

## Depreciation of Labor in Property Insurance Claims: Guidance From Recent Cases

Advocating From Insurer and Policyholder Perspectives

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# Depreciation of Labor

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# Course Overview

1. Background of ACV Valuation Calculation
2. Recent Cases
3. Policyholder Perspectives
4. Insurer Perspectives
5. Best Practices

# Valuation – The Origins of Insurance

- Indemnity – “To make Whole”
- From the Latin Word “*Indemnus*” ... to be Unharmmed!
- Therefore,
  - An ACV policy is a contract of indemnity.
  - A Replacement Cost policy is a contract of betterment.

*Actual Cash Value was not defined in the Standard NY Fire Insurance Policy.*

# 1943 – NY Standard Fire Insurance Policy

(aka – The 165 Line Policy)

1. The **actual cash value** of the property at the time of the loss, or
2. The amount which it would cost to repair or replace the property with material of **like kind and quality** within a reasonable time after such loss, without allowance for any increased cost of repair or reconstruction by reason of any ordinance or law regulating construction or repair, and without compensation for loss resulting from interruption of business or manufacture, or
3. To an amount not exceeding the amounts specified above, but in any event for no more than the interest of the insured, against all direct loss by fire, lightning and by removal from premises endangered by the perils insured against in this policy, except as hereinafter provided.

# Replacement Cost

- The cost to repair or replace material damaged or destroyed, with material of like kind and quality, typically valued at the date and time of loss
- Like kind and quality is typically not a defined term in a property insurance policy
- Numerous materials, most notably in older structures, are often obsolete, no longer economically feasible or sometimes illegal (asbestos), equivalent substitute materials must be calculated based on current cost in lieu of this material

## Functional Replacement Cost – Like Kind and Quality

- Substitute building materials can be considered as equivalent to replacement when they meet the following test:
  1. Will substitute material likely be used in the repair or replacement of damaged material? If yes, then
  2. Will the substitute material result in equivalent functional utility as the damaged material? If yes, then
  3. Will the substitute material result in a decrease in the remaining useful life of the building or its components? If no, then
  4. Will the substitute material result in a decrease in the property's market value or rental value? If no, then the substitute material meets the test of like kind and quality.

# Actual Cash Value (ACV)

Three methods which differ by jurisdiction:

## 1. Replacement Cost Minus Depreciation:

- Replacement Cost is determined and depreciation is deducted to arrive at ACV.

## 2. Market Value:

- The pre-loss market value of the building (exclusive of the land) is determined. Debris removal is added to arrive at ACV. This method can also use a loss in value concept wherein the pre-loss and post-loss values are compared, and the difference (after adding debris removal) is the ACV.

## 3. Broad Evidence:

- A multiple of factors may be taken into account in determining ACV.

# How Broad is Broad Evidence?

The Broad Evidence Rule is an inclusive valuation method that allows any evidence that can establish correct property value:

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

# How Broad is Broad Evidence?

“Where insured buildings have been destroyed, the trier of fact may, and should, call to its aid, in order to effectuate complete indemnity, every fact and circumstance which would logically tend to the formation of a correct estimate of the loss. It may consider original cost and cost of reproduction; the opinions upon value given by qualified witnesses; the declarations against interest which may have been made by the assured; the gainful uses to which the buildings might have been put; as well as any other fact reasonably tending to throw light upon the subject.”

*McAnarney v. Newark Fire Ins. Co.*, 159 N.E. 902 (N.Y. 1928).

# Depreciation = a loss in value from any cause

Three Types:

- **Physical Deterioration** – The effect of age, wear and tear on the building and/or its components.
- **Functional Obsolescence** – the effect of a flaw in the structure, materials or design of the building. Size, Layout, Obsolete Materials and Methods, Excessive Operating Expenses.
- **External Obsolescence** – Economic and other factors external to the property. (A brewery during prohibition, or a house in Libby Montana.)

# Methods of Calculating Depreciation

- Economic Life vs. Physical Life
- Actual Age vs. “Effective” Age
- Straight line method
- Curve Method
- Remaining useful life method

# Calculation of Depreciation – Straight Line

- Typically use the age life method of depreciation. Straight line.
  - Determine the useful life of the building component
  - Determine the age of the building component.
  - Use a ratio of age / life to calculate depreciation.
- Example
  - Building Chiller life 35 years
  - Age 20 years
  - Depreciated Amount –  $20/35 = 57\%$
  - Replacement Cost  $\$250,000 \times .57 = \$142,500$

# But Can You Depreciate Labor?

- Split in authority
- Considerations
  - Is the original labor cost part of the asset so that it is included in the depreciation calculation?
  - If you depreciate the physical components and not the included labor, would the insured recover more than the ACV of the damaged property?
  - If you depreciate the labor, is the insured made whole?

# The Effect of Depreciation of Labor

- Failure to depreciate labor will cause an effect on indemnity
- The economic loss to the market value of property considers the depreciation of labor
- Example:
  - 2- 25 year old tract Homes, side by side are identical. Same age and same condition except one of the homes has a recently replaced roof.
    - The market value difference between the two properties is equivalent to the cost of a new roof, which would include:
      - New roofing materials
      - Labor to install the new roof
      - Materials and supplies necessary to effect the installation
      - Markup to satisfy the contractor's overhead and profit.

# The Effect of Depreciation of Labor – New Roof

- Labor Depreciated

- Material & Labor \$5,000
- Contractor Markup \$1,000
- Total \$6,000
  
- Age/life – 20/25
- Depreciation 80%
- ACV \$1,200

- No Labor Depreciation

- Material \$2,000
- Labor \$3,000
- Contractor Markup \$1,000
- Total \$6,000
  
- ACV
  - Depreciated Material \$ 400
  - Labor \$3,000
  - Markup \$ 680
  - ACV \$4,080

***Papurello v. State Farm Fire & Cas. Co.***,  
144 F. Supp.3d 746 (W.D. Penn. 2015)

- Putative Class Action regarding calculation of ACV.
- Court held that policy clearly provided for ACV if not repaired or replaced.
- The court determined that covered property, like a roof, refers to a finished product, which is “the *result* or physical manifestation of combining knowhow, labor, physical materials . . . and anything else required to produce the final, finished roof itself.”
- The court found the insureds’ view that property equates to only the physical materials strained reason.

But see:

“[W]e conclude that in partial loss situations, in the absence of clear language 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.” *Kane v. State Farm Fire & Cas. Co.*, 841 A.2d 1038, 1047 (Pa. Super. Ct. 2003).

# Courts Allowing Depreciation of Labor

## Arkansas

- Legislature changed the law after the Supreme Court of Arkansas held that labor may not be depreciated notwithstanding policy language that specifically allowed for it in *Shelter Mut. Ins. Co. v. Goodner*, 477 S.W.3d 512 (Ark. 2015).
- Insurance policies may allow for expense depreciation which means “depreciation, including but not limited to the cost of goods, materials, labor, and services necessary to replace, repair, or rebuild damaged property. Ark. Stat. § 23-88-106.

## Florida

- “The Second District [in *Goff*] correctly determined, in essence, that overhead and profit are like all other costs of a repair, such as labor and materials, the insured is reasonably likely to incur .... The Second District therefore held that a portion of overhead and profit, like a portion of all other costs, was included but could be depreciated in an actual cash value policy.” *Trinidad v. Florida Peninsula Ins. Co.*, 121 So. 3d 433, 438 (Fla. 2013).

# Courts Allowing Depreciation of Labor

## Kansas

- “a reasonable person . . . would expect [the insurer] to depreciate all costs necessary to (re)creating the insured ‘property’—including the costs associated with labor—when calculating actual cash value.”  
*Graves v. Am. Family Mut. Ins. Co.*, No. 14-2417-EFM-JPO, 2015 WL 4478468, at \*3 (D. Kan. July 22, 2015).

# Courts Allowing Depreciation of Labor

## Missouri

- *Labrier v. State Farm Fire & Cas. Co.*, 315 F.R.D. 503, 522 (W.D. Mo. 2016), the district court had held the term “actual cash value” to be inherently ambiguous because it was not defined in the policy.
- The district court went on to rule in favor of class certification on the issue of whether the insurer “may withhold labor depreciation from ACV payments under Missouri law.
- The 8<sup>th</sup> Circuit reversed.
- “Embedded-labor-cost depreciation is one factor that a trier of fact may consider in determining actual cash value.” *In re: State Farm Fire and Cas. Co.*, 872 F.3d 567, 576-77 (8<sup>th</sup> Cir. 2017).

# Courts Allowing Depreciation of Labor

## Nebraska

- Because the unambiguous definition of ACV is “depreciation of the whole,” “the insured is not underindemnified by receiving the depreciated amount of both materials and labor.” *Henn v. American Family Mut. Ins. Co.*, 894 N.W.2d 179 (Neb. 2017).

## Ohio

- Finding no ambiguity and “a calculation of the ACV could depreciate labor as well as materials.” *Cranfield v. State Farm Fire & Cas. Co.*, 340 F. Supp.3d 670 (N.D. Ohio 2018).

# Courts Allowing Depreciation of Labor

## Oklahoma

- “Redcorn chose an ‘actual cash value’ policy, and paid premiums based on his choice. He insured a roof surface, not two components, material and labor. He did not pay for a hybrid policy of actual cash value for roofing materials and replacement costs for labor. To construe the policy in such a manner would unjustly enrich the policy holder.”  
*Redcorn v. State Farm Fire & Cas. Co.*, 55 P.3d 1017, 1021 (Okla. 2002)

# Courts NOT Allowing Depreciation of Labor

## Alabama

- *Arnold v. State Farm*, 268 F. Supp.3d 1297 (S.D. Ala. 2017), held that ACV does not unambiguously include depreciation of labor.

## Kentucky

- “The very idea of depreciating the value of labor defies good common society.” *Bailey v. State Farm Fire & Cas. Co.*, No. CIV.A. 14-53-HRW, 2015 WL 1401640, at \*8 (E.D. Ky. Mar. 25, 2015).
- Court applied general principles of indemnity – make the insured whole; give the insured what she had before the loss – nothing more; nothing less
- “Indeed, the cost to install a new garage would be the same as installing a garage with 10 year old materials. In other words, depreciated labor costs would result in **under** indemnification.”

# Courts NOT Allowing Depreciation of Labor

## Montana

- Statute:
  - “If there is no valuation in the policy and unless a basis more favorable to the insured is provided for in the policy, the measure of indemnity in an insurance against fire is the expense, at the time that the loss is payable, of replacing the thing lost or injured, in the condition in which it was at the time of the injury....”  
MONT. CODE ANN. § 33-24-101.
- *McIntosh v. Hartford Fire Ins. Co.*, 78 P.2d 82, 84-85 (Mont. 1938), construed this statute as not allowing depreciation. It only allowed replacement cost.
  - Court reasoned that statute requires, condition aside, that damaged property be replaced
  - Thus, the cost of the *replacement* cannot be discounted; to do so would not yield a complete replacement at the depreciated value

# Courts NOT Allowing Depreciation of Labor

## Tennessee

- The Tennessee Supreme Court refused to construe an ambiguous definition of actual cash value to allow for deduction of labor costs as part of depreciation calculations where labor costs are not clearly addressed in the policy. *Lammert v. Auto-Owners (Mutual) Insurance Co.*, No. M2017-2546-SC-R23-CV (Tenn. Apr. 15, 2019)
  - The insureds argued that depreciating labor would defeat the purpose of indemnity, which was to make them whole
  - The insurer argued that not allowing labor depreciation would give the insureds a windfall by leaving them in a better position than before the loss
  - The TN Supreme Court based its decision on two general principles:
    1. Under Tennessee law, the purpose of indemnity insurance is to reimburse and restore the insured to the position he or she was in before the loss
    2. The dictionary meaning of “depreciation,” is “a reduction in value or price of something; specif[ically] a decline in an asset’s value because of use, wear, obsolescence, or age.”

# Courts NOT Allowing Depreciation of Labor

## Vermont

- “It is the Department's position that depreciation of labor costs is prohibited by 8 V.S.A. § 4724(9)(F) and therefore is an unfair claim settlement practice in violation of 8 V.S.A. § 4723 (the Vermont Insurance Trade Practices Act) when committed or performed with such frequency as to indicate a business practice.” Bulletin 184, 2015 WL 1975918 (VT INS BUL).

## Washington

- Court held that policy language was ambiguous and an insurer improperly depreciated labor costs where the policy defined actual cash value as “the amount it costs to repair or replace property with like kind and quality less depreciation for physical deterioration and obsolescence.” *Lains v. American Family Mut. Ins. Co.*, No. C14-1982-JCC, 2016 WL 4533075, at \*2 (W.D. Wash. Feb. 2, 2016).

# Should Be Considered in Broad Evidence State

“When [an] insurance policy does not define the term “actual cash value” or otherwise state whether embedded labor costs are depreciable for the purpose of calculating actual cash value, the trier of fact may consider embedded-labor-cost depreciation when such evidence logically tends to establish the actual cash value of a covered loss.”

*Wilcox v. State Farm Fire & Cas. Co.*, 874 N.W.2d 780, 785 (Minn. 2016)

# Depreciation of Labor Allowed:

- Arkansas
- Colorado
- Florida
- Indiana
- Kansas
- Mississippi (see Ms. Ins. Bulletin 2017-8)
- Missouri
- Nebraska
- North Carolina
- Ohio
- Oklahoma
- **Pennsylvania** (possibly no depreciation of labor when there is a partial loss)

# Depreciation of Labor NOT Allowed:

- Alabama
- California
- Kentucky
- Montana
- Tennessee
- Vermont
- Washington

Thank you!

Questions?

