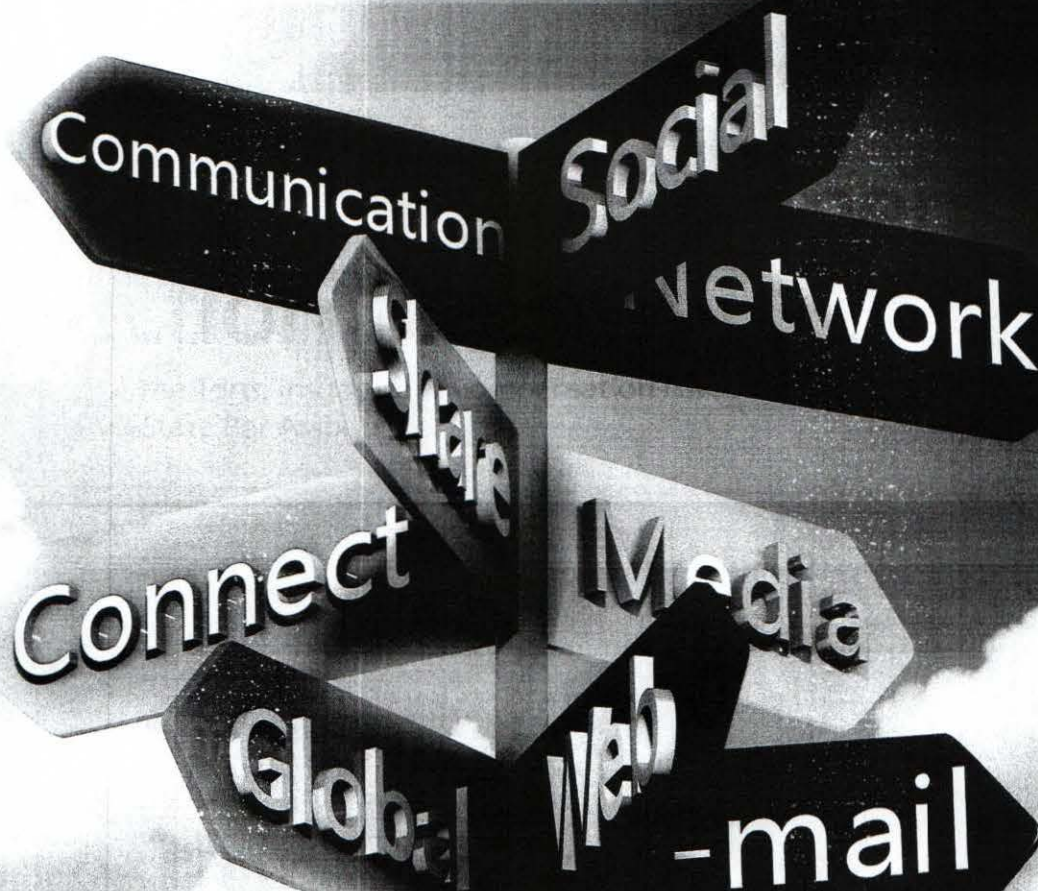


Torts, Insurance & Compensation Law Section Journal



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of the New York State Bar Association



SOCIAL MEDIA

- Do Employers Have the Right to Demand Social Media Passwords from Job Applicants and Employees?
- Ethical Rules Relating to Social Media Investigation and Discovery

Also Inside

- Insurance Recovery After Hurricane Sandy
- Tips for Writing a Good Coverage Letter
- The New Wave of Food Labeling Litigation
- The Right of Publicity
- Expert Disclosure in Motion Practice
- The Prehearing Conference Statement

Table of Contents

Vol. 42, No. 1

	Page
A View from the Chair (Robert F. McCarthy).....	6
Articles	
Do Employers Have the Right to Demand Social Media Passwords from Job Applicants and Employees? If So, Is It Good Practice— and How May the Accessed Information Be Used?	7
(Denine K. Carr)	
Ethical Rules Relating to Social Media Investigation and Discovery	11
(Odette J. Belton)	
Insurance Recovery After Hurricane Sandy: Correcting the Improper Depreciation of Intangibles Under Property Insurance Policies	19
(Don Wood and John Wood)	
Tips for Writing a Good Coverage Letter and Avoiding Common Pitfalls	29
(Dan D. Kohane and Elizabeth A. Fitzpatrick)	
The New Wave of Food Labeling Litigation: Primary Defenses and Practical Considerations	37
(Andrew J. Scholz, Matthew R. Shindell, and Matthew D. Cabral)	
The Right of Publicity: Show Me the Money	41
(James A. Johnson)	
The Adequacy of Expert Disclosure in Motion Practice	45
(David A. Glazer)	
The Prehearing Conference Statement: Necessary or Sheer Redundancy?	50
(Moya M. O'Connor)	
How Does a Brain Injury Qualify as a Grave Injury?	53
(Allison Marley)	
Ethical Boundaries in Settlement Discussions	56
(Eileen E. Buholtz)	

Insurance Recovery After Hurricane Sandy: Correcting the Improper Depreciation of Intangibles Under Property Insurance Policies

By Don Wood and John Wood

Summary

In light of the billions of dollars of insured losses suffered by property owners in the New York area, this is a timely article addressing a significant issue involving the insurance claims process. This article concerns the depreciation of partial losses of insured property. Depreciation is one of the factors that lead to differences between the estimates of a loss prepared by a contractor estimating a job for the policyholder and an adjuster estimating the same job for an insurance company. This subject is of critical importance to all professionals in the insurance industry—from adjusters to contractors, litigators, and policyholders—because the method used to calculate depreciation could lead to drastically different estimates of the value of the loss, and therefore widely divergent settlement expectations. This article lays out and defends a method that is most beneficial to the policyholder, and criticizes the intellectual foundations provided for alternative methods that should otherwise be rejected because they happen to disadvantage the policyholder.

The bottom line is that the cost of intangible items like labor and supervision should never be depreciated. The trend in the insurance industry to apply depreciation to intangible items such as labor for partial repairs defies this general principle of insurance law, as well as common sense. The trend is not a harmless shortcut. Depreciating intangibles and applying blanket depreciation rates inappropriately discounts as much as two-thirds of the items covered under the policy, significantly undermining the value of the settlement and leading to an underpayment of the insured.

There are a variety of methods of applying depreciation, or not allowing it at all in different states. Both state law and the policy must be consulted to settle a loss. Best practices should be adjusted in favor of the policyholder in light of the arguments made in this article.

If the insurance policy is a Replacement Cost Value (RCV) policy, the lowering of the estimate by the depreciated amount on the initial settlement can be a setback even if it can be recovered on completion of the work, since it forces the policyholder to come out of pocket for the amount withheld and then seek reimbursement. There is no question but that many policyholders cannot come up with the difference, which means the RCV policy is effectively settled as an ACV only policy. Excessive depreciation becomes a hindrance to indemnification.

But if the insurance policy is an Actual Cash Value (ACV) only policy, it is even more crucial to apply depreciation properly or the policyholder will never be fully indemnified. If depreciation is applied too severely, the insured may never be able to complete repairs, defeating the purpose of indemnity.

The Meaning of “Depreciation”

Depreciation means the loss in value of real or personal property over time as a result of physical deterioration from age, wear and tear from use, or economic obsolescence. The loss in value due to physical depreciation is deducted from the estimated replacement cost (RCV) of insured property in determining its actual cash value (ACV). This much is clear. What is less clear is the method by which the amount of depreciation is to be calculated. Proper application of depreciation is one of the most confusing parts of calculating a settlement on an insured property loss. Readers should be aware that this form of depreciation is distinct from financial asset remaining life calculations used for tax and accounting, and it is inappropriate to apply the latter form of depreciation in the context of property insurance. Depreciation as we are using it here is distinctly an insurance settlement term.

The Broad Evidence Rule

The manner of applying depreciation to an insured property settlement is the subject of significant potential misunderstanding. It is applied differently by different carriers in different states, and sometimes by different managers and adjusters within the same company and location. A common method of calculating the settlement amount is to subtract Depreciation from Replacement Cost to determine Actual Cash Value of the replaced property. But this is not the only method, and it may not be the best way in every instance. Market Value has also been considered in case of total losses. But now, the Broad Evidence Rule is the most commonly used method for all losses in most states. This rule is a departure from the principle that the traditional actual cash value measurement (replacement cost less depreciation) is the only measure of value at the time of the loss. The Broad Evidence Rule requires consideration of every standard of value that has a bearing on the property—its age, its likely profit, its tax value, etc.—in order to determine the value that will provide complete indemnification and no more.

Contracts of Adhesion are Construed Against the Drafter

The means of calculating depreciation should be the method that is most favorable to the insured. This was the position taken in *The Fire, Casualty & Surety Bulletin* (1992). That is a result of certain legal doctrines. Insurance policies are so-called "contracts of adhesion," which means they are contracts offered intact to the property owner by the insurance carrier under circumstances requiring the owner to accept or reject the contract in total without having an opportunity to negotiate over the wording. As a matter of contract law doctrine, contracts of adhesion are construed strictly against the party that writes them; in this situation, they would be construed strictly against the insurer. Therefore, insurance policies are interpreted in the light most favorable to the policyholder. In general, this should benefit the property owner in situations where the insurance policy is unclear. The uncertainty in the context of determining depreciation under an insurance policy means that depreciation should be calculated according to the method most favorable to the policyholder.

Repairs for Partial Losses Are Never Depreciated

Repairs to property in situations of partial loss are never depreciated. I was taught this principle as part of my extensive training as an insurance adjuster, and it is also case law in multiple jurisdictions, including Florida (*Am. Reliance Ins. Co. v. Perez*, 689 So. 2d 290 (Fla. 3d DCA 1997)); New York (*Eshan Realty Corp. v. Stuyvesant Insurance Co. of New York*, 202 N.Y.S.2d 899, *aff'd*, 12 A.D.2d 818, 210 N.Y.S.2d 256 (1961), *aff'd*, 11 N.Y.2d 707 (1962)); and Kansas (*Thomas v. Am. Family Mut. Ins. Co.*, 233 Kan. 775 (1983)). However, over time, depreciation has evolved into a practice whereby some estimators arbitrarily depreciate structures or assemblies that are totally damaged, as well as apply depreciation if just a portion is being repaired.

Partial Versus Complete Loss

How do you determine what is a "partial" versus "complete" loss of insured property? Is a roof an entire component system, or is it a collection of thousands of individual shingles? If a portion of the roof is replaced, should those shingles have depreciation applied to calculate the insurance settlement? What if the entire roof is damaged? What if the entire house is damaged? What should be depreciated?

Repair Versus Replace

Where do you draw the line? If a portion of an interior room's sheetrock ceiling is replaced and the entire room painted, is the room to be depreciated since it was a repair and not a replacement? If an entire sheet of 4x8

sheetrock is replaced, would it be depreciated since it was an entire sheet, but if a 2x2 portion is replaced, would it be calculated without depreciation, since it is a repair? Would it change if you calculated depreciation on the room instead of an item? The questions prompted by the attempt to depreciate insured items proliferate, almost beyond reason.

Different Component Should Mean Different Depreciation Rates

When depreciation is applied, it is not appropriate to apply the same depreciation rate to different components within the same structure, since they have different lifespans.

The questions from the foregoing sections reveal that the calculation of depreciation is rife with decision-points that will, in aggregate, significantly influence the estimate amount. When these decisions are made in an unprincipled manner by adjusters in the field the results will be arbitrary, inconsistent, and likely to the detriment of the insured. This is true in both the insurance industry and in the courts, where the battle over depreciation is engaged regularly.

Some states require that total losses, especially total fire losses, be paid without any depreciation at all. The point here is that in those cases where depreciation is applied as a policy provision should be done so on an item-by-item basis. Furthermore, the depreciation should apply to materials only. That argument will be made clearly below.

When to Determine Actual Cash Value

Some courts have held that the actual cash value is the value immediately before the loss occurred. This would allow insurance adjusters to apply a depreciation rate for determining actual cash value based on the time of the loss. The time of the loss determines the age of the components. This means the value of the physical property would be determined on the date of the loss. However, especially in the context of catastrophic losses, the value of the repair labor should be calculated based on the price at the time proper repairs would have been made had they been made at a reasonable time after the loss. This would align depreciation rates with the reality of the insurance company's handling of the insurance claim, since the cost of repairs will vary drastically depending on when they are performed. Repairs cannot be made immediately at the time of the loss. They are made shortly thereafter.

Repair Costs Are Time-Sensitive

So the physical components age for depreciation purposes is determined at the time of the loss. Repairs can

only be made after the loss, and therefore the labor portion of repairs should be calculated based on market prices after the time of the loss. In situations of catastrophic loss, the cost of material and labor both escalate dramatically after the loss date due to increased overhead, shortages of material and labor, delays, and difficult work conditions. These elevated costs must be borne by the contractors and the insured when repairing or replacing the property, not the costs of material and labor the day before the loss occurred. The time of loss affects the rate of depreciation that is applied to the settlement. The actual cash value should be calculated based on replacement cost at the time of replacement, which is shortly after the loss, not an arbitrary price set before the trigger for coverage manifested. To do otherwise puts an impossible burden on the insured to replace their property with insufficient funds in a time of labor and material shortages. The reasonable time after the loss in which the repairs could be accomplished should be the time period to determine the costs of these items. Of course, replacement parts and the extent of labor are based on the scope of damages as a result of the loss on the loss date, so that date remains important for the calculation of costs. The loss date sets the age of the structure's materials, but it should not be the tether for values of material and labor. Those are set by market fluctuations immediately after the loss.

To repeat, the value of the property should be calculated based on the price of material and labor at the time proper repairs would have been made had they been made at a reasonable time after the loss. This means estimators must determine several categories of costs, all of which fluctuate by region, time, and conditions. Material cost is one category. Another is labor cost.

Other Costs Must Be Added

The category of "soft costs," such as General Conditions must be considered, which includes Direct Costs attributable to the repairs or rebuilding such as permits, inspections, architect fees, engineering fees, debris removal, access, and safety. Additionally, the other categories of Overhead, Profit, and Taxes must be considered.

General Contractor Overhead and Profit

In America's economy, contractors make a profit to stay in business. The only contractors who do not need to make a profit work for the government. Insurance losses include a calculation for profits. Subcontractor's overhead and profit are built into their bids or their unit costs. That is not true for a General Contractor. Usually an estimated rate of 10% of the entire cost of the job is added for Overhead and 10% for Profit for a General Contractor. The "rule of thumb" for including a General Contractor's additional Overhead and Profit is to add the amount to the entire estimate if there are three trades or more, or

if the type of work would normally require the skill and time of a general contractor. This applies whether or not the policyholder does the work himself.

I would add that it would also apply if the insured were unable to supervise and coordinate the work himself. For instance, even if it is just a roof replacement, if the insured is a surgeon working long hours, he cannot leave work to supervise crews, receive deliveries, or verify proper installation. He would have to hire someone to care for the supervision, coordination, and security of his interests. The same would be true of a single mom working a job she could not leave. It would be true of anyone who did not possess the requisite skill to oversee construction. In all those cases, indemnity requires that a line item for Direct Cost of Supervision be added, or the services of a General Contractor be obtained in order to complete the job, even if it involves less than three trades.

Direct Costs and Line Items

Direct Cost is a term understood by builders and contractors, but usually is a mystery to an adjuster who has never served as a superintendent on a job. If an item is a "Direct Cost" attributable to the repair or rebuilding, it should be added into the estimate as a line item, not included in the General Contractor's Overhead. Overhead, on the other hand, cannot be reduced to a line item or assigned to only one project. Onsite supervision is a line item. Portable toilets and dumpsters are each a line item, being assigned to a jobsite. A temporary fence or field office is a line item. Overhead pertains to things that continue when the General Contractor is between jobs, or that are not attributable to the job, such as cell phones, offices, secretary labor, office supplies, vehicles, insurance, etc. Direct Cost items are each a separate line item in the estimate, and not paid for out of Overhead. Neither adjusters nor contractors should misunderstand Direct Costs.

Replacement Costs Include Sales Taxes

The basis of calculations of insurance losses always starts with Replacement Cost Value, which includes state sales tax. Taxes are calculated on Materials, Labor, or both, Materials and Labor, or on the entire Total including Overhead and Profit, depending on the type of loss and how the contractor engages to do the work. States have their own rules that vary greatly. Estimators should become familiar with local rates and emergency bulletins in order to properly estimate a loss.

Cost Evaluation Concepts

In considering a total loss versus a partial loss, there are frequently differences in how depreciation is calculated to arrive at a number for actual cash value. Total loss of a structure is sometimes measured by comparable

costs of total structures in the area at the time of the loss. This is a market value approach. Real estate comparable values or a professional appraisal would be examples of total loss comparisons. So would a calculation based on a dollar per square foot basis. These are conceptual cost evaluations that would have to be modified by property distinctions such as elevated structures, pools and accessories, grade of construction and many other factors. Sometimes the actual cash value of a total loss is higher than the replacement cost of building a comparable structure, due to unique factors of construction or market demand. The Broad Evidence Rule of considering all the factors that affect depreciation and actual cash value is important for adjusters to keep in mind. The indemnification of the policyholder that is in the policyholder's best interest is the important factor.

Market value as a means of determining depreciation is impossible on a partial loss since there is no ready market for debris or for damaged components that are still attached to undamaged components. Some adjusters calculate depreciation as a percentage of the replacement cost room by room, by construction categories, or sometimes applied to the entire structure (as most flood adjusters and some insurance carriers do). On all partial loss settlements, I believe the only appropriate means of applying depreciation is on a line-by-line item basis. This also serves the purpose of separating the damaged and undamaged portions of the property.

Costs Vary According to Region

Since the actual cash value of the loss must be determined at the time of the loss, that means the current material costs and current labor costs must be determined and applied to the scope of damages. Material costs will vary for the geographic location and conditions. Many materials are found in one locale and not in another—especially roofing, which is highly localized by style and type. Material costs escalate due to shortages and delivery problems.

Depreciation Should Not Apply to Intangibles Such as Labor

Labor costs are found for each region as well. After a catastrophe, labor will fluctuate upward due to availability and extra travel, housing, overtime, and food for crews working away from their home area. Large fluctuations in material and labor do not usually occur during normal claims settlement, but do occur in almost every catastrophe. Depreciation is physical deterioration. Insurance companies and courts have erred in including labor in depreciation calculations. Labor is involved in both tear off and replacement of the physical items. Only physical items are subject to wear and tear, obsolescence, or deterioration by exposure to elements. Labor is an

intangible, not subject to wear and tear, but may actually increase while the cost of the physical item decreases due to lower manufacturing costs.

Insurance companies and courts have both argued whether labor and material should be depreciated when the policy calls for an Actual Cash Value settlement, as means of arriving at a proper cost. They have further argued whether the labor to remove damaged items should be depreciated. Some courts have ruled yes and some no. To further add to the confusion, some have argued to not apply depreciation to labor when it is to remove an item, but to apply depreciation to labor when it is to install the replacement item.

The arguments that involve depreciating labor in any form just don't make sense. They are arbitrary. Depreciation can be appropriately applied only to tangible items. Labor is intangible. Therefore, depreciation should not be applied to labor in either removal or installation phases.

Depreciation is the physical deterioration of a tangible item. This position is bolstered by the traditional common law in New York (*McAnarney v. Newark Fire Ins. Co.*, 247 N.Y. 176, 159 N.E. 902 (1928); Florida (*Sperling v. Liberty Mutual Ins. Co.*, 281 So.2d 297 (Fla. 1973), *Glens Falls Ins. Co. v. Gulf Breeze Cottages, Inc.*, 38 So.2d 828 (Fla. 1949)) and possibly other jurisdictions.

It is inconsistent to state that labor to remove an item from its position where it was previously installed as a part of a structure should not be depreciated, but labor to install a new item in its place should be depreciated. This was the unfortunate holding of an erroneously reasoned Oklahoma court case.

Example: Debris Removal

It is an error to state that the difference in treatment between repair and removal is due to the fact that the policy includes Debris Removal in its coverage. Picture the craftsman removing sheetrock or framing or roofing materials. He disassembles the components and sets them on the ground. For the roofer, he lays it down and it may slide off the roof to the ground. The Xactimate definition of removal is to take the item off and set it down. This is disassembly, not Debris Removal.

Next, the item previously removed has to be carried to the dumpster or trash truck. That is probably in the category of "Daily Labor," or "Daily Cleanup." But once the rubble is assembled into a pile and swept or carried to the dumpster and placed inside, it is then undeniably, "Debris." The cost of the rental of the dumpster or trash truck and the cost of hauling the dumpster to the approved waste site and paying the dump fees is Debris Removal. It is this latter operation—removing the debris from the Loss Site and conveying it to an approved dump location—that qualifies as Debris Removal. It is a separate

and subsequent operation from the removal of the item from where it was previously installed.

In any case, neither removal nor Debris Removal are depreciable. They are intangible labor operations. Decades ago, as a staff property adjuster for a national carrier, I was trained not to depreciate either labor or Debris Removal. This should remain the rule.

Materials and Labor Prices Are Not Linked

Recall that the ACV is determined as of the Date of Loss (DOL). What was the value of the material item on the DOL? You can find out its age and calculate its lifespan using industry charts from manufacturers. What was the value of the labor on the DOL? Federal labor and wage tables, local bid practices—all can be consulted to find labor and wage rates for the time period of the required repairs. While materials generally go down in value with time, with some exceptions, labor generally goes up due to a variety of pressures. They are not linked. It is inappropriate to use the same rate of depreciation on two components of an item—material and labor—particularly when the value of one is going down and the other is going up.

When and How to Apply Depreciation

I was taught years ago that depreciation, when it was applied, must be done on a line-by-line, item-by-item basis. At the very least, it should be applied to categories of items, based on the lifespan of that category of material, rather than applied like a blanket to the entire loss.

I obtained charts of the average lifespans of materials. A few sample pages from the National Association of Home Builders is attached. Material lifespans shown in the attachment were derived from reports by product manufacturers. Nowhere in any of the lists of materials is any labor item mentioned with its appropriate lifespan! Only physical, tangible items are listed.

Rates of depreciation are different for each of the various types of materials in the estimates I produced. Sheetrock, Paint, Wood Trim, Windows, Carpet—they all have different lifespans, and therefore once I knew their approximate age, I could figure how much of their useful lifespan to deduct.

I have heard some adjusters use the example of depreciating a refrigerator and its loss of value over the years in talking about depreciating a roof. It is a nonsensical comparison. The refrigerator was assembled in a factory under controlled conditions. It only had to be set in place and connected. It would be proper to depreciate a refrigerator's material and labor as one unit, since it came pre-assembled. I have never seen anyone assemble a refrigerator onsite.

The roof components, on the other hand, have to be assembled on the job, custom fit into place, individually installed into a whole unit, and properly completed over a period of days. The roof does not come pre-assembled. That would be impossible considering the variety of houses, businesses, and types of roofing, and types of job-site conditions.

The crew does not come with the roof. The roof installation costs are obtained separately by a bid or referral process and their pricing is individualized by the job type, supply and demand, and job conditions.

There is no comparison between depreciating a refrigerator and depreciating a roof. The same is true of nearly all site-built structure components.

Material may become obsolete. An example would be organic shingles. They are not generally available. Labor does not become obsolete. If it did, it would go up, not down, due to its scarcity. Labor is always priced at current availability.

Material may suffer from wear and tear from use. This is common on floor coverings and paint finishes. Labor, on the other hand, does not suffer from wear and tear. It is intangible and temporary. It does not stick around to be abused. It has to be priced after the Date of Loss.

Material may deteriorate. It is normal for the organic compounds in roofing to evaporate or break down due to heat and sunlight. The labor is not there to be affected by the weather conditions. Once the material was installed, like Elvis, the labor is gone from the building. If it is needed again in the future, it would come with a new current price.

So, depreciation should be applied only to physical items. This is the historic and usual use of depreciation in the insurance industry.

Determining Replacement Costs

Replacement Costs are composed of:

- Material Direct Costs
- Labor Direct Costs
- Soft Costs
- Overhead
- Profit
- Taxes

These are all included in a determination of Replacement Costs. Of all these items, the only portion subject to depreciation is the Material Direct Costs.

Conclusion

If depreciation can only be applied to physical tangible items, then only about 1/3 of a loss estimate is even subject to depreciation.

Xactimate includes an option to select "Depreciate Material Only." It is there because it has been the option for much of insurance claim settlement history. I believe selecting that option is the most appropriate choice in every case where the policy calls for depreciation. Depreciation should not be applied to any other component of a loss, and especially not intangible items.

Furthermore, in all partial losses, the only appropriate depreciation is line item depreciation based on the age of the item in question.

If the writers of the policies meant to depreciate an intangible item, they should define it as such. The courts

likewise should consistently avoid applying market value depreciation to a combination of tangible and intangible items that are affected differently by obsolescence, wear and tear, and deterioration.

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Xactimate Screen Shot

The screenshot displays the Xactimate software interface with several key areas highlighted by circles:

- Pricing Section:** The "Tax Jurisdiction" dropdown menu is circled, showing "8.25% Com Rep/Rem".
- Add Ons Section:** The "Depreciate Material" checkbox under "Depreciation Options" is circled. The "Overhead & Profit" section, showing "Overhead: 10.0%" and "Profit: 10.0%", is also circled.
- Report Text Section:** The "Company Header" dropdown menu is circled, showing "SUNCOAST".

Other visible elements include:

- Navigation tabs: "Complete", "ss Recap", "Claim Reports", "Activity Report".
- Activity (Default) options: "Use price list defaults" (selected), "Select".
- Repaired By (Default) options: "Contractor" (selected), "Homeowner".
- Labor Efficiency: "Restoration/Service/Remodel".
- Default Tags: "Salvage Retention", "Additional Charges", "Labor Burdens...", "Advance Payments", "Sales Taxes...".
- Depreciation (Default): "Recoverable".
- Depreciate By: "Age/Use".