

Actual Cash Value: What Is It? How Do You Arrive at It?

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One of the biggest problems in property loss adjusting is setting a loss on an "actual cash value" (ACV) basis. To most in the insurance industry, ACV is a 'term de arte.' That may be well and good for those who know how to read and understand insurance policies, but it sure doesn't do any good for the members of the general public out there who buy property insurance policies. In fact, ACV often causes problems for claims professionals evaluating a loss.

Unless written on a replacement cost basis, most property policies agree to settle losses based on the ACV of the property at the time of the loss. Policies have read this way for a long time and adjusters and insureds have had arguments about ACV for just as long.

The problem? The term "actual cash value" is not defined in any policy. It would seem simple enough for Insurance Services Office (ISO) to add a definition of ACV to its property policies, but that hasn't happened and doesn't appear likely in the near future.

FC&S Bulletins has a fine discussion of what ACV means and how its use has evolved over the years. That discussion says, in part: "Over time, courts have developed three primary tests to measure the actual cash value of property. They are:

1. Fair market value, usually described as the price a willing buyer would pay to buy property from a willing seller in a free market.
2. Replacement cost less depreciation, generally accepted to mean the cost to replace property at the time of the loss, minus its physical depreciation.
3. The broad evidence rule - a judicious application of either one or two to the unique circumstance of the claim, whichever is more favorable to the insured."

ACV = Fair Market Value?

Although the broad evidence rule seems to be the fairest to both insured and insurer, the California Court of Appeals has recently thrown a monkey wrench into the works. This is important, because so many trends in the law seem to start in California and move eastward. In the case of *Cheeks v. California Fair Plan*, 61 Cal. App. 4th 423 (1998), the court clearly and unequivocally ruled that ACV means "fair market value."

In the case, Cheeks' home was severely damaged in the Northridge Earthquake of 1994. It was insured on a policy with the California Fair Plan (CalFair) that promised: "Covered property losses are settled at actual cash value at the time of loss, but not more than the amount required to repair or replace the damaged property."

CalFair determined that the replacement cost of Cheeks' loss was \$563,888. According to the trial transcript, the insurer then "reduced [that amount] by applicable amounts of depreciation and/or betterment, thereby reducing the overall loss settlement to an actual cash value amount (as required by your policy)," arriving at a final figure of \$53,143. From that, the insurer subtracted the deductible of \$8,800 and sent Cheeks a settlement check for \$44,343.

Cheeks sued, contending that the ACV of his home, based on its market value, was more than the insurer's estimate. The trial court, however, agreed in principle with CalFair on the method used to determine the amount of the loss. The court found a slight error and awarded Cheeks an additional \$700.

In reversing the trial court and finding for Cheeks, the Court of Appeal quoted an earlier Supreme Court case - *Jefferson Insurance Company v. The Superior Court of Alameda County*, 3 Cal. 3d 398 (1970) - in which the justices said: "It is clear that the legislature did not intend the term 'actual cash value' in the standard policy form, set forth in section 2071 of the Insurance Code, to mean replacement cost less depreciation."

Applying *Jefferson* to the *Cheeks* case, the Court of Appeal said: "Nothing in *Jefferson* prevents the insurer and insured from agreeing to value damage to property on the basis of replacement cost less depreciation. The question in *Jefferson* was how the term 'actual cash value' should be interpreted in the absence of such an agreement." The Court of Appeal came down on the side of "fair market value." The Supreme Court later upheld Cheeks with its refusal to review the lower court's decision.

So, what's the solution? How can insurers continue to use "replacement cost less depreciation" to determine ACV? In *Cheeks*, the California Court of Appeal gives a very simple (and workable) suggestion: "If it [the insurer] wants to determine 'actual cash value' on the basis of replacement cost less depreciation, all it has to do is say so in the policy."

Overhead and Profit

Another ACV issue that creeps into an insurer's dealing with its customers is "overhead and profit." Some insurers are famous for trying to get around paying for overhead and profit, saying that it is not actually part of the replacement cost of an item. When calculating the ACV to be paid prior to the actual repair being completed, some insurers start at replacement cost and deduct both depreciation and another 20 percent for overhead and profit.

In *Gilderman and Gilderman v. State Farm*, 437 Pa. Super. 217 (1994), the Pennsylvania Superior Court clearly said this practice was wrong. This decision was upheld in 1995 by the state Supreme Court's refusal to review the case.

When the Gilderman home suffered a loss, State Farm offered them the ACV of the damage up front, waiting for the work to be done. The insurer calculated ACV at

replacement cost less depreciation. From that figure, they then deducted another 20 percent for "contractor's overhead and profit." Why the deduction? The insurer stated because "contractors are not always used to repair or replace damaged property." The insurer contended that the insured would be "unjustly enriched" by payment of overhead and profit if no contractor were involved.

The court agreed with State Farm - up to a point. While recognizing that there are some types of work where a contractor would not be involved often the opposite is true. It concluded: "There are many instances where the insured reasonably would be expected to call a contractor, especially where there is extensive damage to a home requiring the use of more than one trade specialist. Thus, State Farm may not make repair or replacement estimates and then deduct 20 percent, representing contractor's fees, when those expenses reasonably are expected to be incurred."

However, the court said that the more important issue is whether or not the insurer agreed to pay its customer ACV. Since ACV means "repair or replacement cost less depreciation," the Pennsylvania court said, "We hold that repair or replacement costs include any cost that an insured is reasonably likely to incur in repairing or replacing a covered loss. In some instances, this will include use of a general contractor and his 20 percent overhead and profit."

The Court of Appeals of Michigan went even further in decrying the practice of withholding 20 percent for a contractor's overhead and profit. In *Salesin v. State Farm*, 581 N.W.2d 781, (1998), the court said this about the calculation of ACV:

"State Farm's insurance Policy in this case does not contain a definition of 'actual cash value,' nor does it set out the basis on which State Farm determines actual cash value. The process by which actual cash value would be determined was contained in State Farm's Operation Guide. In accordance with the provisions of that document, State Farm routinely deducts contractor's overhead and profit as well as depreciation when it makes an 'actual cash value of the damage' payment under section I.c.(1) of its insurance policy. There was deposition testimony that this procedure is contrary to industry norms and practices."

Again in *Salesin*, the insurer advanced the argument of "unjust enrichment" as a reason for the 20 percent deduction. Regarding this issue, the court said:

"It is uncomfortably true that finding that State Farm owes Salesin an additional \$5,581.79 for the contractor's overhead and Profit will result in a payment to him for costs that he has not incurred and almost certainly will not incur. However, it is also true Salesin has paid a premium for a full replacement cost policy. There is no logical reason, nor any reason based upon the insurance Policy itself or the record below, for deducting estimated contractor's overhead and profit when making payments under section I.c.(1) of State Farm's insurance Policy."

It seems that these courts were just exercising common sense. After all, the price of anything – a car, a house, a shirt – includes the value of the raw materials that went into it, plus the cost of the labor to make it. Try to buy a car, but tell the dealer that you want to deduct 20 percent for the dealer's overhead and profit. That wouldn't fly. And these two courts have said that it won't fly with insurance settlements, either.

However, that still leaves open the question: "How should ACV be calculated?" While that may be up for debate – as noted in the *FC&S* discussion cited earlier – what these courts have strongly implied is that insurers should define ACV in their property policies. Such a definition might go a long way toward short-circuiting arguments between insured and adjuster.

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