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VIA EMAIL

July 13, 2021

David Forte
Rules Coordinator
Office of the Insurance Commissioner
302 Sid Snyder Ave., SW, Suite 200
Olympia, WA 98501
rulescoordinator@oic.wa.gov

RE: State Farm Fire and Casualty Company's Comments on R 2021-04 Prohibiting Depreciation of Labor on Property Claims

Dear Mr. Forte:

State Farm Fire and Casualty Company ("State Farm") writes in response to the request for comments by the Office of the Insurance Commissioner ("OIC") regarding the first stakeholder draft ("Proposed Rule") for R 2021-03 "Prohibiting depreciation of labor on property claims," released June 23, 2021, and the CR-101 ("the CR-101") for R-2021-04 released on June 22, 2021. State Farm appreciates the opportunity to submit written comments to the rules coordinator.

The Proposed Rule prohibiting the depreciation of estimated labor costs is inconsistent with (1) the OIC's prior approval of multiple State Farm policy forms that expressly permit the depreciation of all components of estimated replacement cost in the calculation of actual cash value ("ACV") payments, including labor costs; (2) Washington Supreme Court precedent recognizing that depreciation may properly be applied to *all* components of estimated replacement cost when ACV is calculated; and (3) the position taken by nearly every other Department of Insurance and the majority approach nationwide to the "labor depreciation" issue. Moreover, the Proposed Rule may inadvertently create an incentive for policyholders *not* to complete repairs for reasons explained below.

1. The Proposed Rule is Inconsistent With the OIC's Prior Approval of State Farm Policy Forms Defining ACV to Include the Depreciation of Labor Costs.

On November 15, 2016, State Farm submitted a proposed endorsement for multiple Washington structural damage policy forms—entitled "FE-3650 ACTUAL CASH VALUE ENDORESEMENT" (hereinafter, the "ACV Endorsement")—stating that State Farm would calculate the ACV for damaged property as the "estimated cost to repair or replace such property, less a deduction to account for pre-loss depreciation." *E.g.*, Tracking # SFMA-130806554. The ACV Endorsement specified that "all components of this estimated cost including, but not limited to . . . labor . . . are subject to depreciation." *Id.* On November 17, 2016, the OIC objected to the

ACV Endorsement on the grounds that it did not state that ACV would not be less than the fair market value of the damaged property. *Id.* State Farm responded on January 9, 2017, explained its disagreement with the OIC's objection, and requested that the OIC approve the language in the ACV Endorsement as originally submitted. *Id.* On January 18, 2017, the OIC did precisely that, formally approving the original version of the ACV Endorsement through the SERFF system. *Id.*

In reliance on that approval, State Farm filed a rewrite of its homeowners' policy form in 2019 that contained identical language to the ACV Endorsement. That filing was approved by the OIC, after further communications with State Farm, on May 13, 2019. *See* SERFF Tracking # SFMA-131890366. State Farm has numerous other policy forms that have been approved by the OIC containing the same language that appears in the ACV Endorsement. State Farm is not aware of any legal developments in Washington since the OIC's approval of the ACV Endorsement on January 18, 2017, that changed Washington law to prohibit the depreciation of labor. Both State Farm and its policyholders have relied on this OIC-approved policy language and structural damage claims have been adjusted in Washington consistent with that policy language. To issue a new rule now that contravenes this OIC-approved language would be disruptive to both State Farm and its policyholders.

2. The Proposed Rule Conflicts With Washington Supreme Court Precedent.

While the Washington Supreme Court has not specifically addressed the issue of labor depreciation, it has addressed the calculation of ACV under the "replacement cost less depreciation" formula for ACV, and its analysis strongly suggests that the Court would approve a policy that expressly allows for labor depreciation. In *Holden v. Farmers Insurance Co. of Washington*, the Court held that the "replacement cost" to which depreciation should be applied in calculating ACV is the ***full*** estimated replacement cost of property, including any non-material components. Specifically, the Court held that sales tax should be "included in calculating the replacement cost of the damaged property before subtracting for depreciation." 239 P.3d 344, 349 (Wash. 2010) (*en banc*). The Court in *Holden* also recognized that courts should endeavor to enforce the plain language that appears in an insurance policy whenever possible. *See id.*

Just like the sales tax component of replacement cost that was at issue in *Holden*, estimated labor costs also comprise a portion of the total replacement cost for damaged property. Thus, it is reasonable to expect that the Washington Supreme Court would direct that estimated labor costs should be included when depreciation is applied in calculating ACV, particularly if the policy language—like the language in State Farm's approved Washington policy forms—expressly authorizes such depreciation. The Proposed Rule conflicts with this guidance from *Holden*.

3. The Proposed Rule is Inconsistent With the Position Taken By Nearly all Insurance Departments and the Majority Approach Nationwide on this Issue.

The overwhelming majority of state departments of insurance, state legislatures, and court decisions across the country recognize that insurers may properly apply depreciation to estimated labor costs, particularly when the policy expressly permits it, as do State Farm's previously approved policy forms in Washington. The Proposed Rule conflicts with this majority approach.

With respect to departments of insurance and state legislatures, the approach is nearly uniform. As of the date of this letter, 46 states, plus the District of Columbia, have approved State Farm policy language that explicitly allows for the depreciation of estimated labor costs in the calculation of ACV. This includes jurisdictions such as Arkansas, where the state legislature in 2017 expressly approved the practice of labor depreciation. *See* Ark. Code § 23-88-106 (2017).

Similarly, five of the seven state supreme courts to consider the issue of labor depreciation—Oklahoma, Minnesota, Nebraska, North Carolina, and South Carolina—have flatly rejected the idea that estimated labor costs cannot be depreciated when calculating ACV.[1] A sixth state supreme court, Arkansas, previously ruled that labor depreciation was improper, but that decision was overturned by statute in 2017. *See* Ark. Code § 23-88-106. The seventh state supreme court to consider this issue, Tennessee, held that labor depreciation was improper only because the insurance policy in question did not expressly permit it, unlike the State Farm policy that the OIC has approved.[2]

Only a few states currently outright prohibit or seek to prohibit labor depreciation (e.g., California and Vermont). In addition, although a minority of courts have upheld the viability of labor depreciation claims at the initial pleading stage of litigation, those cases have involved policies that—unlike State Farm's approved policy forms in Washington—do not expressly permit labor depreciation. Moreover, while there has been some suggestion that Tennessee and Montana have "forbidden" the practice of labor depreciation,[3] that assertion is not correct. As noted above, Tennessee merely concluded that a policy which does not *expressly* permit labor depreciation is ambiguous and for that reason should be read to prohibit labor depreciation. And while the

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[1] *See Redcorn v. State Farm Fire and Casualty Co.*, 55 P.3d 1017, 1021 (Okla. 2002); *Wilcox v. State Farm Fire and Casualty Co.*, 874 N.W.2d 780, 784-85 (Minn. 2016); *Henn v. American Family Mutual Insurance Co.*, 894 N.W.2d 179, 189-90 (Neb. 2017); *Accardi v. Hartford Underwriters Insurance Co.*, 838 S.E.2d 454, 457 (N.C. 2020); *Butler v. Travelers Home & Marine Ins. Co.*, 858 S.E.2d 407, 408 (S.C. 2021).

[2] *See Lammert v. Auto-Owners (Mut.) Ins. Co.*, 572 S.W.3d 170, 178-179 (Tenn. 2019).

[3] *See* WA State Office of the Insurance Commissioner, "Homeowner alert: Some insurers 'depreciate' labor costs for repair claims," https://medium.com/commissioners-eye-on-insurance/homeowner-alert-some-insurers-depreciate-labor-costs-for-repair-claims-88bcb683a507 (June 30, 2021).

Montana Commissioner of Securities and Insurance ("MCSI") previously suggested in an advisory opinion that labor depreciation was not acceptable, it *rescinded* that opinion in full in May 2020.[4]

4. The Proposed Rule is Inconsistent With Principles of Indemnity and Would Be a Disincentive to Repairs.

In the CR-101, the OIC offered the following explanation for the Proposed Rule: "The practice of depreciating labor costs on insurance payments for property damage claims floats a significant part of the labor repair costs to the consumer and their repair contractor, unfairly shifting a burden to the consumer during the repair process." This explanation does not comport with State Farm's structural damage claim handling practices or experience in Washington. Moreover, the Proposed Rule may inadvertently create an incentive for policyholders *not* to complete repairs.

As a threshold matter, as the Washington Supreme Court has recognized, ACV coverage is not intended to cover the cost for an insured to complete repairs. Rather, it exists to give the insured the "fair cash value" of the damaged property. *Hess v. N. Pac. Ins. Co.*, 859 P.2d 586, 587 (Wash. 1993) (en banc). Replacement cost coverage, in contrast, is intended to make the insured whole by covering "the increased cost to repair or to rebuild." *Id.*[5]

Consistent with this dichotomy, State Farm pays covered losses under its "replacement cost" policies in two stages: ACV before repairs are completed, and replacement cost benefits thereafter. Importantly, however, State Farm does not require insureds to complete repairs before they are paid replacement cost benefits. Instead, State Farm informs every insured in writing that it will consider paying replacement cost benefits *prior* to repairs if the insured presents a signed contract for the repairs. Thus, under State Farm's claim handling practices, *none* of the labor costs are "floated" or "shifted" to the insured; the insured need only present a signed contract for the repairs and State Farm frequently will pay the full repair costs before the insured has paid any of them.

Moreover, even where an insured waits to claim replacement cost benefits until after repairs are completed, State Farm's experience is that the insured often has not paid out of pocket for *any* of the repairs. That is true for several reasons: (1) sometimes the insured can complete all repairs in full for the amount State Farm has paid for ACV; (2) more often the insured will turn over their ACV payment to their contractor as a partial payment so that the contractor will begin work; and (3) many times the contractor will simply ask for payment after repairs are completed. In all three scenarios, the insured has not been forced to "float" any labor costs.

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[4] *See* MCSI, Rescission of Notice re: CSI Advisory Memorandum on Depreciation of Labor (May 22, 2020), available at https://csimt.gov/wp-content/uploads/Rescission-of-Notice-re-CSI-Advisory-Memorandum-on-Depreciation-of-Labor.pdf.

[5] As the Nebraska Supreme Court correctly recognized, the ACV payment "can be used as seed money to start the repairs." *Henn*, 894 N.W.2d at 185.

However, State Farm respectfully submits that the Proposed Rule may well inadvertently create an incentive for policyholders *not* to complete repairs. That is, if insurers are required to pay full labor costs for repairs as ACV *before* repairs are done, and regardless of whether repairs are done, an insured who chooses not to repair will "make a profit out of his loss." *Hess*, 859 P.2d at 589 (quoting 6 J. & J. Appleman, *Insurance* § 3823 n.66.57 (Supp. 1992)). Such a result is contrary to the basic principle of indemnity. *Id.*; *see also Gossett v. Farmers Ins. Co. of Wash.*, 948 P.2d 1264, 1271 (Wash. 1997) (the principle of indemnity ensures that insurance policies are not used "as gambling or wagering contracts").

For the reasons set forth above, State Farm respectfully requests that the OIC withdraw the Proposed Rule. State Farm appreciates the opportunity to comment through this letter and would welcome the opportunity to discuss the Proposed Rule further with the OIC.

Sincerely,

Victoria K. Kidman, Esq. CPCU