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Policy Language Or No, You Can't Depreciate Labor In Ark.

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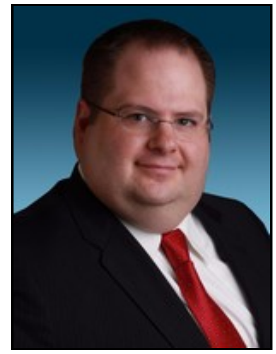

Benjamin R. Messing

Steven P. Nassi

The Arkansas Supreme Court in a 4-2 decision[1] became the first court in the nation to hold that, as a matter of public policy, labor cannot be depreciated when calculating the actual cash value of a property damage claim, despite policy language to the contrary. Shelter Mutual Insurance Co. v. Goodner, 2015 Ark. 460 (Dec. 10, 2015). What is particularly unusual about Shelter is the fact that the court did not cite to any legislative authority as the basis for its public policy rationale when it voided the policy language at issue.

In almost every jurisdiction in the United States, courts have opined upon the esoteric question of how to calculate the actual cash value of a covered loss. However, despite the plethora of court decisions, many questions remain unanswered. One of these open questions is whether or not labor costs should be depreciated along with material costs when calculating the actual cash value.

Oklahoma was the first state supreme court to address this issue in Redcorn v. State Farm Fire & Casualty Co., 55 P.3d 1017 (OK 2002). One of the most widely cited opinions on both sides of this question, the certified question in Redcorn was framed as follows: "[i]n determining actual cash value, using the replacement costs less depreciation method, may labor costs be depreciated?" Id. at 1018. The Redcorn court noted at the outset that the policy at issue did not define the term actual cash value, and that the insurer arrived at the actual cash value of the covered loss by utilizing a replacement cost less depreciation methodology as permitted by Oklahoma law. Id. at 1019. The plaintiff insured argued that, "depreciation of labor costs is inconsistent with the principle of indemnity" and, therefore, only material costs may be depreciated but not labor costs. Id. at 1020.

The majority in Redcorn rejected the plaintiff's argument, reasoning that "a building is the product of both materials and labor" and the policy insured the building as a whole, without distinguishing between material and labor. Id. at 1021. Furthermore, the insured's decision to purchase a less expensive actual cash value policy did not entitle the insured to "a hybrid policy of actual cash value for [building] materials and replacement costs for labor." Id. Accordingly, the majority decision in Redcorn is frequently cited as persuasive authority for the legal position that depreciation of both material and labor is appropriate when calculating actual cash value.

The dissenting opinion in Redcorn reasoned that a building should not be depreciated as a singular product similar to a preassembled consumer good or integrated product. Id. at 1022. Instead, a building is comprised of both materials and labor which should be considered separately. Id. The dissent agreed that the materials and goods used to construct a building should be depreciated based upon such factors as the useful lifespan and age of the building at the time of loss. Id. In contrast, the same factors which support depreciation of physical material cannot be equally applied to labor. Id. In a series of rhetorical questions, the dissent expressed concern that labor is not logically depreciable because labor does not lose its value due to the passage of time or wear and tear. Id. Accordingly, the dissenting opinion in Redcorn is frequently cited as persuasive authority for its holding that depreciation of labor is inappropriate when calculating actual cash value.

When this issue came before the Arkansas Supreme Court in 2013, the court held that when a policy does not expressly define actual cash value, an insurer may not depreciate the costs of labor when calculating the actual cash value of a covered loss. Adams v. Cameron Mutual Insurance Co., 430 S.W.3d 675, 678 (2013), reh'g denied (2014). The court in Adams reasoned that both arguments for and against the depreciation of labor were reasonable interpretations of the policy language where the policy did not otherwise define "actual cash value." Id. Therefore, because two reasonable interpretations were supported by the policy language, it was ambiguous as a matter of law. Id. The court then looked to Redcorn for guidance, and found the dissent's reasoning more persuasive. Id. Accordingly, the court in Adams sided with the policyholder friendly interpretation that depreciation of labor was not appropriate when calculating the actual cash value of a covered loss. Id. at 679. The court also cited to the Arkansas Insurance Department Bulletin 13A-2013 as supporting its position. Id.

Shortly after the court in Adams issued its grant of certification to hear the matter on June 27, 2013, the Arkansas Insurance Department issued Bulletin 13-2013 on July 5, 2013, announcing the commissioner of insurance's directive that the depreciation of labor was prohibited when calculating actual cash value. This one-page bulletin was viewed as so poorly worded that it was quickly replaced two weeks later on July 18, 2013, with Bulletin 13A-2013, which attempted to clarify and narrow the scope of the guidance:

> The purpose of this bulletin is to clarify the position of the Arkansas Insurance Department regarding the depreciation of labor. When an insurance claim is filed for structural loss, *the relevant insurance policy requires either replacement cost or actual cash value depending on the method provided for in the policy.* Certain items may be depreciated in value to account for their age and wear and tear. *The items that are eligible for depreciation in policies with Actual Cash Value (ACV) loss settlement provisions are what this Bulletin seeks to clarify, as depreciation does not apply to Replacement Cost loss settlement provisions.* Bulletin 13A-2013 [emphasis added].

While affirmatively stating this was not a new policy, the Arkansas Insurance Department belied this assertion by adding to Bulletin 13A-2013 a 90-day period for insurers to conform their claims handling practices.

A month before the announcement of the decision in Adams, on Sept. 18, 2013, the Arkansas Insurance Department replaced Bulletin 13A-2013 in its entirety with Bulletin 13B-2013, which provided as follows:

> The purpose of this bulletin is to clarify the position of the Arkansas Insurance Department regarding the depreciation of labor *in property claims*. When an insurance claim is filed for structural loss, *the relevant insurance policy requires payment of the replacement cost or actual cash value depending on the terms of the policy.* Certain items may be depreciated in value to account for their age and wear and tear. *The items that are eligible for depreciation in policies with only Actual Cash Value loss settlement provisions are what this bulletin seeks to clarify, and the bulletin does not apply to replacement cost policies that hold back a portion of the replacement cost until repair or replacement is completed.* Bulletin 13B-2013 [emphasis added].

It is readily apparent from the revisions made in each successive bulletin that the Arkansas Insurance Department was grappling with a highly nuanced topic and the unintended consequences potentially resulting from its choice of language. The department effectively converted all nonreplacement costs policies into hybrid policies of actual cash value for materials and replacement costs for labor. In doing so, it also created two separate methods for calculating actual cash value which were dependent upon the type of property policy at issue. The first method applied only to nonreplacement cost policies as prescribed by the department, and the second method applied only to replacement cost policies as prescribed by the terms of the policy. It appears that the majority in Adams, which did not cite to the most current version of the bulletin (13B-2013), may have overlooked the bulletin's significance in creating two actual cash value standards.

In Shelter the court had a golden opportunity to revisit Adams and the Department's Bulletin 13B-2013 to clarify the current state of the law in Arkansas regarding calculating actual cash value. Unlike the nonreplacement cost policies considered in Adams and Redcorn, the court in Shelter was confronted with a policy that did in fact contain a precise definition of actual cash value. The policy in Shelter defined actual cash value ("total restoration cost less depreciation,") as well as the terms "total restoration cost" and "depreciation." The defined term "depreciation" explicitly provided for the depreciation of labor costs, along with material costs and tax. Shelter at 2. Furthermore, the operative policy language in Shelter highlighted the problem within Bulletin 13B-2013, which prohibited the deprecation of labor in nonreplacement cost policies when calculating the actual cash value, but also "requires payment of the ... actual cash value *depending on the terms of the policy.*"

The insurer in Shelter argued unsuccessfully that the holding in Adams was limited to those cases involving policies where "actual cash value" was left undefined and that the policy language controlled. Shelter at 4-5. Instead, the majority interpreted Adams as articulating a broader statement of Arkansas law without attribution to any statute; to wit: that "depreciation of labor violates established principles of indemnity." Id. at 5. Interestingly, there is no mention or discussion anywhere in the majority opinion regarding the position of the Insurance Department or its directives in Bulletin 13B-2013. Accordingly, policy language defining actual cash value to include depreciation of labor costs was voided as a matter of public policy.

In a well-reasoned dissent, the minority characterized the majority's opinion as "vague at best" and agreed with the insurer's argument that the holding in Adams was only applicable when an insurance policy failed to define actual cash value. Id. at 7. The dissent also rejected the public policy argument relied upon by the majority to bypass policy language to the contrary, noting that this was not an area of paramount public concern where the court should create public policy independently of the legislature. Id. at 8. It further admonished the majority, noting that "[t]he Arkansas legislature enacts public policy through its statutes, and there is no statute on the depreciation of labor." Id. at 9.

The danger inherent with an opinion such as Shelter is that it will be cited in other jurisdictions as persuasive authority for the general proposition that clear policy language permitting the depreciation of labor is void and unenforceable as a matter of public policy. Only after a detailed review does it become apparent that Shelter is not a sound legal analysis of Adams or reasonable extension of the dissent in Redcorn.

If Shelter becomes widely adopted in other jurisdictions, the broader implications are multifold. Insurers will likely need to revise their policy pricing to accommodate for the increased costs of labor factored into nonreplacement cost policies. Insurers will also have to implement updated claims handling processes to address two different actual cash value standards. There will likely be an increased burden on the judiciary arising out of appeals from appraisal awards applying the wrong actual cash value standard. And some insurers may even go as far as to abandon issuing nonreplacement cost polices altogether because of the lack of premium differential and to simplify claims handling.

—By Steven P. Nassi and Benjamin R. Messing, Kaufman Dolowich & Voluck LLP

Steven Nassi is a partner in Kaufman Dolowich's New York office.

Benjamin Messing is an attorney in Kaufman Dolowich's Blue Bell, Pennsylvania, office.

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[1] A full panel of the Arkansas Supreme Court is normally comprised of seven justices; however, in Shelter only a panel of six justices adjudicated the matter, with three of the six justices in the majority sitting by designation as special justices.