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Taking Depreciation into Account in Actual Cash Value Policies

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A frequent question in settling property and casualty insurance claims for damaged buildings is how to take depreciation into account. An aspect of this question is now before the US Court of Appeals for the Tenth Circuit. Two federal district courts took different positions on the question of whether to depreciate labor costs in calculating benefits for partial damage based on an actual cash value policy.¹ Although this may seem to be a minor issue in the overall context of calculating benefits, different answers to this question can mean thousands of dollars to consumers and can determine whether they are restored to their position before a loss. Answering this question also raises fundamental questions about how to interpret and apply actual cash value policies.

This article suggests how the courts should deal with this issue under Oklahoma law in a way that is consistent with the goals of insurance policy. This article first discusses the goals of insurance and some of the

1. See, *Davis v. Mid-Century Ins. Co.*, No. Civ-96-2070-T, 1998 WL 1285714, at *6 (W.D. Okla. Mar. 26, 1998) (holding that expenses for debris removal and labor costs to replace the roof are not subject to depreciation under the actual cash value policy); *Branch v. Framers Ins.*, 123 F. Supp.2d 590, 594 (W. D. Okla. Oct. 4, 2000) (holding that it is proper to depreciate the cost of labor and the tear-off cost of removing the old roof surface).

underlying conceptual questions about how to value the loss from damaged or destroyed buildings. It then explains the difference between replacement and actual cash value policies and reviews the various approaches courts have used in interpreting actual cash value policies. Next, the article discusses Oklahoma's approach to interpreting actual cash value policies. Finally, the article discusses the theoretical arguments for and against depreciating labor costs in applying an actual cash value policy and concludes that labor costs should not be depreciated in settling claims under an actual cash value policy.

THE GOALS OF INSURANCE

The principal goal of property and casualty insurance is indemnity—restoring the insured to the position he was in before a loss.² If all goes well, this goal of indemnity, subject to limitations that both the insurer and insured understand, is embodied in the insurance agreement. The rationale for the indemnity principle is straightforward. Undercompensating the insured will leave the insured in a worse position than he was in before the loss and will fail to meet his reasonable expectations. Overcompensating him drives up premiums for other insureds and creates a potential “moral hazard”—an incentive for the insured to destroy his own property in order to reap a windfall. Although it is easy to state the goal of indemnity, determining how to achieve it in the case of a damaged or destroyed building is difficult in many cases and has led to substantial confusion and disagreement among the courts.³

Ultimately, the value of a loss from damage to a building has to be reduced to monetary terms in order to calculate the insured's obligation. There are significant differences in approach to estimating this value because there are a variety of ways to conceptualize the loss. One approach is to view the problem in individual terms and estimate the impact of the

2. See, *Eagle Fire Co. of N.Y. v. Snyder*, 392 F.2d 570, 570 (10th Cir. 1968) (a contract of fire insurance is one of indemnity); *Chambless v. Travelers Lloyds of Tex. Ins. Co., Inc.*, 123 F. Supp.2d 1028, 1031 (N.D. Tex. Nov 28, 2000) (a contract for insurance against fire is a contract of indemnity); *Davis*, 1998 WL 1285714, at *4 (a contract of fire insurance is one of indemnity whose purpose is to reimburse the insured; restore him to the position he was in before the loss); *Travelers Indem. Co., v. Armstrong*, 442 N.E.2d 349 (Ind. 1982) (an actual cash policy is a pure indemnity contract which purpose is to make the insured whole); *Braddock v. Memphis Fire Ins. Corp.*, 493 S.W.2d 453, 459-460 (Tenn. 1973) (purpose of fire insurance policy is to reimburse the insured; to restore him as nearly as possible to the position he was before the loss); *McAnarney v. Newark Fire Ins. Co.*, 159 N.E. 902, 904 (N.Y. 1928) (indemnity is the basis and foundation of all insurance law). See also, Margaret A. Wurzer, *Actual Cash Value*, in 2 *Insuring Real Property* 24-1, 24-5 (Stephen A. Cozen ed. 1998); Johnny Parker, “Replacement Cost Coverage: A Legal Primer,” 34 *Wake Forest L. Rev.* 295, 296 (1999); Harold H. Reader, “Modern Day Actual Cash Value: Is What the Insurers Intended,” 22 *Tort & Ins. L.J.* 282, 282 (1987).

3. See discussion below.

loss on a particular insured. This usually leads to an emphasis on the cost of replacing or repairing a particular structure. Another approach is to view the problem in market terms and to assess how the loss would be valued in a market of willing buyers and sellers. This usually leads to an emphasis on the market value of a structure or the change in market value caused by damage. Neither approach is entirely satisfactory, however, and the modern trend is to rely on some hybrid of these approaches.

A number of considerations point toward focusing on the cost of repair. Unlike many types of property, buildings are unique. They always have a unique location. They may have a unique design and use. They may have been modified over time to suit their owners. In addition, there may be few buyers and sellers in the geographic area, and even if there are many sales, there may be no close substitutes for the particular building that has been damaged or destroyed. Even if similar buildings, for example, single-family homes, have been bought and sold, people have made economic and social investments in their homes and neighborhoods. To them, their homes may be worth far more than market value. Moreover, from the point of view of the insured, he may reasonably assume that, except for deductibles and coinsurance, insurance coverage will provide the resources to restore his building, at least in the condition it was in before the loss.

On the other hand, estimating the value of a loss based on the cost of replacing the home of an individual insured raises other problems. First, buildings physically deteriorate. Materials that have a limited life begin to wear out. Putting the insured in the precise position he was in before the loss requires rebuilding a structure with materials of the same age and quality. Yet, doing so might be impractical and might even be more expensive than replacing a building with new materials. On the other hand, replacing or repairing a building with new materials can overcompensate the insured by placing him in a better position than before the loss.

Second, buildings (though not so much homes) economically deteriorate. Their original uses may have become obsolete or outdated. Rebuilding a buggy whip factory with a new buggy whip factory or replacing expensive plaster moldings that neither the owner nor the market values is economically irrational. Consequently, paying the insured the value of the replacement costs may appear to overcompensate him if the market value of a building is much lower than the replacement costs. Moreover, as a practical matter, the insured often will be happier with a cash settlement that can be used to buy a productive building than with a higher settlement that must be used to rebuild an unproductive one. These considerations point in the direction of relying on the value established in the market.

Achieving the goal of indemnity in cases of partial, rather than total, damage raises some special questions. Damage to a portion of a structure can make the entire structure essentially worthless until it is repaired. Consequently, the effect of damage to a building on its market value has no meaning apart from the cost of repair. As in the case of total damage, however, repairs make the building better than before, and paying the insured to repair with new materials can put him in a better position than before the loss. On the other hand, reducing compensation by depreciating the materials can result in undercompensating the insured by overstating the decline in quality. Traditional depreciation formulas are often accounting conventions that bear no close relationship to the actual change in the condition of the structure.⁴ These formulas can be even more arbitrary when applied to a portion of a structure. Many houses in excellent condition are 50 years older or more, even though they may depreciated over 27 and a one-half years for tax purposes.⁵ Depreciation accounting conventions that lead to deep discounts below the costs of repairs can leave homeowners far worse off than they were before the loss.⁶ The homeowner is still forced to repair his home at current costs, and the home, after repair, is marginally, if at all, in better condition. Finally, depreciating the costs of labor can exacerbate the problem of undercompensation because the insured must pay to repair a building based on current labor costs.

REPLACEMENT AND ACTUAL CASH VALUE POLICIES

Property and casualty policies distinguish between two major types of coverage for damaged or destroyed structures—"replacement" and "actual cash value" coverage. Although there are variations within each category, replacement coverage generally means that the insured receives a payment from the insurer sufficient to rebuild the damaged or destroyed structure with no deduction for depreciation.⁷ Actual cash value policies,

4. Wurzer, *supra* n.2, 24-21. See generally, Anthony P. Polito, "Fiddlers on the Tax: Depreciation of Antique Instruments Invites Reexamination of Broader Tax Policy," 13 *Am. J. Tax Pol'y* 87 (1996) (tax depreciation does not reflect the actual consumption of the assets); Daniel N. Shaviro, "Risk and Accrual: The Tax Treatment of Nonrecourse Debt," 44 *N.Y.U. Tax L. Rev.* 401, 434 (1989) (stating that tax depreciation does not reflect the asset's actual and economic value).

5. Dwellings are typically depreciated over 27.5 years for tax purposes. See I.R.C. §168(c) (West 2000).

6. Consider a homeowner with a damaged roof, which costs \$10,000 to repair, including new materials and labor. If the insurer estimates that the roof will last only half of its original life, the benefit might be reduced by 50 percent under a straight-line depreciation approach (less any applicable deductibles and coinsurance). The insured then must spend \$5,000 out of pocket for a new roof, while, before the loss, he did not anticipate any expenses for many years.

7. Wurzer, *supra* n.2, 24-5. See also *Travelers Indem. Co.*, 442 N.E.2d at 352 (replacement cost coverage reimburses the insured for the full cost of repairs, even if it results in putting the insured in a better position than he was before the loss).

on the other hand, take depreciation into account.⁸ Beyond this simple dichotomy, the application of both types of provisions becomes more complex.

Replacement insurance provides a contractual solution to some of the problems discussed above.⁹ There is no need to calculate depreciation because the policy does not require a deduction for it, nor is there a need to calculate market value because the benefit is based on the costs of repair or replacement. The insured pays a higher premium for this policy because of the higher expected costs of the benefit, and there is some moral hazard since the insured will be in a better position than before the loss.¹⁰ On the other hand, a replacement policy is highly attractive to consumers since they know they will be able to replace or repair a damaged structure without worrying that their insurance policy will leave them with substantial out-of-pocket expenses.

In order to provide an incentive to the insured to maintain coverage that is close to the value of the property, the policy might penalize the insured if the value of the coverage drops below a minimum ratio of the value of the coverage to the value of the property.¹¹ In addition, the policy might require the insured to actually complete the repair or replacement

8. Wurzer, *supra* n.2, 24-5.

9. The phrase "replacement policy" is ambiguous because it does not specify the condition of the structure after the "replacement." In theory, strict "replacement" might be read to mean replacing a deteriorated building with one that is equally deteriorated. Consequently, most replacement policies include language that specifically says depreciation will not be deducted. A typical replacement policy provides:

3. *Loss Settlement*: Covered property losses are settled as follows:

b. Buildings . . . at replacement cost without deduction for depreciation, subject to the following amounts:

(1) If, at the time of loss, the amount of insurance . . . on the damaged building is 80% or more of the full replacement cost of the building immediately before the loss, we will pay the cost of repair or replace , after application of deductible and without deduction for depreciation, but not more than . . .

(a) The limit of liability under the policy . . .

(b) The replacement cost of that part of the building damaged for like construction and use on the same premise; or

(c) The necessary amount actually spent to repair or replace the damaged building

(2) If, at the time of loss, the amount of insurance . . . on the damaged building is less than 80% of the full replacement cost of the building immediately before the loss, we will pay the greater of . . .

(a) The actual cash value of that part of the building damaged; or

(b) That portion of the cost to repair or replace, after application of deductible and without deduction for depreciation, that part of the building damaged, which the total amount of insurance in this policy on the damaged building bears to 80% of the replacement cost of the building.

Id. at 25-8 to 25-10 (citing ISO Form HO 00 03 04 91, Copyright, Insurance Services Office, Inc., 1990 (set forth in Appendix 4 B)).

10. See, Parker, *supra* n. 2, at 298 (replacement cost policy violates the principle of indemnity because the insured receives a betterment). See *e.g.*, Hess v. N. Pacific Ins. Co., 859 P.2d 586 (Wash. 1993) (replacement cost policy goes beyond the concept of indemnity); *Travelers Indem. Co.*, 442 N.E.2d at 349 (stating that replacement cost insurance is not a pure indemnity agreement but is optional coverage purchased at higher rates).

11. Wurzer, *supra* n.2, at 25-7 to 25-10.

before the entire benefit is paid.¹² Finally, the policy might contain exclusion for parts of a structure that are particularly expensive to replace, unless the owner is willing to pay a higher premium.¹³ This allows the owner to decide whether it is worthwhile to insure parts of a structure that he may not particularly value.

Unlike replacement policies, actual cash value policies take depreciation into account in some way in order to avoid overcompensating the insured. A typical actual cash value policy provides that the insurer only insures "to the extent of the actual cash value of the property at the time of the loss, but not exceeding the amount it would cost to repair or replace the property with material of like kind and quality . . ."¹⁴

Interpreting actual cash value provisions has turned out to be a difficult problem for courts because of the inherent ambiguity in the phrase and the conceptual difficulties in measuring the value of the loss as discussed above. Three different approaches have evolved over the years:¹⁵ (1) replacement costs less depreciation (the Pennsylvania rule);¹⁶ (2) fair market value (the California rule);¹⁷ and (3) the broad evidence rule (the New York rule).¹⁸ Each of these has its advantages and limitations.

Replacement Cost Minus Depreciation

The replacement costs less depreciation approach stems from a Pennsylvania case, *Fedas v. Insurance Co. of State of Pennsylvania*.¹⁹ The policy reviewed in *Fedas* provided coverage to the "extent of the cash value, with allowance for proper depreciation of the property at the time of loss."²⁰ The court stated that actual cash value is the "cost of replacing in as nearly as possible the condition as it existed at the date of the fire."²¹ In determining the obligation of the insurer, the court specifically rejected a market value approach.²² The court was obviously troubled that the market value of a building, because of "time, place, circumstance, use and benefit" might be drastically lower than the costs to replace it.²³ A later

12. Wurzer, *supra* n. 2, at 25-7. A typical replacement policy provides "... pay no more than the actual cash value of the damage until actual repair or replacement is completed . . ." *Id.*

13. *Id.*

14. See *e.g.*, *Commercial Union Ins. Co. v. Ryals*, 355 So. 2d 684 (Ala. 1978); *Braddock*, 493 S.W. 2d at 453-54; *Fedas v. Ins. Co. of State of Pennsylvania*, 151 A. 285 (Pa. 1930); *McAnarney*, 156 N.E. at 181.

15. See, Wurzer, *supra* n.2, at 24-8; Reader, *supra* note 2, at 283-288.

16. *Fedas*, 151 A. 285 (Pa. 1930).

17. *Jefferson Ins. Co. v. Superior Court*, 475 P.2d 880 (Cal. 1970).

18. *McAnarney*, 159 N.E. 902.

19. *Fedas*, 151 A. 285.

20. *Id.* at 288.

21. *Id.*

22. *Id.*

23. *Id.*

Pennsylvania decision, *Faber v. Perkiomen Mutual Insurance Co.*,²⁴ clarified *Fedas* by holding that actual cash value means replacement cost less depreciation in a case in which an entire building is destroyed, but means the costs of repair with no deduction for depreciation in the case of partial damage.²⁵ Other courts, applying the replacement cost less depreciation approach, have said that there should be some deduction for depreciation in the partial loss situation as well.²⁶

Fair Market Value

The fair market value test stems from a California decision, *Jefferson v. Superior Court*.²⁷ In *Jefferson*, the policy penalized the insured for maintaining coverage at a value too far below the "actual cash value."²⁸ The insurer argued that the actual cash value was the cost of replacement less depreciation, which resulted in a value much higher than the value of the coverage and led to a significant coinsurance penalty.²⁹ The insured argued that the actual cash value meant fair market value, which led to a lower value for the property and a better result for the insured.³⁰ The court sided with the insured and held that the calculation of the "actual cash value" should take into account the income, location, and other relevant factors.³¹ Later cases have held that, in applying the market value test, an appraiser may consider the evidence of offers to buy and sell the property and compare the value of the land alone.³²

24 *Faber v. Perkiomen Mut. Ins. Co.*, 88 A.2d 776 (Pa. 1952).

25. *Id.* See e.g., *Thomas v. American Family Mut. Ins. Co.*, 666 P.2d 676, 679 (Kan. 1983) (holding that the term "actual cash value," when applied to a partial loss under the insurance policy means the cost to repair without any reduction for depreciation.); *Commercial Union Ins. Co.*, 355 So. 2d 684 (Ala. 1978) (holding that no reduction for depreciation should be taken in measuring damages when the insured sustained a partial loss); *Faber v. Perkiomen Mut. Ins. Co.*, 88 A.2d 776 (Pa. 1952) (holding that no reduction for depreciation should be taken in measuring damages when the insured sustained a partial loss).

26. See, *Wurzer*, *supra* n.2, at 24-20. See also, *London v. Ins. Placement Facility of Pennsylvania*, 703 A.2d 45, 50 (Pa. 1997) (holding that depreciation is considered in determining actual cash value in partial loss); *Braddock*, 493 S.W.2d at 459-60 (holding that depreciation may be considered in determining actual cash value for partial loss); *Reliance Ins. Co. v. Orleans Parish Sch. Bd.*, 322 F.2d 803, 809 (5th Cir. 1963) (holding that under Louisiana law, depreciation must be considered in the event of partial loss).

27. *Jefferson*, 475 P.2d 880.

28. *Id.* at 881.

29. *Id.*

30. *Id.*

31. *Id.* at 882.

32. See e.g., *Elberon Bathing Co. v. Ambassador Ins. Co.*, 389 A. 2d 442, 443 (N.J. 1978) (since buildings ordinarily have no independent market value independent from the land, market value is calculated by subtracting from the market value of the entire parcel, the appraise market value of the land); *Elliano v. Assurance Co. of America*, 45 Cal.App.3d 170, 181 (1975) (in calculating the market value of the land, the appraiser considered both the value of the land with improvements before the fire and the value of the land itself after the fire).

Broad Evidence Rule

The broad evidence rule stems from a New York case, *McAnarney v. Newark Fire Insurance Co.*³³ The New York standard policy provided coverage for “the extent of the cash value (ascertained with proper deductions for depreciation) . . . but not exceeding the amount which would cost to repair or replace . . . with material of like kind and quality.”³⁴ The insured made a claim for the total loss of several buildings from fire.³⁵ The trial court held that the measure of recovery was replacement costs less depreciation for “physical deterioration,” which resulted in a value of \$55,000.³⁶ The trial court refused to consider evidence about the market value of the buildings, including the fact that the best offer the insured had received for the building was \$6,000.³⁷

The *McNarney* court rejected both the replacement cost less depreciation test and the fair market value approach.³⁸ It pointed to the policy language and concluded that, since market value already took depreciation into account, a reference to “cash value [with deductions for depreciation]” was redundant.³⁹ Consequently, the parties could not have intended actual cash value to be equivalent to market value.⁴⁰ The court was also troubled by the fact that, if the market value of a building had been reduced to zero (e.g., in a case in which it was economically rational to tear down a building and rebuild), the insured would recover nothing.⁴¹ It also rejected the cost of replacement less depreciation approach because that test focused on physical deterioration and failed to take into account economic deterioration or obsolescence.⁴² In the case before it, for example, neither the owner nor the market put a value on the building that approached the costs of replacement.

Advantages and Disadvantages

None of these approaches is entirely satisfactory. The Pennsylvania rule, replacement cost less depreciation, is one variation of the individual approach discussed above. By focusing on costs to the individual insured of replacing a structure, the Pennsylvania rule avoids the hardship of the market value rule, which can result in a settlement that is far less than the

33. *McAnarney*, 159 N.E. 902 (N.Y. 1928).

34. *Id.* at 181.

35. *Id.* at 179.

36. *Id.*

37. *Id.* at 180.

38. *Id.* at 181.

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.* at 183, 184.

costs of repair or replacement. On the other hand, the Pennsylvania rule arguably can overcompensate the insured because the cost of replacement, even with a deduction for physical deterioration, fails to take into account economic deterioration.⁴³ Although this is usually not an issue for homes, it can be an important issue for placing a value on manufacturing plants or other commercial facilities that were designed for a particular purpose. Another difficulty is that the Pennsylvania rule requires calculating depreciation, which can be difficult.⁴⁴ For example, the insurer may apply a depreciation formula, based on arbitrary accounting conventions, that reduces the benefit far below replacement costs and far more than the actual physical deterioration justifies.

The California market value rule is a variation of the market approach discussed above. The advantage is that it takes into account economic obsolescence, and it avoids the problem of calculating depreciation. On the other hand, calculating fair market value itself presents difficulties.⁴⁵ As courts have noted, buildings do not have a market value apart from the land on which they sit, but calculating the value of a building requires segregating it somehow from the value of the land.⁴⁶ In addition, as mentioned above, a settlement based on market value can result in substantial hardship to the insured when the market value is far less than the cost of replacement.

For all these reasons, most commentators tend to favor the New York broad evidence rule.⁴⁷ The obvious disadvantage of the rule is that its very

43. *Elberon Bathing Co.*, 389 A.2d at 443 (noting that replacement cost less depreciation is inflexible and results in excessive recovery).

44. Wurzer, *supra* n.2, at 24-20 to 24-23 (discussing difficulties in determining and calculating depreciation). Some commentators argue that although tax depreciation is easy to calculate it does not reflect actual or economic depreciation. See, Polito, *supra* n.4, at 94 (stating that assets value vary for a number of reasons other than physical deterioration, exhaustion, wear and tear); Shaviro, *supra* note 4, at 434 (the tax systems accelerates depreciation in relation to economic depreciation).

45. See generally, Wurzer, *supra* n.2, at 24-13 to 24-17 (discussing three approaches used by courts to determine market value: (1) the cost approach, (2) the income approach and (3) the market sale or comparable sales approach); Reader, *supra* n.2, at 285-287 (discussing the problems with the market value approach).

46. The courts have taken various approaches in deciding how to calculate the value of buildings. See Wurzer, *supra* n.2, at 24-15; *Braddock*, 493 S.W.2d at 458 (noting that buildings have no market value independent of the land on which they rest); *Falcone v. Perry*, 416 P.2d 690, 692 (Wash. 1996) (noting that buildings have no "market value" in the strict sense); *Elberon Bathing Co.*, 389 A.2d at 449 (noting that buildings ordinarily do not have a market value independent of the land).

47. Wurzer, *supra* note 2, at 24-27 n.17. The majority of jurisdictions in fact now apply the "broad evidence" rule to define actual cash value. *Id.* at 25-4 fn 3. See e.g., *Wisconsin Screw Co. v. Fireman's Fund Ins. Co.*, 297 F.2d 697 (7th Cir. 1962); *First Nat'l Ins. Co. v. Norton*, 238 F.2d 949 (10th Cir. 1956); *Group von Graupen v. Employer's Mut. Fire Ins. Co.*, 259 F. Supp. 934 (D.P.R. 1966); *Zochert v. Nat'l Farmers Union Property & Casualty Co.*, 576 N.W.2d 531, 533-534 (S.D. 1998); *Emperance v. Royal Clobe Ins. Co.* 512 N.Y.S.2d 313 (1987); *Travelers Indem. Co.*, 442 N.E.2d 349 (Ind. 1982); *Elberon Bathing Co.*, 389 A.2d 442, 444 (N.J. 1978); *Rochester Am. Ins. Co. v. Short*, 252 P.2d 490 (Okla. 1953); *Mamou Farm Servs. v. Hudson Ins. Co.*, 448 So.2d 259 (La. App. 1986); *Worcester Mut. Fire Ins. Co. v. Eisenberg*, 147 So.2d 575 (Fla. App. 1962).

attraction—the ability to consider a wide range of factors—means that results are not uniform or predictable.⁴⁸ Nevertheless, the broad evidence rule is flexible enough to lead to pragmatic, sensible results in particular cases.⁴⁹ Consequently, it is best suited to lead to fair and logical result in determining how to take depreciation into account.

THE OKLAHOMA APPROACH

Oklahoma uses the broad evidence rule in interpreting actual cash value policies.⁵⁰ The value is to be determined by considering all relevant factors, including the original cost, the replacement cost, the age of the property, the condition of the property at the time of the loss, the location, use, and profitability.⁵¹ Replacement cost is one factor in determining actual cash value, but it is not the exclusive factor.⁵² Sometimes courts say that, in ordinary fact situations, replacement cost less depreciation is the primary factor to consider in applying the broad evidence rule.⁵³ In Oklahoma, parties are free to contract for coverage as they see fit, and the construction of an insurance policy should be a natural and reasonable one.⁵⁴ Ambiguities in language should be resolved in favor of the insured.⁵⁵

48. *Ohio Casualty Ins. Co. v. Ramsey*, 439 N.E.2d 1162, 1169 (Ind. Ct. App. 1982) (noting that the disadvantage of broad evidence rule is lack of predictability).

49. *Elberon Bathing Co.*, 389 A.2d at 444 (noting that the broad evidence rule is the most consistent with the principle of indemnity); *Ward v. Merrimack Mut. Fire Ins. Co.*, 753 A.2d 1214 (N.J. Super. A.D. 2000) (broad evidence rule achieves complete indemnity).

50. *Rochester American Ins. Co.*, 252 P.2d at 493.

51. See *id.* at 493–494; *Eagle*, 392 F.2d at 571 (other factors considered in determining “actual cash value” under the broad evidence rule are original cost, replacement cost, the age of the insured property, the condition and location); *Firemen’s Fund Ins. Co. v. Box*, 252 P. 21,33 (Okla. 1926) (factors in determining actual cash value include value of property at time of loss, value of property after loss, depreciation, cost of to repair or replace of material of like kind and quality).

52. *Rochester*, 252 P.2d at 493. See also, *Mamou Farm Services, Inc. v. Hudson Ins. Co.*, 488 So.2d 259 (3d Cir. 1986) (noting that depreciation is only one of the many factors considered in determining actual cash value); *Travelers Indem. Co.*, 442 N.E.2d at 357 (holding that element of depreciation may be considered but it is not the only factor); *Elberon Bathing Co., Inc.*, 389 A.2d at 445; (noting that replacement cost minus depreciation can be significant evidence but not necessarily conclusive evidence); *Zochert*, 576 N.W.2d at 534 (recognizing that replacement cost less depreciation is an element to be considered but not the sole test of actual cash value).

53. See *Ohio Casualty Ins. Co.*, 439 N.E.2d at 1169; *Kingsley v. Spofford*, 11 N.E.2d 487 (Mass. 1937).

54. See *Dodson v. St. Paul Ins. Co.*, 812 P.2d 372, 376 (stating that insurance contracts are liberally construed so as to accomplish the object sought) (Okla. 1991); *Wiley v. Travelers Ins. Co.*, 534 P.2d 1293, 1295 (Okla. 1974) (stating that parties to an insurance contract are at liberty to contract for insurance coverage). See also, *State Ins. Fund v. ACE Transportation Inc.*, 195 F.3d 561, 564 (10th Cir. 1999) (under Oklahoma law, insurance contracts are construed in a natural and reasonable way in order to achieve their objectives); *Flitton v. Equity Fire & Casualty Co.*, 842 P.2d 1132, 1133 (Okla. 1992) (stating that construction of an insurance policy should be a natural and reasonable one).

55. See *Max True Plastering Co. v. USF&G*, 912 P.2d 861 (Okla. 1996) (ambiguities are interpreted consistent with the parties’ intentions and most favorable to the insured and against the insurance

LABOR COSTS AND ACTUAL CASH VALUE POLICIES

Although it is clear that Oklahoma law requires use of the broad evidence rule and that the costs of replacement or repair are to be depreciated in some way, the Oklahoma Supreme Court has never specifically addressed the question of whether to depreciate labor costs. The answer to this question should be consistent with the policy of insurance law in Oklahoma and the reasonable expectations of the parties in applying the insurance agreement. Two cases before the Tenth Circuit present these questions.⁵⁶

In *Davis v. Mid-Century Insurance Company*, an insured homeowner sued the insurer to recover for roof damage.⁵⁷ The homeowner had an actual cash value policy that provided "loss to roof surfacing will be settled at [a]ctual [c]ash [v]alue."⁵⁸ The definition section of the policy defined "actual cash value" to mean "replacement cost of the property at the time of loss, less depreciation," but the endorsement deleted the definition.⁵⁹ In calculating the amount of recovery under the policy, the insurer took depreciation into account in calculating the actual cash value of the roof. In addition to depreciating the cost of materials, it depreciated the cost of debris removal and labor because those expenses were included in the price to replace the roof.⁶⁰ The insured argued that depreciation should not be applied to debris removal and labor cost.⁶¹ The court held that expense for debris removal and labor cost were not subject to depreciation under the language of the policy.⁶² The court stated that there should be no depreciation for debris removal expenses because the policy set out debris removal as a separate item of coverage not subject to depreciation.⁶³ As to labor cost, the court stated that the policy was silent and ambiguous as to this point, and, under Oklahoma law, ambiguity is strictly construed in

carrier); *Kerr-McGee Co. v. Admiral Ins. Co.*, 905 P.2d 760, 762 (Okla. 1995) (ambiguities in insurance policy are resolved in favor of insured); *Avemco Ins. Co. v. White*, 841 P.2d 588, 590 (Okla. 1992) (insurance contract must be strictly construed in favor of insured); *Dodson*, 812 P.2d at 376 (ambiguities in insurance contract are resolved in favor of insured and against the carrier); *Davis*, 1998 WL 1285714 at *6 (Oklahoma law requires that ambiguities be strictly construed in favor of insured). On the other hand, if the meaning of the contract is clear, the court should not rewrite the policy to favor the insured. *See, Avemco*, 841 P.2d at 590.

56. *See Davis*, 1998 WL 1285714, at * 6 (holding that expenses for debris removal and labor costs to replace the roof are not subject to depreciation under the actual cash value policy); *Branch*, 123 F. Supp.2d at 594 (holding that it is proper to depreciate the cost of labor and the tear-off cost of removing the old roof surface).

57. *Davis*, 1998 WL 1285714, at *1.

58. *Id.*

59. *Id.*

60. *Id.* at *5.

61. *Id.*

62. *Id.* at *6.

63. *Id.*

favor of the insured.⁶⁴ Further, the court stated that not depreciating labor cost operates to indemnify the insured by restoring him, as nearly as possible, to the position he was in prior to the loss.⁶⁵

In *Branch v. Framers Insurance Company*, the insured owner of rental property sued the insurer to recover for roof damage.⁶⁶ As the plaintiff in *Davis*, the insured had an actual cash value policy stating that losses were to be settled on "a replacement cost less depreciation basis."⁶⁷ As in *Davis*, there was no definition or explanation of "depreciation." In calculating the amount of recovery under the policy, the insurer, as in *Davis*, depreciated the cost of labor along with materials because these expenses were included in the price to replace the roof.⁶⁸ As in *Davis*, the insured argued that depreciation should not be applied to debris removal and labor cost.⁶⁹ However, the court, in this case, held since the cost of labor and tear-off cost were included within the meaning of replacement cost, it was proper to depreciate them.⁷⁰ The court stated that "replacement cost" is an unambiguous term with one plain and ordinary meaning that includes all costs an insured is reasonably likely to incur in replacing the covered loss.⁷¹ The court relied, without discussion, on *Seaboard Air Line Railroad Co. v. Marine Industries, Inc.*, which held that replacement cost includes labor and materials, all of which should be depreciated.⁷²

Applying Oklahoma Law

Replacement policies and actual cash value policies create different expectations on the part of the insured.⁷³ By paying the additional premiums required for a replacement policy, the insured assumes that his property will be restored in a new condition without requiring out-of-pocket expenses. The principle of strict indemnity is abandoned because of the desire of the insured to avoid significant out-of-pocket expenses. Policy language is intended to make that point express, and this assurance plays a large role in marketing the policy.

By purchasing an actual value policy, on the other hand, the insured assumes that there will be some consideration of the age and condition of his property and that there will be some deduction from the insurance

64. *Id.*

65. *Id.*

66. *Branch*, 123 F. Supp.2d at 590.

67. *Id.*

68. *Id.*

69. *Id.* at 593.

70. *Id.* at 594.

71. *Id.*

72. See *Seaboard Air Line R.R. Co. v. Marine Industries, Inc.*, 237 F. Supp. 10, 13 (E.D. S.C. 1964). The case *Seaboard Air Line* is discussed further below. See *infra* notes 74-78 and accompanying text.

73. See above for a discussion of the difference between replacement and actual cash value policies.

settlement for these factors. Moreover, consistent with the indemnity principle, the insured assumes that, subject to any deductibles, he or she will be restored to the actual pre-loss condition. That is implicit in the concept of actual cash value. What puts the insured in the same position he was in before the loss? In particular, should the actual cash value of the roof be adjusted based on deterioration in the quality of materials only or based on the depreciation of both materials and labor costs?

There is no obviously correct answer to this question because there are different ways of conceptualizing the indemnity principle. For example, *Seaboard Air Line*, which was relied upon in *Branch*, suggests different ways of approaching the problem. *Seaboard Air Line* involved determining damages from a collision to a bridge over a navigable river.⁷⁴ The court, applying federal admiralty jurisdiction, found that the plaintiff was "entitled to have its bridge restored to the same condition prior to the subject collisions insofar as reasonably possible."⁷⁵ The court also cited *Patterson Oil Terminals, Inc. v. Port Covington*,⁷⁶ which stated that damages should be based on the costs of repairing a damaged bridge so that it had the same life expectancy as before the damage.⁷⁷ These statements are consistent with the approach of paying current costs of labor but using older materials, or the theoretical equivalent, paying the current costs of labor and discounting the value of new materials. The *Seaboard Air Line* court, on the other hand, was troubled that, in a case in which repairs that had already been made with new materials and labor constituted a large portion of the repair costs, the plaintiff would end up with a bridge that had twice the life expectancy as the one before the damage but would have paid less than half the costs of the repair out of pocket.⁷⁸

These apparently conflicting statements follow from the fact that there is no simple rule that consistently achieves the indemnity principle. Based on a present value monetary analysis, depreciating labor costs can result in undercompensating the insured, while failing to depreciate labor costs can appear to overcompensate an insured.⁷⁹ Consistent with the broad evidence rule, however, courts should formulate an approach that is most consistent with the goals of insurance law and the indemnity principle. Taken together, several considerations suggest that the most reasonable interpretation of a typical actual cash value policy and the rule that

74. See *Seaboard Air Line*, 237 F. Supp. at 11.

75. *Id.* at 12.

76. *Patterson Oil Terminals, Inc. v. Port Covington*, 109 F. Supp. 953 (E.D.Pa. 1952).

77. *Id.* at 955.

78. *Seaboard Air Line*, 237 F. Supp. at 14.

79. See the hypothetical example discussed *infra* notes 86-89 and accompanying text.

best carries out the goals of insurance law is to depreciate the costs of materials, but not the costs of labor.

First, typical actual cash value policy language is ambiguous as to whether labor costs should be depreciated.⁸⁰ The insured is put on notice that the eventual settlement will take into account the quality of the structure before the loss, but, beyond that, it is unlikely that the insured contemplates any particular approach to depreciation. From the point of view of the insured, the most reasonable expectation is that there will be a sufficient payment to restore a dwelling to its pre-loss condition.

Most courts, including Oklahoma courts, say that insurance contracts, like any other contracts of adhesion, are liberally construed and that ambiguities should be resolved in favor of the insured.⁸¹ The court in *Davis* took this principle into account in deciding that labor costs should not be depreciated.⁸² In *Branch*, on the other hand, the court felt that “replacement cost” is an unambiguous term and, therefore, that all costs included in replacement should be depreciated.⁸³ Although “replacement cost” is arguably unambiguous, “replacement cost . . . less depreciation” is certainly susceptible to different interpretations. An insured could reasonably assume that he will receive a benefit sufficient to restore his dwelling to a pre-loss condition and that the only reduction from repair costs will be based on the quality of materials. Labor costs can constitute a significant share of replacement costs, and depreciating these costs—on top of

80. For example, neither the policy language at issue in *Davis* and *Branch* stated whether labor cost should be depreciated. See *Davis*, 1998 WL 1285714, at *1; *Branch*, 123 F. Supp.2d at 592. Both policy states that losses under the policy are settled on a “replacement cost less depreciation basis.” *Id.*

81. See *Avemco Ins. Co.*, 841 P.2d at 590 (stating that ambiguities in insurance contract are strictly construed in favor of insured); *Dodson*, 812 P.2d at 376 (stating that terms of insurance contract are liberally construed and ambiguities are strictly construed in favor of the insured); *Wiley*, 534 P.2d at 1295 (stating that construction of an insurance policy should be natural and reasonable and construed to effectuate its purpose); *Rochester Am. Ins. Co.* (noting that ambiguities in insurance contract are strictly construed in favor of insured). See also *Coregis Ins. Co. v. Am. Health Found.*, 241 F.3d 123, 127 (2d Cir. 2001) (under Ohio and Connecticut law, language of insurance policy should be given a reasonable and natural interpretation); *Williamson v. J.C. Penney Life Ins. Co.*, 226 F.3d 408, 409 (5th Cir. 2000) (stating that Louisiana courts construe insurance contracts against the insurer); *SCI Liquidating Co. v. Hartford Fire Ins. Co.*, 181 F.3d 1210, 1214 (11th Cir. 1999) (under Georgia law, ambiguities in insurance contracts are construed against the insurer); *Matador Petroleum Co. v. St. Paul Surplus Lines Ins. Co.*, 174 F.3d 653, 656–657 (5th Cir. 1999) (under Texas law, insurance contracts are construed to achieve their objective and ambiguities are resolved against the insurer and in favor of coverage); *Burgess v. J.C. Penny Life Ins. Co.*, 167 F.3d 1137, 1140 (7th Cir. 1999) (under Wisconsin law, insurance contracts are construed reasonably to achieve their objective); *Fajardo Shopping Center v. Sun Alliance Ins. Co. of P.R., Inc.*, 167 F.3d 1, 7 (1st Cir. 1999) (under Puerto Rico law, insurance contracts, by virtue of being considered adhesion contracts, are liberally construed in favor of insured).

82. *Davis*, 1998 WL 1285714, at *5 (noting that Oklahoma law requires that ambiguity be strictly construed in favor of insured).

83. *Branch*, 123 F. Supp.2d at 594.

the depreciation for materials—can significantly disadvantage (and surprise) the insured.

Second, although rebuilding or repairing a home with materials of the same quality that existed before the loss is often impractical, it provides a useful perspective because it would precisely achieve the goal of indemnity. Moreover, it achieves the goal of an actual cash value policy, which is placing the insured in the position he was in before the loss, taking into account the quality of the structure that was damaged or destroyed.⁸⁴ This suggests that the insured should receive an amount that allows him to repair a damaged structure by purchasing used materials (or the equivalent, new materials less a discount for depreciation) and paying the current costs of labor to install them.

Third, whether a repair is made with new or used materials, the homeowner must pay for the current costs of labor in effecting the repair. Although a physical structure deteriorates, the labor used to build a structure does not. From a common-sense point of view, labor does not depreciate in the same way that building materials, or other physical objects, do. This common-sense difference also plays a role in determining the reasonable expectations of insureds who decide to buy actual cash value policies. They almost certainly do not expect the labor component of a repair to be depreciated in the same way that building materials are depreciated.

Fourth, a monetary analysis of typical claims for partial damage shows that paying settlements after depreciating both labor and materials tends to leave an insured significantly worse off than homeowners who have no loss, even after taking into account the condition of the dwelling. Consider a homeowner in 2001 with a 10-year-old roof that is estimated to last 20 years.⁸⁵ Assume further that, if the roof is destroyed, the cost of repair in 2001, including new materials and labor, is \$10,000. If the insurer determines the “actual cash value” of the roof by discounting the current costs of materials and labor by 50 percent, the insured receives \$5,000. He is required to spend an additional \$5,000 out-of-pocket for a new roof, which will last until 2021. By the insurer’s calculation, the roof will have a market value of zero in 2021. The net costs to the insured over the next 20 years is \$5,000.

84. Both the *Seaboard Air Line* and *Patterson* courts, cited *supra* ns. 72 and 76, endorsed this principle.

85. Conventional depreciation formulas tend to be based on tax depreciation schedules, which may understate the life of materials. See generally *Polito*, *supra* n.4, at 92 (tax depreciation does not reflect the actual consumption of the assets); *Shaviro*, *supra* n.4, at 434 (stating that tax depreciation of asset is calculated arithmetically using tables and formulas, without reference to market information about the asset’s change in value).

In contrast, consider the situation of the homeowner in 2001 if no damage occurs. The homeowner does not face the cost of replacing the roof until 2011. Assume that, with inflation at 3 percent per year, the cost of repair in 10 years will be approximately \$13,440. Based on a discount rate of 6 percent, the present value of the cost to the homeowner of a new roof in 2011 is \$7,504.⁸⁶ In order to determine the homeowner's net position, the present value of the roof in 2021 should be deducted from the present value of the insured's expenditure in 2011. Based on the insurer's approach of depreciating the roof by 50 percent, the value of the roof in 2021 is approximately \$2,816.⁸⁷ Subtracting the value of the roof in 2021, the costs to the homeowner with no roof damage is \$4,688, significantly less than the costs to the insured with roof damage. As long as interest rates exceed inflation (*i.e.*, the real interest rate is above zero), the insured with roof damage is worse off after his insurance settlement, even taking into account the age of his roof. This gap occurs even though the valuation of the roof is based on the insurer's own formula. The difference between the insured's position under each scenario grows larger if the value of the roof in 2021 is not subject to such a deep discount for depreciation.

To extend the hypothetical further, compare the positions of the insured and the homeowner after an additional 10 years in 2031. The insured, whose roof was destroyed in 2001, must purchase a new roof in 2021, which has a present value cost of \$5,632.⁸⁸ Under the insurer's formula, the present value of the roof in 2031 is \$2,113.⁸⁹ Adding the expenditures in 2001 and 2021 and subtracting the value of the roof in 2031, the net outlay of the insured is \$8,519. In comparison, the homeowner under the second scenario, where no roof damage occurred, must purchase a new roof in 2011, which has a present value cost of \$7,504. By 2031, the value of the roof, according to the insurer's formula, is zero. Subtracting the value of the roof in 2031 from the present value of the homeowner's expenditures, the net costs to the homeowner through 2031 is \$7,504. Again, the homeowner with no roof damage is significantly better off than the insured, even using the insurer's depreciation formula and after taking into account the quality of the roof at the time of the loss.

86. The present value of an asset or expenditure in the future can be determined by estimating the amount that would have to be invested today to equal the value of the asset or expenditure at a particular time in the future. The example above assumes a discount rate of 6 percent. The present value of the cost of the roof in 2011 is $\$10,000 (1.03)^{10}/(1.06)^{10}$.

87. The present value of the roof in 2021 in the hypothetical above is $\$10,000 (1.03)^{20}/(2)(1.06)^{20} = \$2,816$.

88. Again, assuming inflation of 3 percent and a discount rate of 6 percent, the present value of the cost of the roof in 2021 is $\$10,000 (1.03)^{20}/(1.06)^{20} = \$5,632$.

89. $\$10,000 (1.03)^{30}/(2)(1.06)^{30} = \$24,272/11.4870 = \$2113$.

These hypotheticals suggest that current depreciation formulas disadvantage the insured when the costs of labor, as well as materials, are depreciated.

On the other hand, based solely on this monetary analysis, failing to depreciate the costs of labor can appear to overcompensate the insured. For example, during the first 20 years, the analysis showed that the insured with damage to his roof spent \$5,000 out of pocket, compared to the \$4,688 for the homeowner with no roof damage. When the hypothetical was extended to 30 years, the insured with damage to his roof spent \$8,519 compared to the other homeowner who spent \$7,504. However, if labor costs are not depreciated, their positions are reversed. For example, if the \$10,000 costs of repair are divided evenly between labor costs and materials and materials are depreciated by 50 percent, the insured receives a settlement of \$7,500. His out of pocket costs during 20 years would be \$2,500, compared to \$4,688 for the homeowner with no roof damage. Extending the hypothetical to 30 years, the insured would spend \$6,019, compared to \$7,504 for the homeowner with no damage. This analysis suggests neither approach consistently achieves the goal of indemnity. However, insurance law has traditionally favored the insured in cases in which the policies are ambiguous. Thus, this factor also points toward limiting depreciation to materials.

One final factor deserves mention. Depreciation formulas are notoriously arbitrary. For example, hearings before the Oklahoma Insurance Commission found that some insurance companies cap depreciation at 50 percent; others cap it at 80 percent or more, suggesting that these formulas are far from precise.⁹⁰ Depreciation formulas are often based on tax depreciation schedules, which tend to understate the actual life of materials.⁹¹ To the extent that claims settlement procedures tend to understate the life expectancy of all or part of a dwelling, the insured in the examples above is even worse off. Consequently, this factor points toward a using less drastic use of depreciation schedules in settling claims, such as limiting depreciation to materials.

CONCLUSION

The broad evidence rule, which is applied in Oklahoma, allows courts the flexibility to make commonsense judgments about the value of prop-

90. *Investigatory Hearing on Roof Replacement Claim Procedures for State Farm Fire & Casualty Company Before the Oklahoma Insurance Board of the State of Oklahoma*, Case No. 97-0525-DIS, Tapes 166B & 167A, p. 12-14 (Nov. 26, 1997).

91. *See supra* n.85.

erty, the reasonable expectations of the insured, and other relevant factors. In determining whether to depreciate labor costs in an actual cash value policy, courts should consider a number of factors. First, typical actual cash value policies are ambiguous as to the treatment of labor costs, and such ambiguities should be resolved in favor of the insured. Second, courts routinely state that the indemnity principle means paying the insured an amount sufficient to put him in the position he was in before the loss. Applying that principle in the case of damage to a dwelling means that the insured should receive an amount sufficient to pay for old materials plus the current costs of installing them or, what amounts to the theoretical equivalent, the depreciated value of new materials plus the current costs of installing them. Third, from a common-sense perspective (and no doubt from the point of view of many consumers) labor costs should not be depreciated as physical objects are. Fourth, depreciation formulas are frequently arbitrary and overstate the actual physical deterioration of a structure. Finally, based on a strict monetary analysis, depreciating labor costs, in addition to depreciating the costs of materials, leaves the insured in a significantly worse position than homeowners who do not experience losses, even after taking into account the quality of the materials at the time of the loss. On the other hand, if labor costs are *not* depreciated the positions of the insured with a loss and the homeowner can be reversed. Although this final factor does not point clearly toward either approach, it does suggest that a flat rule requiring depreciation of labor costs is inappropriate. In choosing between a rule that consistently favors the insurer and one that consistently favors the insured, the courts should choose the latter, particularly in light of the other factors discussed above. In summary, Oklahoma courts should take a pragmatic approach, which takes into account all these considerations, and hold that labor costs should not be depreciated in settling typical actual cash value policy claims.