INSIGHTS

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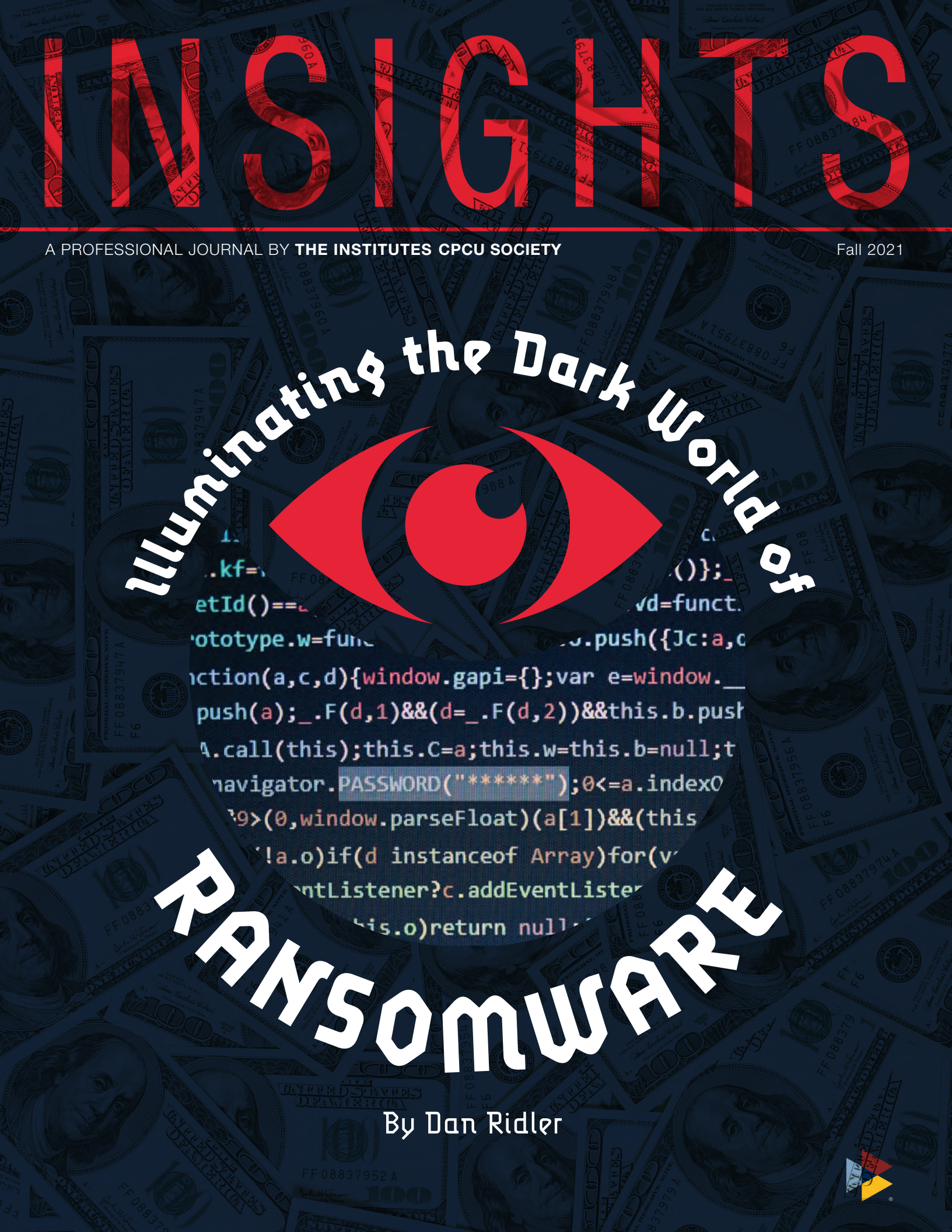

Illuminating the Dark World of RANSOMWARE

By Dan Ridler

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Illuminating the Dark World of Ransomware

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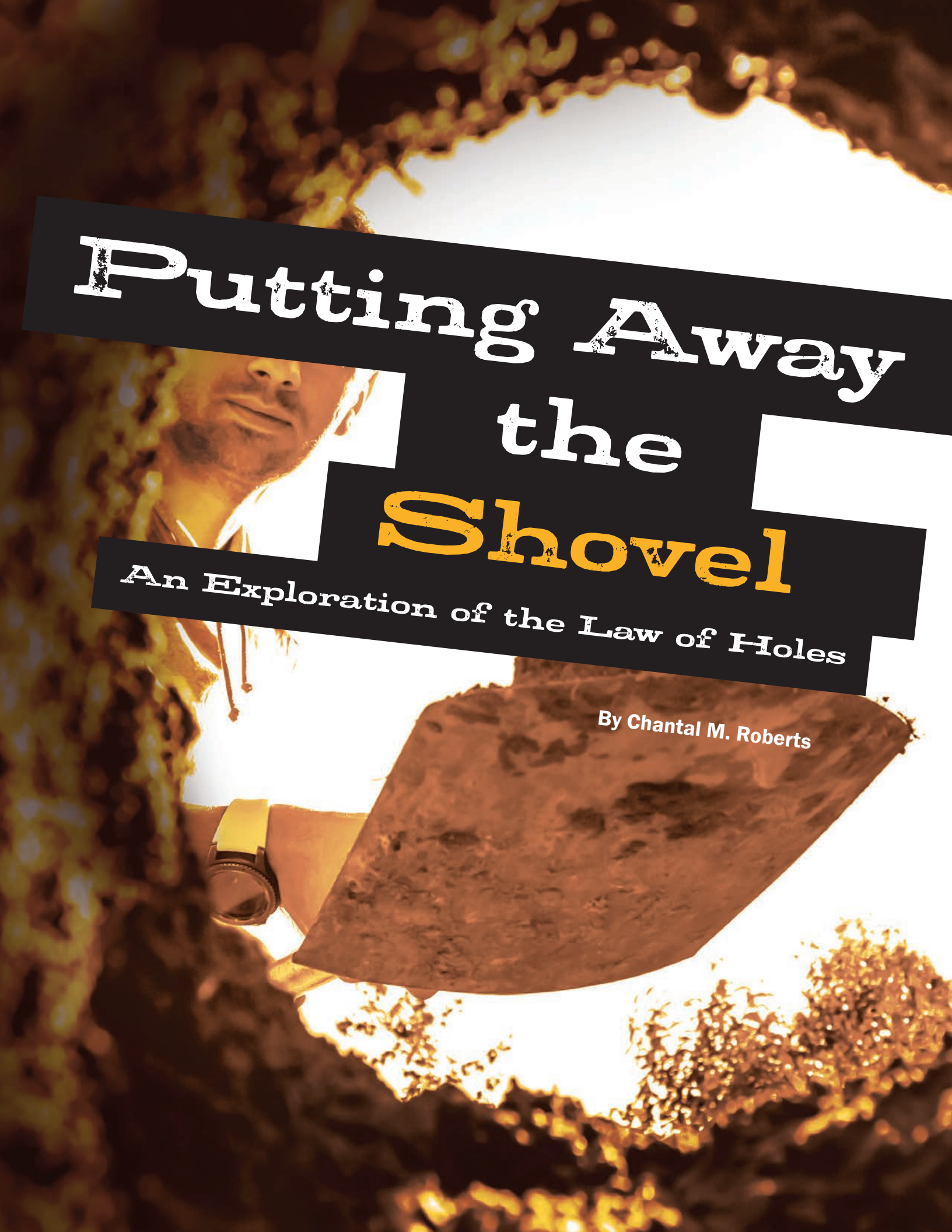

Putting Away the Shovel

An Exploration of the Law of Holes

By Chantal M. Roberts

ABSTRACT

According to the law of holes, if you find yourself in a hole, you should stop digging. One way an insurer may find itself in a legal hole is deducting from or depreciating an actual cash value settlement for labor, overhead, and profit—a practice that is coming under increasing scrutiny. Regulators may intervene in claim settlement and correct perceived bad-faith actions (sometimes mid-policy period) by changing the terms of engagement. This article examines ways insurers can avoid holes—or stop digging if they fall into one—and reduce their exposure to such bad-faith allegations. These methods include reviewing premium formulas, clearly defining terms up front, and maintaining open lines of communications.

As insurance professionals, we can avoid encountering changes in the rules of engagement by adhering to the law of holes: When we find ourselves in a hole, we should stop digging.

Consider these three fairly recent and particularly memorable events: Hurricane Katrina, Superstorm Sandy, and of course, COVID-19.

Sixteen years ago, Hurricane Katrina struck the southeastern United States, which bore the brunt of the $125 billion in total damages the storm caused.[1] State legislatures and insurance regulators rushed to the aid of their constituents with new rules for insurers to follow in the aftermath of the catastrophe.

For example, insurers could not declare a certain percentage of a structure to be flood-damaged based solely on the high-water mark. This slowed appraisals, and the Federal Emergency Management Agency (FEMA) could not issue payments under its flood policies until policyholders' property claims had been settled. Because of the slowdown in settlement, the Louisiana Department of Insurance extended the prescription period (statute of limitations) for policyholders by an additional 12 months.[2]

On October 29, 2012, Superstorm Sandy pummeled several northeastern states. Insurers assessed hurricane deductibles based on the fact that Sandy started out as a hurricane. In response to widespread outcry from policyholders, who said they were unaware of the hurricane deductibles, the New York Department of Financial Services later announced that hurricane deductibles "should not be triggered" by Sandy because it was no longer considered a hurricane by the time it reached New York.

Generally, the definition is linked to the National Weather Service's hurricane warnings, which it issues when sustained winds of at least 74 miles per hour at landfall are expected. In 18 of the 19 states that allow hurricane deductibles, the department of insurance reviews the deductible plan; in Florida, state law regulates this issue.[3]

Soon after it became apparent that COVID-19 would have devastating economic effects, the New Jersey state legislature was presented with a bill requiring property insurers to pay for business interruption losses caused by the novel coronavirus, despite specific exclusionary language. Under the proposed bill, which is still going through the legislative process, if the insurer pays the business interruption claim, it could then apply to the commissioner of banking and insurance for reimbursement. The commissioner, in turn, would demand reimbursement from all other insurers (except life and health) through an "additional special purpose apportionment" paid by insurers underwriting risks in New Jersey.[4]

Regulators took the actions described above in response to public opinion that insurers were taking advantage of policyholders. Insurers, in turn, protested that they were just applying the contract that insureds bought. Regardless of how these actual court battles play out, it seems insurers have already been tried—and convicted—in the court of public opinion.

The lesson learned is this: Legislators and departments of insurance have long used laws and regulations to mold and correct the actions of insurers. To stay ahead of such unanticipated acts, insurers need to examine their methods of determining premium and maintain clear communication between the Claims Department, retail agents, and policyholders—or else risk falling deeper into self-made holes.

THE HOLE

Absent specific policy language, adjusters may be left to wonder what should be included in an actual cash value (ACV) settlement. Indeed, some insurers have treated labor, overhead, and profit as non-damages items and depreciated them across the board, leading to a rash of lawsuits and regulator bulletins. The resulting depreciation debate continues to rage on.

There are three methods for determining ACV: using market value, following the broad evidence rule, and subtracting depreciation from replacement cost.

Adjusters should take care in jurisdictions that emphasize fair market value because this standard includes the value of the land, which policies do not cover. However, case law and state legislation have begun to favor the broad evidence rule. As with everything in claims, jurisdictions determine which test will be used. For example, Texas law states that "the term 'actual cash value' in a commercial property insurance policy is synonymous with 'fair market value.'"[5]

When neither policy language nor state law defines ACV, the broad evidence rule is usually used. This rule allows for deductions from replacement cost for not just depreciation but also purchase price, condition of the item, reproduction of the item, obsolescence of the item, and the item's fair market value.

Several courts have weighed in on the depreciation debate.

The Oklahoma Supreme Court has held that depreciation for labor is allowed—but not without dissent. Some judges argued that labor could not lose value over time and that the insured is owed for the damaged property and the labor to install it.[6]

The Supreme Court of North Carolina determined that labor can be depreciated from ACV payments. The Hartford policy stated depreciation would be deducted "from the cost to repair or replace the damaged roof. In other words, [the insurer] will reimburse for the actual cash value of the damaged roof surfacing less any applicable policy deductible."[7] The court opined that although ACV was not defined in the policy, it was not open to multiple interpretations.

The United States Court of Appeals for the Sixth Circuit in Ohio, however, thought "that it was improper…to depreciate labor costs." The same court later used this decision as precedent in remanding a case to a lower court.[8]

In Texas, courts have ruled that not only is ACV equal to fair market value, but sales tax and incurred costs for repairing or replacing covered property (such as general contractor overhead and profit, or GCOP) are also part of the ACV payment owed to the insured.[9]

GCOP is allowed for a general contractor's reasonable charges to oversee and facilitate repairs. Overhead comprises several different costs, such as salaries, office rent, and job-related expenses like mobile offices and portable toilets. These costs may appear in the estimate as "general overhead" or under the catch-all category of "overhead and profit." Taken as a whole, they can be the largest expense of a construction project. Adjusters are therefore justified in reviewing them, and reputable contractors should have supporting documents to show why their overhead is higher (or lower) than the customary 10 percent.

Some insurers agree with the minority view that GCOP is a non-damages cost and therefore owed if the policyholder has incurred and paid it. Such insurers' policies contain endorsements stating that GCOP and other fees will not be honored (or will be depreciated) to this effect. In a 2020 ruling, the Supreme Court of Pennsylvania opined that the carrier can hold back GCOP if the policy specifically allows it.[10]

Despite these rulings, endorsements that allow for such depreciation could be in violation of state statutes and regulations. GCOP is a valid cost of doing business for the contractor, and most courts and regulators have held that insureds are eligible to be indemnified for these costs.[11]

THE DIGGING CONTINUES

Policyholder advocates point out that when GCOP is removed or labor depreciated, many insureds are unable to pay for repairs. They believe that labor cannot be depreciated since it is a trade, and what the insurers are attempting to depreciate (labor) is still applicable.

For example, shingles on a roof are considered to be materials and have a definite life span. If a windstorm damages a shingle, the labor that installed the shingle remains unaffected. The labor was the physical act of hauling the shingle to the roof, driving the nail (which is material and can be depreciated) into the roof, ensuring the shingles overlapped, and so on. Advocates argue that insurers

LEGISLATORS AND DEPARTMENTS OF INSURANCE HAVE LONG USED LAWS AND REGULATIONS TO MOLD AND CORRECT THE ACTIONS OF INSURERS

shortchange policyholders by depreciating a nonmaterial item—in this case, the act of installing the shingle.

Insurers, meanwhile, maintain that paying insureds for GCOP and labor before they incur those costs could allow the insured to profit if the damaged items are not repaired or replaced. They agree with court rulings that hold that the material and labor cannot be separated. Insurers reason that one needs the labor to install the material, and the labor is part and parcel of the material.

Prior to the aforementioned 2020 decision of the Supreme Court of Pennsylvania, many states looked to previous rulings out of Pennsylvania in which courts ruled that by definition, ACV includes GCOP—and that GCOP would be owed to the insured even if no contractor were used and no repairs made.[12]

The difference between these previous cases and the most recent ruling from the Supreme Court of Pennsylvania involves policy language. The more recent decision emphasizes that unambiguous policy language will result in a ruling that favors drafters of the contract (i.e., the insurer). The Sixth Circuit agreed and stated that if the policy expressly allows for deductions and depreciation of labor, this approach is permissible.

When an insurer assesses a risk, it develops the premium using a formula that assumes that GCOP and labor will be paid in full. Indeed, as the pre-2020 Pennsylvania decisions point out, the insured pays an additional premium for replacement coverage, which includes these factors. Therefore, the insurer needn't worry about the insured profiting from the loss, since the payment is already accounted for in the premiums.

Paying GCOP and not depreciating labor will help insurers avoid unnecessary scrutiny from insurance departments, costly court battles, and insureds coming after them for poorly defined policy language. Because the premium formula assumes payment of these fees, communication with claims departments and retail agents—to ensure proper interpretation of the carrier's intentions across the board—is of paramount importance.

THE ULTIMATE FIND

By now, nearly every insurance professional has waded through oceans of ink about "direct physical loss." Long-time insurance professional Bill Wilson, CPCU, asserts that "Insurance is not a commodity." He implores agents and carriers to spend time educating policyholders about what insurance covers—and does not cover—to reduce frustration later, at the time of a claim.[13]

By unearthing and disseminating education, legislatures' attempts to retroactively change policy terms may be forestalled. Insurers need to recognize this possibility, as 16 states in 2020 considered retroactive legislation ordering insurers to cover COVID-19-related claims. In this way, education is the ultimate find.

Here, again, New Jersey is at the forefront of insurance regulation: Governor Phil Murphy has signed into law—with bipartisan and industry support—a bill (A4805) requiring the New Jersey Department of Banking and Insurance to publish a one-page summary of common insurance clauses regarding commercial property and business interruption coverage for loss of use. Insurers are also required to provide this summary to potential and renewing policyholders. This law opens the lines of communication between insurers and policyholders in order to prevent confusion or disagreement over deductibles or exclusions.

However, an overarching need to educate the public remains. For example, in 2009, the Louisiana legislature enacted new laws about hurricane deductibles in homeowners insurance. But even today, few insureds understand the intricacies of the law, with many likely unaware that a hurricane deductible may apply to more than one loss in a policy period.

Consider the 2020 hurricane season. It saw a record 30 named storms, 5 of which made landfall in Louisiana. A coversheet to the homeowners policy, like the one New Jersey now requires, would explicitly inform insureds with homeowners hurricane deductibles that the insurer may "apply a deductible to the succeeding named storms or hurricanes that is equal to the remaining amount of the separate deductible, or the amount of the deductible that applies to all perils other than a named storm or hurricane, whichever is greater."[14]

Doing this additional paperwork may seem like digging deeper into the hole. But with a well-educated public, adjusters will spend less time explaining the policy, agents will receive fewer threats of nonrenewal, and regulators will receive fewer consumer complaints. The work benefits everyone.

UNAMBIGUOUS POLICY LANGUAGE WILL RESULT IN A RULING THAT FAVORS DRAFTERS OF THE CONTRACT (I.E., THE INSURER)

CONCLUSION

Good-faith claims handling dictates that the insurer indemnify the policyholder when it knows money is owed. The insurer calculates its premium for a replacement cost policy based on the assumption that the insured will replace or repair the damaged property, and most states hold that depreciation or deduction of labor, as well as of overhead and profit, are not permissible as an across-the-board action. Courts have often agreed, but admit that such deductions are allowed if expressly stated in the policy language.

Follow the law of holes. If we stop digging—by accurately defining terms and communicating those definitions to all concerned parties—we can prevent costly court battles and unforeseen regulatory interventions. ■

Many thanks to the Diversity and Inclusion Committee and the Personal Lines Interest Group for their contributions to this article.

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