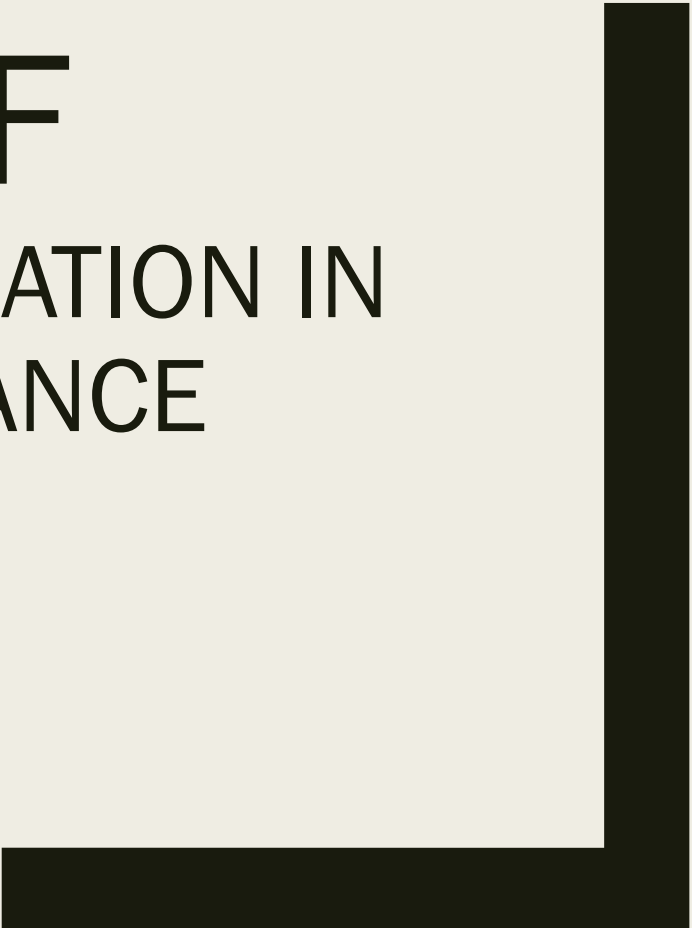




PITFALLS OF REPLACEMENT COST ESTIMATION IN HOMEOWNERS' INSURANCE

IIABCaI Member-Only Webinar
Tuesday, 20 August 2019
10 am



Disclaimer

- Nothing in this presentation is intended, or should be relied upon, as legal advice.
- CDI regulations on estimating HO replacement costs can be found at: www.oal.ca.gov :
- “California Code of Regulations” / “**Title 10**. Investment” / “**Chapter 5**. Insurance Commissioner” / “Subchapter 7.5. Unfair or Deceptive Acts or Practices in the Business of Insurance” / “Article 1.3. Valuation of Homes” / “Sections 2695.180 – 2695.183”

Overview

1. The problem of estimating replacement cost;
2. The Poizner solution;
3. What the CDI regulations require;
4. Legal authority for the regulations;
5. Best practices to follow – and avoid;
6. IIABCaI Strategic Principles.

1. The problem of estimating replacement cost in dwelling coverages.

Infinite variables influence actual replacement cost of any given home, in any given location, at any given time. So estimates can and do reasonably vary. That's why they are ... ESTIMATES.

Even with advances in technology, consumers continue to rely on their broker-agent for help—and many producers can be tempted to substitute their judgment for computer projections.

Experienced broker-agents can sometimes provide more accurate estimations, but in so doing can assume heightened liability for failing to observe and document the “cardinal rule” that consumers must decide how much insurance to buy.

Some insurers, knowing total losses occur only rarely, undercut competitors by “low-balling” estimates.

“Underinsurance” becomes apparent only when a total loss occurs, but the impact is devastating on not only particular homeowners, but also entire communities when a conflagration presents.

Insurers, and their agents, who have sold policies with insufficient limits can face a firestorm of bad publicity and heightened liability, which they have sometimes combatted by paying claims in excess of policy limits.

2. Then-Commissioner Steve Poizner's solution

Legislation to require insurers to offer Schedule A coverages at 200% (or some such percentage) was DOA in the Legislature.

Instead, CDI promulgated regulations. They never aspired to “stop” the problem of underinsurance, but instead tried to improve consumer awareness by requiring all estimates to include the same categories of coverage.

3. What the CDI regulations require.

File documentation on who created the replacement cost estimate, and how the estimate was produced. Estimate required for replacement of the entire single dwelling (not a subdivision); no consideration of land or depreciation; licensees required to annually recheck the underlying factors and cost assumptions used to produce the estimate.

Mandatory factors: Cost of labor, building materials and supplies; Overhead and profit; Cost of demolition and debris removal, of permits and architect's plans; type of foundation, frame, roofing materials and type of roof, siding materials and type of siding; slope; square footage; location; number of stories and any nonstandard wall heights; materials used in interior features and finishes, heating and air conditioning systems, walls, flooring, ceiling, fireplaces, kitchen, and bath(s); age of structure; size and type of attached garage.

Insurers are required to develop written standards for their broker-agents to use in estimating replacement cost, and to train their broker-agents on implementing those standards.

Section 2695.183(k)(3), proposed by IIABCal, states: “the insurer, and **not the broker-agent**, shall be responsible for any noncompliance [...] unless that noncompliance results from failure by the broker-agent to follow the insurer's prescribed written procedures when using the source or tool.”

Section 2695.183(m): Nothing in the regulation requires any licensee to estimate replacement cost or to set or recommend a policy limit to an applicant or insured, or to advise an applicant or insured as to the sufficiency of an estimate of replacement cost.

4. Legal authority for the regulations.

The California Administrative Procedures Act requires every state agency (like CDI) to meet a variety of requirements before it may promulgate any regulation, including necessity, clarity of the proposed rule, lack of ambiguity, internal consistency, ... but the first, most crucial requirement is statutory authority.

California Code of Regulations Section 2695.183(j) “To communicate an estimate of replacement value not comporting with [these regulations] ... constitutes making a statement with respect to the business of insurance which is misleading and which by the exercise of reasonable care should be known to be misleading, pursuant to [Insurance Code section 790.03.](#)”

CIC Section 790.03 is part of the Unfair Insurance Practices Act, which regulators love because it provides vast enforcement discretion.

In ensuing litigation, in *ACIC v. Jones*, both a Superior Court and then the California Court of Appeal, issued rulings flatly rejecting the argument that the Unfair Insurance Practices Act authorized the regulations being challenged.

The (rare) decision by the California Supreme Court to consider an appeal of those decisions signaled its predisposition to overturn that result.

The Supreme Court, in a unanimous decision, overturned the lower courts and upheld the Commissioner's authority to issue the regulations under UIPA.

The Court's written opinion stressed its "deference" to the presumed expertise of the insurance commissioner in applying his interpretative powers under the statute.

But CDI failed to observe express rules for finding "new" unfair practices; instead, it simply declared that any insurer not using all of the factors identified by the Commissioner for calculating a replacement cost estimate had, by virtue of that admission, committed a new unfair or deceptive act—without regard to the accuracy of the estimate actually provided—and relied upon general language in that act authorizing the Commissioner to enforce the law.

The opinion turned in substantial part upon the Court's characterization of what the Commissioner had done as merely "interpretative" in nature, rather than as "quasi-legislative."

In so ruling, the Court not only greatly expanded the Commissioner's enforcement powers, but arguably also substantially weakened the Constitutional "check and balance" afforded by the legislative branch.

5. Best Practices to follow—and to avoid, courtesy of IIABA.

<https://rms.iiaba.net/Resources/Pages/Publications/Angles/2011/10-11-EO-Angle.pdf#search=home%20valuations>

<https://rms.iiaba.net/Resources/Pages/Publications/Advisor/2014/January/The%20Price%20is%20Right%20Considerations%20for%20Avoiding%20EO%20Claims%20from%20Property%20Valuations.aspx>

<http://www.iamagazine.com/strategies/read/2011/09/22/agent-liability-for-property-undervaluation>

Best practices

- There is no simple formula or easy answer.
- Professional duties can be assumed in an any number of ways—including inadvertently (statements, advertising, ...). If you determine or opine on property value, you have a legal duty to do it well. If you state or imply that a consumer is “covered,” you can be liable for misrepresentation.
- The 4 Ds: DETERMINE, DEFLECT, DEVELOP AND DOCUMENT:

Determine

- Determine: Consider from the outset the method of determining the value. **If you are using insurer software, then demand that the insurer provide you with written instructions and training in its use. Scrupulously follow the insurer's written instructions. Take CE courses to understand the computerized valuation process. Annually recheck valuations.** Obtain comparables, when available, in conjunction with any computerized program you use. If valuation is not your forte, do not undertake the process; instead, be sure your client is aware that you are relying on him or her to complete the valuation.

Deflect

- Deflect: Use other reliable resources. If your client has a good understanding of the value of his or her property, and what it would cost to replace it, then have the client provide the valuation. If you are not sure that the client's estimates or the insurer's numbers make sense, consider using an independent property appraiser. Offer all possible endorsements that are available to extend coverage, such as blanket coverage for commercial property, increased cost of construction or code upgrade coverage, coverage for betterments and improvements and endorsements for off premises **power failures** in the event of a disaster.

Develop

- **Develop:** Develop procedures within your agency on how to deal with property valuation. By creating a system that is documented and consistently followed, you have a better chance of successfully defending a claim that you failed to properly value property. For certain risks, checklists may be helpful. Ensure that it is your standard process to routinely advise clients in writing to review the value of their property. Have available a written explanation of how coinsurance may be applied to reduce a loss payment to review with your clients. Make it routine to put a copy of any request to review values or written explanation of coinsurance in the client's file. **Prohibit or restrict employees from offering their own opinions.**

Document

- Document: Success in defending any E&O claim rests on the existence and quality of file documentation. Document various proposals and especially the client's declination to take out coverage for a certain limit. Be sure to document that discussions of valuation were held, how the valuation was determined, and the client's agreement on the value. Document any changes to limits so that the file reflects why the change was made and that it was discussed with your client. Just remember that since there are numerous ways to make mistakes when valuing property, agents must undertake property valuations with as much care as possible.

What Would Nancy Do?



Just Say No

- Do not agree to become an appraiser. Instead, urge customers – *in writing* – to have their property (re)appraised by a licensed professional on a regular basis to ensure that the limits in place are, and remain, adequate.
- ·Make sure the customer understands the definition/concept of ‘replacement cost’. Explain that the 'replacement cost' will likely exceed both the 'actual cash value' and 'purchase price' of a building, often by a significant margin.
- Explain what a '*coinsurance penalty*' is, and how a loss may not be fully covered even if it is within policy limits. Consider highlighting the provision in the policy.

Just Say No

- Offer some examples of resources you might suggest to find a *licensed* appraiser include:
 - o www.appraisalinstitute.org
 - o www.appraisers.org
 - o California Contractors State License Board, e.g., www.cslb.ca.gov
 - o Other alternatives: reconstruction cost estimates by licensed general contractors, architects or engineers.

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- Document your recommendation that a licensed professional be consulted, as well as the customer's refusal to do so.
- Make clear to the customer the **substantial** limitations on your training and experience as an appraiser – particularly with respect to determining the "replacement cost" of a commercial or residential building – and document those warnings, too.
- -If you use a 'replacement cost estimator' (from the insurer or a third-party), provide a copy of the program's disclaimer (it's sure to have one) to the customer, indicating that your estimate is subject to the same limitations. Offer the figure to your customer as evidence that the current number is too low and that a professional valuation is needed.

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- Replacement cost estimators are affected by many variables, e.g., location, square footage, usage, materials and design. Document the information used in arriving at an estimate and its source(s).
- Be explicit: construction costs go up every year by varying amounts, depending on market conditions. So should policy limits. A yearly 'inflationary increase' likely will not keep pace with the cost of construction, which is why periodic reappraisals are essential.
- Request that the carrier confirm that the property is insured to replacement cost such that no coinsurance penalty will apply.

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- *Above all*, place the final decision firmly in your customer's lap, and document their determination or approval of the estimate.

6. IIABCaI Strategic Principles

IIABCaI Strategic Principles

(a) that broker-agents are not exposed to liability for estimates selected by consumers, or suggested/mandated by insurers, contractors or other third parties;

(b) that broker-agents who voluntarily assume the responsibility of determining or recommending a replacement cost estimate are doing so on a fully informed and intentional (as opposed to inadvertent) basis;

(I) IIABCaI Strategic Principles

(c) that consumers are put in a better position to make well-informed and more fully knowledgeable decisions about their insurance needs;

(d) that any changes are, in practical effect, delivery-system neutral (i.e., does not place independent agency companies or their producers at a competitive disadvantage);

(I) IIABCaI Strategic Principles

- We oppose new laws to mandate particular methodologies, or impose legally-required limits because we believe such laws have the practical effect of both inhibiting price competition and forcing people to pay more for homeowners' insurance, which we do not believe to be in the consumer interest.

(I) IIABCaI Strategic Principles

- Such proposals, while perhaps well-intentioned, have the unquestioned effect of increasing governmental regulation, decreasing competition, suppressing innovation, and exacerbating the "commoditization" of insurance products--which plays right into the hands of direct writers and has the potential to further impair the ability of independent agents and brokers to fulfill their customers' needs.

For More Information

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