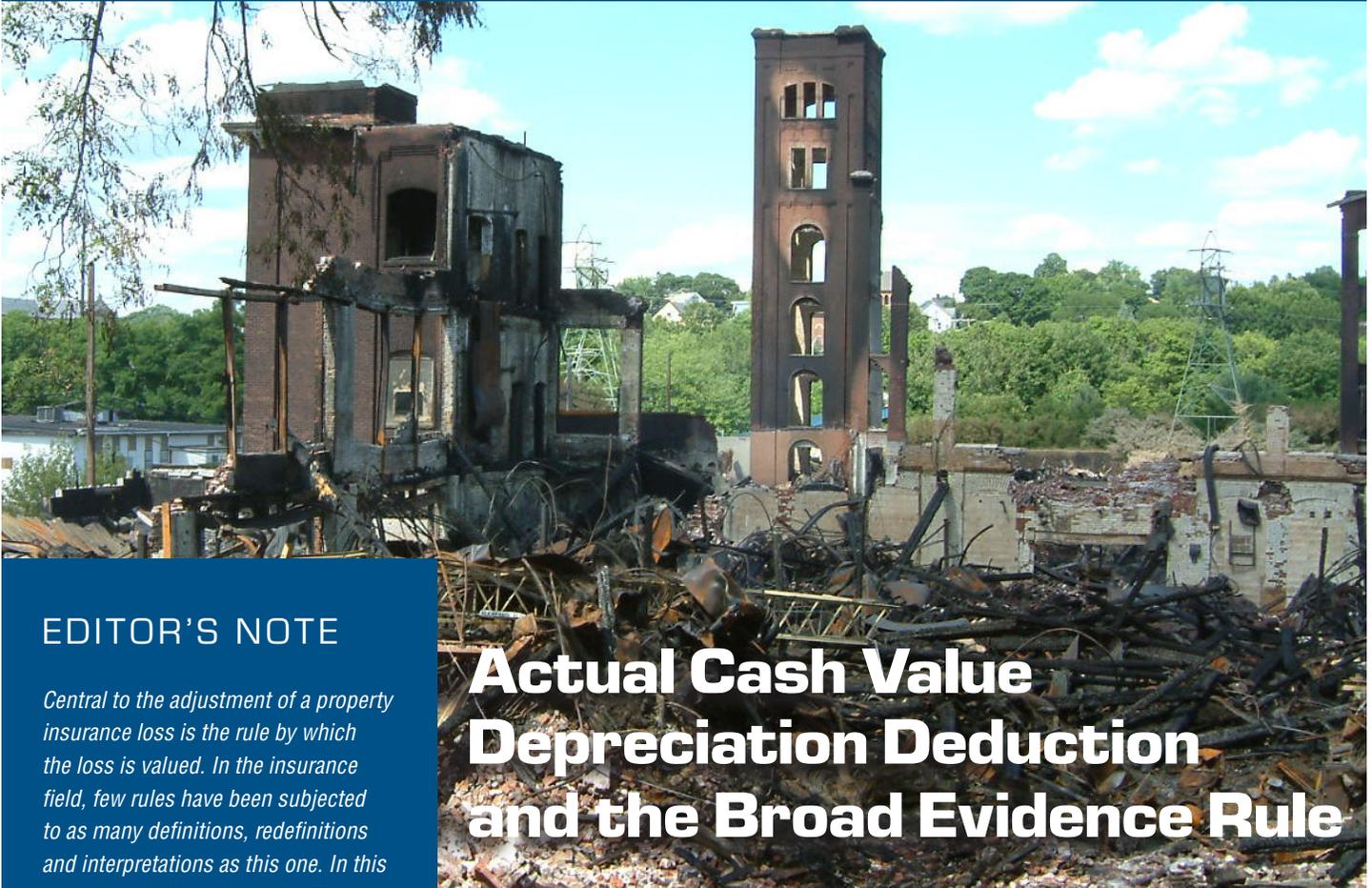




ADJUSTING TODAY

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EDITOR'S NOTE

Central to the adjustment of a property insurance loss is the rule by which the loss is valued. In the insurance field, few rules have been subjected to as many definitions, redefinitions and interpretations as this one. In this special e-edition of *Adjusting Today*, expert Jerome Trupin discusses the two fundamental approaches to loss valuation: the Actual Cash Value Depreciation Deduction and the Broad Evidence Rule. His analysis, examples and professional perspective combine for informative and insightful reading. We thank him for sharing his expertise and opinion and are confident you will find them helpful.

Sheila E. Salvatore,
Editor



Actual Cash Value Depreciation Deduction and the Broad Evidence Rule

by Jerome Trupin, CPCU, CLU, ChFC

Does actual cash value (ACV) always equal replacement cost less depreciation? Don't be too sure. A recent New York court case held that the insurer could not deduct depreciation when calculating the actual cash value of a partial loss.¹ The valuation provision in the policy read as follows:

9. Valuation

We will determine the value of Covered Property in the event of

loss or damage as follows:

- a. *At actual cash value as of the time of loss or damage...*

(There were some exceptions that followed, but they didn't apply to this loss.)

The court said that, unlike older New York policies, the policy did not specify that actual cash value is to be ascertained with proper



deductions for depreciation. The reference to a “proper deduction for depreciation” was eliminated in the 1943 revision of the New York Standard Fire Insurance Policy (SFP) — it had appeared in the 1918 version and prior iterations. Because those words are no longer used, the judge ruled that depreciation could not be deducted in calculating actual cash value.

Most current forms don’t include the depreciation wording and even if they do, many states require the insurer to provide at least as much coverage as that afforded by the 1943 SFP wording no matter what the current policy says. Insureds in those states can claim the advantage of the SFP wording.² There are 28 states that mandate coverage at least equal to the 1943 Standard Fire Policy. They are:

- Arizona
- California
- Connecticut
- Georgia
- Hawaii
- Idaho
- Illinois
- Iowa
- Louisiana
- Maine
- Massachusetts
- Michigan
- Minnesota
- Missouri
- Nebraska
- New Hampshire
- New Jersey
- New York
- North Carolina
- North Dakota
- Oklahoma
- Oregon
- Pennsylvania
- Rhode Island
- Virginia
- Washington
- West Virginia
- Wisconsin³



“ The reference to a ‘proper deduction for depreciation’ was eliminated in the 1943 revision of the New York Standard Fire Insurance Policy (SFP)... ”

Is ACV Still Important?

We sometimes think that all policies are written on a replacement cost basis and that ACV is only of academic interest, but that’s not correct. Right off the bat you have Fair Plan policies that, in most states, call for ACV valuation. Furthermore, replacement cost coverage is only an option in the Insurance Services Office (ISO) commercial property forms used by most insurers. Many insureds don’t elect replacement cost coverage because they don’t want to spend the additional premium,⁴ the insurance company won’t provide the coverage, or they

weren’t informed that the option was available.

Homeowners policies provide replacement cost, but only if the amount of insurance equals 80 percent of the replacement cost. If it doesn’t, recovery is the higher of the ACV of the loss or a coinsured payment based on dividing the amount carried by 80 percent of the replacement cost. Many business owners policies provide replacement cost coverage as the standard, but such ISO policies follow the homeowners model. The result: numerous losses are settled on an ACV basis.



What is the definition of ACV?

In “Insurance 101” we learned that *ACV equals replacement cost less depreciation* is written in stone. This decision seems to be an aberration that violates the rule. However, courts have decided against a deduction for depreciation in a number of other cases. The leading New York case, *Lazaroff v. Northwestern National*, was decided in 1952 and affirmed on appeal.⁵ Pennsylvania courts have also come down on the side of no deduction for depreciation for partial losses. In *William Kane, et al. v. State Farm Fire and Casualty Company, et al.*, the Pennsylvania Superior Court, which was confirmed on appeal, ruled:

[*P19] From these cases, we conclude that in partial loss situations, in the absence of clear language [***24] to the contrary, an insurer may not

deduct depreciation from the replacement cost of a policy and that the phrase “actual cash value” may not be interpreted as including a depreciation deduction, where such deduction would thwart the insured’s expectation to be made whole. Where qualifying language is absent and an insured is promised “actual cash value,” the insured is entitled to the cost to repair or replace the damaged property.⁶

In a more general sense, the New York Court of Appeals (New York’s highest court and, at the time of the decision, probably the leading court for insurance matters in the United States) dealt with the meaning of ACV in *McAnarney v. Newark Fire Insurance Company*.⁷ *McAnarney* posed an

interesting problem for the court. In 1919 *McAnarney* purchased seven buildings designed for use as a brewery for \$8,000, and in January 1920, insured them with various insurance companies for a total of \$60,000.⁸ The amount of \$60,000 was probably a reasonable valuation based on replacement cost less depreciation. The buildings were destroyed by fire in April 1920.

McAnarney submitted a claim for \$60,000 based on replacement cost less depreciation. However, the 18th amendment, which prohibited the manufacture, sale, or transportation of intoxicating liquors in the United States, had been ratified on January 16, 1919. Because that greatly affected the value of the buildings, the insurance companies disputed the claim. They pointed out that *McAnarney* had been unable to find a purchaser for the buildings



“ Because those words are no longer used, the judge ruled that depreciation could not be deducted in calculating actual cash value. ”



even though he advertised them for sale for \$12,000; that he had submitted an affidavit to the local assessors saying that the buildings had no value as they were only suitable for the manufacture of malt liquor, which was illegal under Prohibition; and that the

best offer he had received for the property was \$6,000.⁹

In the court case that followed, the jury awarded McAnarney \$55,000. The insurers appealed and the Court of Appeals reversed the lower courts. It wrote:

Indemnity is the basis and foundation of all insurance law. The contract with the Insurer is not that, if the property is burned, he will pay its market value, but that he will indemnify the assured, that is, save him harmless or put him



“ We sometimes think that all policies are written on a replacement cost basis and that ACV is only of academic interest, but that’s not correct. ”

in as good a condition, so far as practicable, as he would have been in if no fire had occurred.

In effect, the court rejected both the insured's claim that actual cash value equals replacement cost less depreciation and the insurer position that it equaled market value. As a standard for determining the payment that would restore the insured to the same condition that existed before the loss, the Court adopted what's come to be known as the Broad Evidence Rule. The Broad Evidence Rule says that everything that bears on the value of property should be considered. The list of possible factors is a long one. Here are some of them:

- Market value
- Replacement cost
- Depreciation
- Original cost
- Condition of the property
- Location
- Use
- Assessed value
- Offers to sell
- Offers to purchase¹⁰

The court in *Goorland v. New York Property* discussed *McAnarney* pointing out that it is the "seminal case" on the subject. The strength of the Broad Evidence Rule is its inclusiveness. The problem is that it doesn't provide a specific method for doing the calculation. Which factors do you consider? How much weight do you give to each of the factors?



“ The Broad Evidence Rule says that everything that bears on the value of property should be considered. The list of possible factors is a long one. ”

What's Happening in Practice?

Insurance companies did raise the broad evidence issue in the 1970s when arson was ravaging inner cities and real estate values had fallen through the floor. The market value of many buildings was far lower than replacement cost less depreciation. Insurance companies wanted that factored

into the settlement of large losses. It was not unusual to have a building that was insured for \$1 million sustain a loss, on an ACV-equals-replacement-cost-less-depreciation basis, that equaled or exceeded the amount of insurance. At the bottom of the market, buildings in depressed areas were selling for one-times annual



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rents.¹¹ The market value of such a building might have been \$200,000 or less; insurance companies argued that the Broad Evidence Rule indicated that ACV for such a building was close to \$200,000. In certain situations insureds also seized on a broad-evidence valuation approach as a way to reduce or avoid coinsurance penalties for smaller losses. However, even then the typical ACV loss was adjusted on the basis that ACV equals replacement cost less depreciation and that continues to be the case today. Will we see a change in this standard? My guess is that, despite the court decisions, replacement cost less depreciation will continue to be the way insurers want to settle losses. Insureds will have to resort to the courts to recover more than

replacement cost less depreciation for ACV losses.

The Situation in Other States

The Broad Evidence Rule is widely accepted, although some states (for example California) specify that ACV equals market value. A few have other opinions or their courts have not resolved the issue. Munich Reinsurance publishes a guide for adjusters dealing with a number of subjects, one of which is the Broad Evidence Rule. With regard to the Broad Evidence Rule, when the policy does not define ACV, the guide shows:

- 23 states where courts have adopted the Broad Evidence Rule
- 11 that use fair market value

- Four that say ACV equals replacement less depreciation
- Two that call for replacement cost with no depreciation, and
- 10 where no pertinent decisions were found.¹²

If I Were King

If I could make the rules, I would focus on betterment. That is, is the insured in a better position after the loss is paid than they were before the loss? If so, a deduction is in order. If not, then replacement cost should be the standard. For example, if a fire destroys one apartment in a multi-family dwelling, replacement of structural elements will probably not produce any economic benefit for the insured. Repainting the apartment,



if it hasn't been painted in several years, probably would. My position is that the component items in a loss should be looked at separately. For some, a deduction for betterment is proper; for others it's not.

For property that isn't going to be repaired, I'd go for a market-value standard: would the lack of the repairs reduce the market value of the property? If so, that's the measure of the loss. If not, the insured hasn't sustained any loss and shouldn't receive indemnification until the repairs are done.

A similar version of this article will appear in the Spring 2012 issue of the CPCU Society's Risk Management Interest Group newsletter, Claims Quorum.

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- ¹ *Goorland v New York Property Insurance Underwriting Association* Supreme NY 106212/08 4/5/2011.
- ² The advantages to an insured of SFP wording have cropped up in several places in recent years. For example, because there is no terrorism exclusion in the SFP, fire damage resulting from otherwise excluded terrorism would be covered in SFP states. Insurers have sought a change that would permit the terrorism exclusion to apply to fire, the SFP notwithstanding. Many states have complied. The latest is Massachusetts, which amended its law as of 4/13/2011. Although that eliminates the SFP as a source of terrorism coverage in those states, it affirms the validity of claims based on SFP wording in other cases.
- ³ Source: http://www.aasonline.com/terrorism/SFP_NSFPchart.html. In many of these states the mandate does not apply to Inland Marine insurance and in some it does not apply to terrorism losses.
- ⁴ There is no rate increase when the replacement cost option is selected, but most companies require an increase in the amount of insurance, which increases the premium.
- ⁵ 121 N. Y. S. 2d 122, affd. 281 App. Div. 672 1952.
- ⁶ *2003 PA Super 502; 841 A.2d 1038; 2003 Pa. Super. LEXIS 4588 Appeal denied by Kane v. State Farm Fire & Cas. Co., 2005 Pa. LEXIS 470 (Pa., Mar. 15, 2005).*
- ⁷ 247 NY 176 159 N.E. 02 1928.
- ⁸ Prior to the 1960s insurance companies would only provide small amounts of insurance on any one risk and it was necessary to place coverage with multiple companies to cover most properties.
- ⁹ Dennis M. Perlberg, Esq. and Gina M. Fortunato, “The Broad Evidence Rule” <http://www.longislandweb.com/speyer/pages/news/cashvalue.pdf>.
- ¹⁰ The first seven are from an article by Joshua Mallin, Esq. “Actual Cash Value vs. Replacement Cost Coverage Defined and Distinguished” <http://www.wegandmyers.com/Articles/Article-29.aspx>.
- ¹¹ At the present, these buildings, if they’re still standing, can sell for seven-times annual rents or more.
- ¹² “First Party Property Claims Desk Reference” Edward J. Ryan, editor, 2nd Edition, 2010, Munich Reinsurance America, Inc. Broad Evidence is discussed on pages 40 through 46.

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