



# The Legal Update

POLICYHOLDER REPRESENTATION

SEPTEMBER 2009

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## Replacement Cost v. Actual Cash Value

Once a carrier decides to pay a property damage claim business owners and homeowners often learn for the first time the differences between replacement cost and actual cash value insurance policies. Its not that these terms are concealed in the insurance policy, but rather that the distinction between to the two most common types of policies is never seriously

considered by many policyholders until the carrier signals that it is ready to make a payment.

Ideally, policyholders should learn of the difference between these terms prior to purchasing the policy.

The term "replacement cost" or a replacement cost policy generally refers to an insurance policy where the payment of a loss is based upon the amount of money necessary to repair or replace the damaged property without deduction for depreciation. In contrast, "actual cash value" or "actual value" refers to an insurance policy where the payment of a loss is based upon the actual value of the loss at the time of the loss. Thus, a replacement cost policy provides greater protection against loss than an actual cash value policy.

Generally, insurance carriers charge higher premiums for replacement cost policies than they do for actual cash value policies due to the greater protection afforded. However, the differences between a replacement cost policy and an actual cash value policy do not end with the premium charged. Significant differences exist with regard to the types of evidence used to determine the amount of the loss.

### Replacement Cost Policies

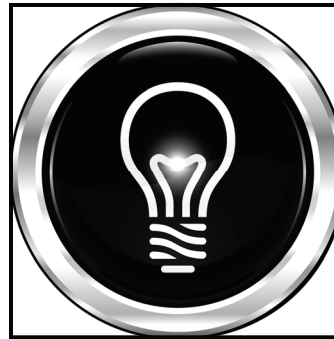
Most replacement cost policies structure payments to a policyholder after a loss on an "actual cash value" basis and then require the policyholder to make repairs or replace the property within a certain period of time (typically 180 days) prior to issuing the final payment for the full replacement

cost. For example, if you suffer a covered loss to your roof and your insurance carrier determines the replacement cost for your roof is \$100,000, under most property damage policies, the carrier is not initially required to issue you a check for the

full replacement cost - \$100,000. Initially, the insurance policy allows the carrier to pay you the "actual cash value" of your loss and only after repair or replacement is completed will the carrier be obligated to make the final replacement cost payment. So, after the carrier determines that the replacement cost to your roof is \$100,000, the carrier makes a reasonable deduction for depreciation. For example, if the roof has a useful life of 20 years and the roof is 10 years old, then the carrier may decide to depreciate the roof at a factor of 50%. In this example, then the carrier would issue its initial payment of \$50,000 for the "actual cash value" of the loss, at the time of the loss, with its promise to pay the remaining replacement cost of \$50,000 upon the completion of repairs or replacement, an inspection and proof of payment for the

repairs ( $\$100,000 \times .50 = \$50,000$ ).

Aside from issues of determining a reasonable basis for the depreciation factor to be applied, policyholders occasionally have financial trouble in covering the gap between the replacement cost and the actual cash value payment. Notwithstanding the difficulty of bridging the gap, most courts hold that if repair or replacement is not made within the time



*Creative counsel can exploit the differences between the valuation methods for actual cash value to increase the damages recoverable by the policyholder.*

Continued on Page 2

For more articles, reports, studies, news, and commentary on these and other legal matters...

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## ***Replacement Cost v. Actual Cash Value cont.***

limits set forth in the policy, the carrier's obligation to make the final replacement cost payment is not triggered. One interesting exception to this rule is that within a litigation context, upon settlement, the carrier must pay the entire amount of the judgment or settlement despite policy conditions regarding the timing and requirements for the balance of the replacement cost payment.

### ***Actual Cash Value Policies***

Continuing with the foregoing example under an "actual cash value" policy, if the insured were to suffer the same covered roof loss, most would assume that the carrier would be required to make the same actual cash value payment of \$50,000, but no subsequent replacement cost payments. While this approach reflects the most popular approach to determining "actual cash value", it is not the only accepted definition for the term. In fact, most insurance policies do not define the term, "actual cash value". Obviously, actual cash value means something less than replacement cost, but it does not mean simply replacement cost minus depreciation.

Judicial attempts to formulate a measure of "actual cash value" have resulted in three standards: (1) fair market value; (2) cost to repair or replace less depreciation; and (3) the broad evidence rule. In determining "actual cash value" of a loss, courts will utilize one or more of these three standards.

### ***Fair Market Value***

The fair market value standard has been defined as the difference between what a willing buyer would pay and a willing seller would sell, neither being under any compulsion to buy or sell. This standard is difficult to apply in a context where the market

may not be well defined with frequent transactions. Furthermore, three various methods are generally used to appraise a property's fair market value: (1) the income approach; (2) the replacement cost approach, and (3) the sales or comparison method. Intuitively, the fair market value standard to actual cash value seems reasonable, but in practice there is disagreement upon which factors constitute fair market value.

### ***Cost To Repair or Replace Less Depreciation***

The cost to repair or replace less depreciation approach described in connection with replacement cost policies is probably the most popular method to determine "actual cash value"; however, it has its own disadvantages. When the cost or repair less depreciation standard is used, the actual depreciation factors employed must be fair. This raises concepts of whether the depreciation factors should refer only to physical depreciation or should include broader concepts such as obsolescence and economic and functional depreciation. Most carriers argue that the cost to repair or replace less depreciation approach to actual cash value overcompensates the insured in those cases where substantial obsolescence has taken place apart from physical depreciation. For example, if a mansion is destroyed by fire and its replacement costs are high, but the mansion is located in a slum and has little market value; insurers would argue that the cost to repair or replace less depreciation approach overcompensates the insured.

### ***The Broad Evidence Rule***

The broad evidence rule derives from a New York insurance case in which a building used to make malt was destroyed by fire. The case arose after the passage of Prohibition and the malt industry had been destroyed. The owner

of the building had placed it on the market for sale prior to loss and had received no offers. He had also previously stated to others that the buildings had no value. The lower court made an award in favor of the insured based upon the replacement cost less depreciation method to determine actual cash value to which the carrier appealed. The New York Court of Appeals held that neither the fair market value, nor the cost to repair or replace less depreciation were the sole measures of actual cash value; but rather to arrive at determining "actual cash value" the courts or juries were empowered to consider every fact and circumstance logically tending to the formation of the correct estimate of loss.

Thus, the broad evidence rule stands for the proposition that almost any evidence of value is admissible in determining actual cash value. Texas adopted the broad evidence rule approach to actual cash value in 1963. Under the broad evidence rule the list of factors utilized in determining the actual cash value of the property can include: its original cost, the cost to repair or replacement less depreciation; its age; its economic value; its condition; its maintenance; its income; its location; its materials; its potential uses; its rental value, and its salvage value, etc. Thus, with the goal of a providing complete and fair indemnification for a loss the broad evidence rule recognizes the shortcomings of a strictly fair market value or cost to repair or replace less depreciation approach for actual cash value and seeks to eliminate a windfall by allowing the broadest possible admission of evidence of value to be considered by the courts or juries.

### ***Conclusion***

Currently, property damage policies are typically offered on a replacement cost basis or actual cash value basis. However, between the two types of policies, creative approaches to determine the actual cash value of a loss can be employed to fully compensate policyholders for their loss.

Something **BIG** is in the works at Durrett Law Firm –  
Look for an announcement in next month's *The Legal Update*!!!

## *TDI Undertakes Investigations of Public Adjusters*



Durrett Law Firm (“DLF”) recently undertook representation in an administrative matter on behalf of a public insurance adjuster with the Texas Department of Insurance (“TDI”). The TDI is investigating Mr. Durrett’s client for a number of technical violations of the Public Insurance Adjusting Act. Among the aspects of the investigation is the following: (1) whether a public insurance adjusting company is required to be separately registered or can legally operate if all public adjusters within the company are individually licensed; (2) whether public adjusting contracts charging 30% of new monies, not to exceed 10% of the total settlement amount, comply with statutory limitations on compensation; and (3) whether estimators working under the supervision of a public insurance adjuster to investigate a loss violates the Act.

**In researching these issues, we have reach the opinion that all public insurance adjusting companies must be licensed in order to practice public insurance adjusting in Texas.** This requirement is not clear from a reading of the Public Insurance Adjusting Act, but becomes clear when read in conjunction with other statutes from the Texas Administrative Code. It is interesting to note that in November, 2008, there were less than 16 licensed public insurance adjusting firms in Texas and today there are in excess of 43 firms. In discussing these issues with other prominent public insurance adjusters, we are learning that the TDI has initiated a crack down on this aspect of licensing by sending letters to numerous public insurance adjusting firms. We have also discovered that the use of contractual language charging 30% of new monies, not to exceed 10% of the total settlement amount is widespread in the industry. It remains to be seen how the TDI views the practice.

If you receive a letter from the TDI, please do not ignore the letter. Violations of the act can be punished with draconian penalties, including forfeiture of your license and monies paid for services. Instead, immediately contact Brant Durrett for representation.

## *Lloyds Settles Lawsuit with Hotel for \$350,000.00*



**D**urrett Law Firm announces that it recently settled a property damage claim with Lloyds of London arising from Hurricane Rita. Mr. Durrett’s client was a small company that owned an America’s Best Value Inn in Beaumont, Texas. The hotel suffered a loss to its “chiller unit” that serviced the hotel. After reporting the claim, it took the Lloyds’ adjuster over 3 months to inspect the loss. At the time of the inspection, the hotel gave the adjuster an independent repairman’s report showing damage to the “chiller unit” that necessitated the complete replacement of the air conditioning system at the hotel. Despite this information, Lloyds refused to pay the claim and (to add insult to injury) sued DLF’s client in Houston, Harris County, Texas seeking a declaratory judgment from the Court that the policy did not cover damage to the chiller.

Mr. Durrett answered the lawsuit, filed a counterclaim and transferred venue from Harris County, Texas to Jefferson County, Texas. Thereafter, Mr. Durrett developed the evidence necessary to negotiate the successful resolution of the claim at mediation which included compensation for the chiller and penalty interest and attorney’s fees under the Texas Insurance Code.

Mr. Durrett has successfully handled many claims against Lloyds over the last 20 years. Let us put our experience to work for you.

**DISCLAIMER:** This newsletter is intended to offer insurance related information and critical commentary pertinent to the clients, friends and fellow professionals of the Durrett Law Firm. It is not intended to be legal advice and does not constitute an attorney-client relationship. The information contained in this newsletter is intended to be general in nature; readers should obtain professional legal advice before undertaking any action on the basis of this material.





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**JOE DURRETT DISPLAYS THE RESULTS OF THE MORNING DOVE HUNT**

### 2009 Opening Day Dove Hunt

For about the last couple of years, a core group of 5 city slickers from Houston have joined together on an opening day dove hunt.

The group consists of myself, my brother, my father, my brother's father-in-law, and a good friend, Doug Brickley. We usually hunt outside of Hondo and Castroville; however, this year, we decided to stay closer to Houston and hunt just outside of Sealy.

One of the best things about these hunting trips is being able to share the experience with my father and brother. Pictured is my father displaying the results of the morning hunt. He is 74, but still enjoys the hunt as much as my brother and I do. While I think Texas dove are safe for at least another year, we hope to continue our opening day hunts for as long as the state of Texas will issue each of us a license to hunt.

### **Get Connected To Attorney Brant Durrett**

In the virtual world of the internet, social media is the way people get connected and stay connected. To learn more about Brant Durrett or the Durrett Law Firm make a connection on LinkedIn, Facebook and Twitter.



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