or replacement. No windfall occurs where insureds receive benefits for which they have paid and to which they are entitled, even if repair or replacement costs are not incurred."

Minority View: Payment Not Required Unless Incurred

A minority of courts have rationalized that overhead and profit are "non-damage" factors that have no relation to the value of the damage. In their dim view, these represent only the cost or expense that would be incurred if repair or replacement were involved.

That rationale has been roundly criticized in at least four cases. The "majority view" courts have explained that the estimate of the ACV is just that — an estimate. Certainly, the insured has not incurred the cost of contractor's overhead and profit at this point or, for that matter, the cost of labor or materials. Logically speaking, it makes no more sense to exclude one on the grounds that it is a "non-damage factor" and not the other.

But even more importantly, by applying the "minority view" logic, an insured who opts not to repair or to replace the damaged property would not incur any expenses, including the cost of building materials. As such, the insured would collect nothing under an ACV settlement, thereby rendering coverage illusory.

The two "minority view decisions" — *Karl v. State Farm Fire and Casualty Co.*, and *Snellen v. State Farm Fire and Casualty* — also were based on an application of the "broad evidence" rule, for which there is no single measure of ACV.

As the *Karl* court reasoned, the broad evidence rule is "fatal to the position that, as a matter of law, general contractor's overhead and profit must always be included as part of the ACV in each instance where a general contractor could be necessary to actually complete the repairs."

State Insurance Commissioner Rulings

Quite impressively, the Texas Department of Insurance took action and squarely addressed the propriety of State Farm deducting contractor's overhead and profit from replacement cost when calculating ACV.

In a bulletin issued June 12, 1998, the Commissioner of Insurance strongly articulated the position of the Texas Department of Insurance relative to such practice: "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 Colorado Division of Insurance lent support to that position when it fired off a missive declaring its own stance on the issue. In a June 4, 1998, letter to a State Farm representative, the Colorado Division of Insurance wrote: "Based on the provisions in the policy, and the legal definitions of 'replacement cost,' 'actual cash value,' and 'depreciation' there do not appear to be grounds for State Farm to have refused to pay the 'overhead and profit' which is part of the replacement cost of the property. The 'actual cash value' of the property allows for a deduction for 'depreciation,' but under no legal definition, nor policy definition, is there a provision for a separate deduction for overhead and profit."

Industry Custom and Practice

Textbooks commonly used in the insurance industry include contractor overhead and profit as a component of repair or replacement cost. *Property Loss Adjusting* is a textbook for property claims adjusters published by the Insurance Institute of America for use in its industry-wide insurance designation and certification programs. It lists the following elements as comprising repair or replacement cost:

- materials
- labor and employers' burden
- tools and equipment
- overhead and profit
- miscellaneous direct costs such as permits and taxes

Widely accepted construction estimating publications like *Marshall & Swift/Boeckh*, *RS Means*, and *Sweets* that are used in the insurance industry in estimating the replacement cost of commercial buildings and residential dwellings, define replacement cost to include labor, materials, and contractor's overhead and profit.

To add even further validation, the Property Loss Research Bureau (PLRB), a recognized resource used by insurers in the interpretation of property insurance policy provisions, has taken the position that "contractor's overhead and profit are included in ACV, because they are part of replacement cost." The PLRB concludes that "any estimate of actual cash value should include overhead and profit."

Other industry groups are taking similar positions. *The Fire, Casualty*

> ***"The majority of courts that have considered the issue have concluded that payment of GCO&P is required where the use of a general contractor is reasonably likely in repairing or replacing a covered loss, even if no general contractor is used or no repair or replacement is made."***

& Surety Bulletins (FC&S), a National Underwriter Publication used by insurance professionals in the interpretation of property insurance policy provisions, is one notable example. In response to a question describing the practice of not including the costs of GCO&P as part of an ACV payment, an FC&S editor explained:

"Both [general contractor overhead and profit as well as subcontractor overhead and profit] are to be used in calculating final replacement cost, since they are obviously a part of the function of repairing or replacing the building, and it is from this that the actual cash value settlement is derived."

An FC&S editor applied this same rationale in response to another question about an insurer's refusal to include architect's fees in its replacement cost payment: "When the home was new, the replacement cost on the first policy included the architect's fees, because they were surely included in the purchase price. Rebuilding is no different. The replacement cost of a home includes everything that goes into it — not just the building materials. The architect's fees should be paid as part of replacement cost."

Why GCO&P Always Should Be Included

Arguably, there is no basis for an insurer ever to exclude the costs of GCO&P from the replacement cost calculation that is used in arriving at an ACV estimate and settlement based on the replacement cost less depreciation rule, even if the insured is not reasonably likely to incur such costs.

One reason is that many insurers include the cost of specialty contractor and subcontractor overhead and profit as well as sales tax in its replacement cost and ACV calculations, even if the contractor is not used and even if building materials are not purchased. As a result, many insurers pay for replacement costs policyholders never incur: those being the theoretical expenses of specialty contractors or subcontractors and sales taxes.

Once again it goes back to the simple premise that it is illogical for insurers to include some, but to exclude other, "contingent" expenses in its replacement cost calculation. In *Gilderman*, it was ruled that "All repair or replacement costs are, in theory, 'contingent' prior to being incurred." Likewise, in *Mazzocki*, the court stated, "A replacement cost estimate is equally hypothetical or contingent as to all materials, labor and contractor services."

Additionally, there is no real meaningful distinction between general contractor overhead and profit and that of the specialty contractor/subcontractor. Overhead is overhead and profit is profit.

Furthermore, many insurers include both general and specialty contractor/subcontractor overhead and profit when estimating the replacement cost that determines the limit of liability upon which a policyholder's premiums are based.

As the Texas Department of Insurance so aptly stated in its bulletin, "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."

Let's also not forget that, as a cardinal rule of insurance contract interpretation and construction, if a provision in an insurance policy is subject to more than one reasonable interpretation, then it is ambiguous and must be construed against the insurer and in favor of the insured.

The reasons for this rule are two-fold:

- The intent of an insured in purchasing an insurance policy is to obtain coverage and, therefore, any ambiguity that may jeopardize such coverage should be construed consistent with the insured's intent.

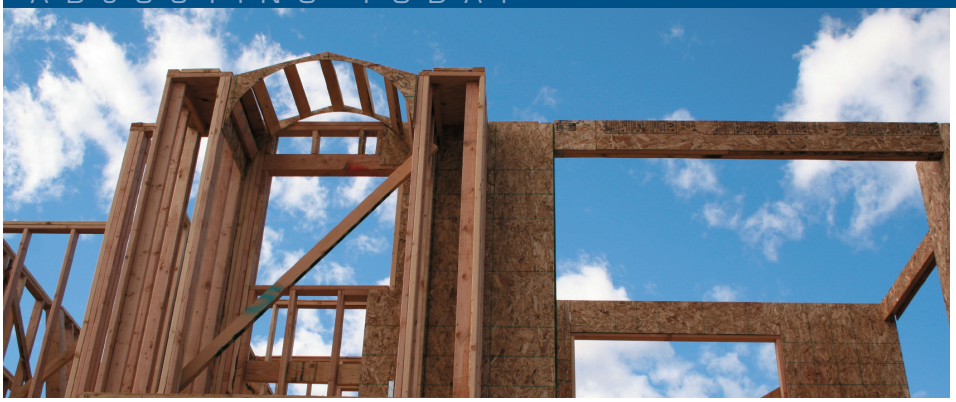
- The insurer is the drafter of the policy and could have drafted the ambiguous provision clearly and specifically.

"Arguably, there is no basis for an insurer ever to exclude the costs of GCO&P from the replacement cost calculation that is used in arriving at an ACV estimate and settlement based on the replacement cost less depreciation rule, even if the insured is not reasonably likely to incur such costs."

Following this analysis, it is a reasonable interpretation of the standard provisions in the typical property insurance policy that the costs of GCO&P should be included in every loss estimated and settled based on the "replacement cost less depreciation" rule. So in accordance with this rule of insurance contract interpretation and construction — a rule designed to protect the insured's reasonable expectation of coverage in a situation in which the insurer-draftsman controls the language of the policy — a court would be required to construe the policy strictly against the insurer and in favor of the insured.

But as insurance industry professionals, let's evaluate this issue in its purest sense. The most fundamental of insurance principles is the principle of indemnity. The role of insurance is to put insureds back into the same position they enjoyed before the occurrence of an insured event.

Now, just as various parts of a property contain building materials whose value cannot be excluded from ACV regardless of whether they are replaced, each part of that property also contains at least some portion of the original general contractor



overhead and profit associated with its construction.

Because some of that value is left at the time of the loss, the loss of that value is, in fact, part of the damage suffered by the insured. A claims practice of excluding, deducting or withholding the costs of GCO&P in these calculations clearly violates the principle of indemnity. Specifically, insureds are not being compensated for the value included in that portion of the general contractor overhead and profit when the property was first constructed.

Conclusion

The inclusion of GCO&P in ACV payments is pervasive and traditional to the insurance industry. Numerous courts of law, the Texas and Colorado departments of insurance and widely accepted insurance publications all acknowledge this fact. They clearly recognize the need to include these expenses in situations where the insured is reasonably likely to incur such costs in repairing or replacing their loss.

Although many insurers routinely pay for GCO&P if more than three trade categories of specialty contractors/subcontractors are needed, a strong argument can be made for including the costs of CGO&P in *every* loss when the replacement cost less depreciation rule is used. At the very least, insureds should receive some compensation for the time spent and the expense incurred while acting as their own general contractor in losses where the services of a general contractor normally would not be utilized.

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AT07-R1 3032