State Farm

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VIA ELECTRONIC MAIL

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

Dear Mr. Forte:

State Farm Fire and Casualty Company ("State Farm") submits the following additional comments to the Office of the Insurance Commissioner ("OIC") regarding the proposed rule addressing the depreciation of labor on property claims (Matter R 2021-04, hereinafter the "Proposed Rule"). State Farm stands behind its original comments and addresses the following additional points through this submission: (1) the Proposed Rule will provide a "windfall" to many insureds, contrary to Washington law; (2) the comment letter submitted by United Policyholders incorrectly portrays the practice of "labor depreciation" as a new phenomenon, when in fact the opposite is true; and (3) the Proposed Rule does not take into account State Farm's longstanding, well-documented practice of releasing depreciation following the presentation of a signed repair contract.

1. The Proposed Rule Will Provide a "Windfall" to Many Insureds.

Under longstanding Washington law, insurance indemnity payments should not permit the insured to "make a profit out of his loss." *Hess v. North Pacific Ins. Co.*, 859 P.2d 586, 589 (Wash. 1993) (en banc) (quoting 6 J. & J. Appleman, *Insurance* § 3823 n.66.57 (Supp. 1992)). State Farm's Washington homeowner's insurance policy, like many similar policies sold today, guards against this risk by establishing a two-step process for payment of structural damage losses. At the first step, pre-repair, the insured is paid the actual cash value (or "ACV") of the damaged property, a value derived by estimating the current replacement cost of the property and subtracting both depreciation and the insured's deductible. Any applied depreciation that is recoverable under the policy is released at step two, after repairs are completed—or, as discussed further below, after the insured has provided a signed contract for the completion of those repairs.

The Proposed Rule upends this process by effectively forcing insurers to pay full labor costs for replacement up front, contrary to the terms of State Farm's replacement cost policies, before any repair work has begun, and regardless of whether an insured's actual labor costs end up being less their estimated labor costs. That result will over-indemnify insureds in many common losses and provide a windfall in the event a policyholder with a replacement cost policy decides not to complete repairs.

Consider the common loss of wind-damage to a roof. If the total cost to replace a wind-damaged roof is $10,000, comprised of $4,000 for materials and $6,000 for labor, applying depreciation *only* to material costs will produce an inflated ACV payment whenever the roof is nearing the end of its useful life. For example, the inflated ACV for a 16-year-old roof composed of 20-year shingles (80% through its useful life) would be $6,800—the full, undepreciated $6,000 cost for labor, plus $800 for the depreciated cost of materials ($4,000 – ($4,000 * 80% depreciation)). That plainly overstates the value of such an aged roof. Indeed, it represents nearly 70% of the *full* cost of a brand-new roof.

As several courts have recognized, the overvaluation of damaged property in this manner provides a windfall to insureds who choose not to repair or who have purchased an ACV policy without replacement cost coverage:

- "[I]f improperly American Family could depreciate only the cost of materials in determining the actual cash value of [Plaintiff's] loss, **she would receive a windfall based on labor costs she never incurred** with respect to her kitchen ceiling. Such a result is contrary to the principle of indemnity because she would be in a better position than she was before the damage occurred." *Graves v. Am. Fam. Mut. Ins. Co.*, 686 F. App'x 536, 539 (10th Cir. 2017) (emphasis added).

- "We agree with American Family that a payment of actual cash value that included the full cost of labor would amount to a **prepayment of unearned benefits**." *Henn v. Am. Fam. Mut. Ins. Co.*, 295 Neb. 859, 875, 894 N.W.2d 179, 190 (2017) (emphasis added).

- "[Plaintiff's] insistence that ACV should include an up-front award of full labor costs of repair is illogical. . .. A policy that paid full repair or replacement cost for all losses would undoubtedly cost [Plaintiff] substantially more in premium payments because of increased risk exposure placed on Hartford. To allow [Plaintiff] to purchase, pay lower premiums for, and make claims under a hybrid insurance policy, yet receive reimbursements like someone who chose a replacement cost policy, would allow [Plaintiff] to receive a windfall." *Accardi v. Hartford Underwriters Ins. Co.*, No. 18 CVS 2162, 2018 WL 5273971, at *6 (N.C. Super. Oct. 22, 2018), *aff'd*, 373 N.C. 292, 838 S.E.2d 454 (2020).

In addition, requiring full payment of all estimated labor costs before any repair work has begun will also overcompensate insureds under a replacement cost policy whose repair costs end up being less than the costs estimated at the beginning of the claim process.

Finally, it has been mistakenly suggested by some that the full labor costs necessary for repairs should be paid as ACV to enable a policyholder to repair their property using old, depreciated materials (e.g., 16-year-old roofing shingles, which are not even generally available for purchase in the marketplace). That very concept confuses the purpose of ACV coverage—to provide the policyholder with the value, *in cash*, of the damaged property—with the purpose of replacement cost coverage. Although insurers do consider what the full replacement costs may be when arriving at a reasonable estimate of ACV, that is only because the "replacement cost less depreciation" formula serves as a proxy for the value of aged property—not because ACV coverage is designed to enable a policyholder to repair using old materials to otherwise pay for a lesser level of repairs. To interpret ACV coverage in that manner will lead to many insureds receiving a "windfall" through their ACV payment, which could very well increase the overall cost of insurance to Washington consumers. The Proposed Rule fails to account for these principles.

2. The Comment Letter Submitted by United Policyholders Misstates Historical Insurance Practices with Respect to Depreciation of Estimated Labor Costs.

State Farm has reviewed the comment letters submitted to date regarding the Proposed Rule and is concerned that the comment letter submitted by United Policyholders on July 15, 2021 (the "UP Letter"), presents an especially misleading picture of historical insurance practices. Specifically, the UP Letter's statement that the "traditional industry approach was not to depreciate labor when calculating a policyholder's ACV payment," and that this supposed practice changed "over the past ten to fifteen years" is without factual basis. UP Letter at 2. United Policyholders cites two sources as purported support for this statement: (1) a 2013 article that itself does not cite to any sources in declaring that labor costs historically were not depreciated,[1] and (2) an internet "blog" written by a plaintiff's-side insurance lawyer discussing two Oklahoma Supreme Court decisions from nearly 20 years ago specifically holding that estimated labor costs were properly depreciated when ACV is determined.[2]

The false narrative presented in the UP Letter has appropriately been summarily brushed aside by the courts. For example, the Nebraska Supreme Court reviewed the same materials cited in the UP Letter and concluded that they "fail to support the premise of any such historical practice" by insurers of not depreciating labor. *Henn*, 894 N.W.2d at 190.

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[1] *See* Don Wood *et al.*, *Insurance Recovery After Hurricane Sandy: Correcting the Improper Depreciation of Intangibles Under Property Insurance Policies*, in 42 Torts, Ins. & Compensation L.J. 19 (Winter 2013)).

[2] Chip Merlin, "Few Judges and Insurance Regulators Worked in Property Claims: Understanding New Depreciation Rulings," Property Insurance Coverage Law Blog (Aug. 16, 2017), https://www.propertyinsurancecoveragelaw.com/2017/08/articles/insurance/few-judges-and-insurance-regulators-worked-in-property-claims-understanding-new-depreciation-rulings/; *see also* Website Biography of Chip Merlin, https://www.merlinlawgroup.com/attorneys/william-f-chip-merlin-jr-esq/ (referring to Merlin as the "Babe Ruth of Hurricane Lawyers").

In fact, actual historical insurance texts demonstrate the exact opposite. For example, a 1988 textbook called *Introduction to Claims* provides an example of the replacement cost less depreciation formula that applies depreciation to the *entire* estimated replacement cost:

$400,000	Replacement cost new
- $100,000	Depreciation (25% x $400,000)
$300,000	Actual cash value

Robert J. Prahl, CPCU, *Introduction to Claims* at 88 (1st ed. 1988).

Likewise, courts in insurance cases have, for nearly a century, recognized that depreciation is properly applied to the *full* estimated cost of replacement, not just the materials portion thereof. *See, e.g., Providence Washington Ins. Co. v. Gulinson*, 215 P. 154, 155 (Colo. 1923) ("If $3,016 was the cost of repairs it should have been reduced for depreciation at something like the same rate as the cost of the whole reconstruction — 50 per cent.").

Washington law is consistent with this precedent. In *Holden v. Farmers Insurance Co. of Washington*, for example, the Washington Supreme Court held in 2010 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 Proposed Rule conflicts with this guidance from *Holden*.

In addition, as State Farm explained in its initial comment letter, the Proposed Rule undercuts the OIC's approval, nearly five years ago, of State Farm's ACV endorsement specifically permitting depreciation of all estimated replacement costs when ACV is calculated (consistent with *Holden*). The OIC subsequently approved State Farm's rewrite of its homeowners' policy form to incorporate the same language from the ACV endorsement. The OIC's apparent decision to reverse its position on this issue several years later, without a showing that intervening facts warrant such a change, undermines the reliability of the Office's decisions, and could produce additional, unintended consequences in the market.

3. The Proposed Rule Does Not Account for State Farm's Longstanding Practice of Releasing Depreciation Upon Submission of a Signed Repair Contract.

As State Farm explained in its initial comment letter, the OIC's apparent concern in articulating the Proposed Rule that applying depreciation to estimated labor costs unfairly "floats" to policyholders the full cost of labor necessary for repairs (*see* CR-101 for R-2021-04) does not comport with State Farm's structural damage claim handling practices. The reason is that State Farm informs every insured that it will consider

paying replacement cost benefits *prior* to repairs if the insured presents a signed contract for the repairs or otherwise has repairs substantially underway.

While State Farm's claims practice is not stated on the face of its policy, State Farm notifies each insured of the practice *in writing* and has done so consistently for years. Specifically, State Farm's Explanation of Building Replacement Cost Benefits form that is provided with every estimate states as follows:

> Without waiving the above requirements, we will consider paying replacement cost benefits prior to actual repair or replacement if we determine repair or replacement costs will be incurred because repairs are substantially under way or you present a signed contract acceptable to us.

State Farm's internal claims guidelines describe the same longstanding practice.

Because State Farm's well-established claims practice addresses the OIC's specific concern that policyholders will be forced to pay repair costs out-of-pocket prior to receiving payment for those same costs from insurers, State Farm respectfully submits that either the Proposed Rule should expressly provide an exception for insurers following similar claims practices or the OIC should clarify through a regulatory bulletin that the Proposed Rule is not intended to apply to insurers following similar claims practices.

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For the reasons set forth above and in State Farm's original comment letter dated July 13, 2021, State Farm respectfully requests that the OIC reconsider adopting the Proposed Rule.

Sincerely,

Victoria Kidman, Esq. CPCU