“OVERHEAD AND UNDER PAID” – A REVIEW OF THE INCLUSION OF GENERAL CONTRACTOR OVERHEAD AND PROFIT IN PROPERTY CLAIMS

by

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Introduction

In July 1998, rain entered Jules Tritschler's Arizona home and caused extensive damage.[1] The home was insured under Allstate Insurance Company's "Deluxe Plus Homeowners Policy,"[2] which included actual cash value (ACV) and replacement cost value coverage for both the structure and the contents.[3] Allstate recommended Better Way Services, Inc. to make the repairs, whose estimate included 10 percent profit and 10 percent overhead charges.[4] After Tritschler fired Better Way for its allegedly substandard work, he accepted Allstate's offer to "cash out" his repair claim.[5] Allstate paid Better Way what it claimed it was owed for work performed, including amounts for general contractor overhead and profit (GCOP), and then paid Tritschler an amount that "represented the difference between Better Way's estimated cost of repair and the amount Allstate paid Better Way."[6] Allstate excluded GCOP listed on the Better Way estimate from its payment to Tritschler.[7]

Tritschler hired a public adjuster, who submitted a demand for an additional $7,967 in GCOP that Allstate refused to pay.[8] Tritschler completed the remaining repairs himself, and then sued Allstate for breach of contract and bad faith for their refusal to pay GCOP.[9] Following the

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[1] First Amended Complaint at 1, *Tritschler v. Allstate Ins. Co.*, 2001 WL 35963446 (Ariz.Super.).

[2] *Id.*

[3] *Id.*

[4] Tritschler v. Allstate Ins. Co., 213 Ariz. 505, 144 P.3d 519 (Ariz. Ct. App. 2006).

[5] *Id.*

[6] *Id.*

[7] *Id.*

[8] *Id.*

[9] *Tritschler*, 144 P.3d at 531.

refusal, Tritschler's independent public adjuster inquired of Allstate's adjuster: "[H]ow does Allstate legally justify withholding overhead and profit from the insureds?"[10] No answer was ever given, no legal opinion was ever sought, nor did Allstate follow up in any way on this inquiry.[11] Its silence spoke volumes. On appeal, the court held that an insured can recover GCOP as part of ACV, whether or not repairs are actually completed, as long as the cost to repair or replace the damaged property would likely require the services of a general contractor.[12] Allstate did not seek legal opinion, or follow up on the public adjuster's request, because it had no justification for excluding GCOP regardless of whether Better Way, Tritschler, or no one completed the repairs.

This paper argues that GCOP is properly included in a property claim settlement for ACV in states which follow the "broad evidence" or "replacement cost less depreciation" rules whether or not the insured property is actually repaired or replaced, and that GCOP should be included in ACV calculations in all jurisdictions. Part I provides background on the role of the general contractor, profit, and overhead in a property claim, and on property insurance and the typical policy language involved in a dispute over GCOP. Part II introduces the debate over whether an insurance company may withhold or refuse to pay GCOP where repairs are not yet made. Part III discusses the standards for when GCOP must be included. Finally, Part IV recommends that public adjusters support the inclusion of GCOP in a building claim settlement as a matter of law and sound public policy, and offers a suggestion for changing the practice of excluding GCOP in states that have not yet adopted the majority rule.

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[10] *Id.*

[11] *Id.*

[12] *Id.* at 529.

I. Background

A. General Contractor Profit and Overhead

A general contractor is "[o]ne who contracts for the completion of an entire project, including purchasing all materials, hiring and paying subcontractors, and coordinating all the work."[13] General contractors hire all the trades necessary for the project, and sequence, coordinate, and supervise their work.[14] They also research zoning and permit requirements, and obtain the necessary permits.[15] Licensing and certification of general contractors varies by state, but typically requirements include experience, good moral character, financial responsibility, and an exam.[16,17] A majority of states that do not require general contractor or contractor licenses still require licenses for specialty contractors.[18]

Overhead represents costs incurred by a general contractor to operate its business,[19] and can be divided into general and job-specific overhead. General overhead involves a variety of costs typically involved in doing business, including office rent, staff, equipment, and supplies;

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[13] Black's Law Dictionary (9th ed. 2009), contractor, *available at* Westlaw BLACKS.

[14] Edward Eshoo Jr., *Overhead and Profit: Its Place in a Property Insurance Claim*, Adjusting Today, 1-2 (2007), http://www.adjustersinternational.com/AdjustingToday/ATfullinfo_fullstory.cfm?page_no=1&pdfID=43&start=1

[15] *Id.*

[16] A. Scott McDaniel, *The Good, the Bad, and the Unqualified: The Public Interest and the Unregulated Practice of General Contracting in Oklahoma*, 29 Tulsa L.J. 799 (1994).

[17] In seventeen states, licensing of "general contractors" is expressly required by statute: Alabama, Alaska, Arkansas, Connecticut, Delaware, Florida, Hawaii, Louisiana, Mississippi, Nevada, North Carolina, North Dakota, Oregon, South Carolina, Tennessee, Utah, and Washington. In another eight states and the District of Columbia, licensing of broadly defined "contractors" is required: Arizona, California, Maryland, Massachusetts, Minnesota, Nebraska, Rhode Island, and Virginia. Robert F. Cushman, *et al*., *§2.03 State-by-State Survey of Licensing Requirements*, Design Build Contracting Handbook (Aspen 2013).

[18] *Id.*

[19] Eshoo, *supra* note 14 at 2.

sales, marketing, and advertising costs; and finance charges.[20] Job-specific overhead includes costs directly related to a specific job other than expenditures for labor and materials.[21] It may include costs for "building permits, fees and inspections, utility hook-up charges, construction drawings … , surveys, erosion control …, construction driveway, culvert or curb cut, interior cleaning of the building prior to occupancy, and site security."[22]

Profit is defined generally as "the excess of revenue over expenditures in a business transaction."[23] In essence, it is the positive return on an investment into a business undertaking. In the context of building construction and contracting, profit is "the fee charged by a general contractor for construction services provided."[24] Profit and overhead can vary significantly across different general contractors, but is routinely stated as a percentage of the total cost of construction.[25] Industry custom generally dictates that GCOP are calculated as 20% of the amount of the estimated cost of repair or replacement, with 10% attributable to overhead and 10% attributable to profit.[26]

B. Property Insurance Policies and Claims

[20] Diana Reitz, *Overhead and Profit*, Claims Magazine (Jan. 3, 2007), http://www.propertycasualty360.com/2007/01/03/overhead-and-profit?t=education-training&page=2 (citing PETER M. WELLS, INSURING TO VALUE (2nd ed., Feb. 1, 2007)).

[21] *Id.*

[22] *Id.* at 2.

[23] Black's Law Dictionary (9th ed. 2009), profit, *available at* Westlaw BLACKS.

[24] Reitz, *supra* note 20 at 2.

[25] Eshoo, *supra* note 14 at 2.

[26] Laura C. Hill, *A General Contractor's Ability to Receive "Overhead and Profits" Payments from Amounts Paid on Claims for Structural Losses Covered by a Homeowner's Insurance Policy Under Oklahoma Law*, Gable Gotwals, n.2 (2011), http://gablelaw.com/news_resources/2011/contractor_article_hill.pdf (citing Burgess v. Farmers Ins. Co., Inc., 2006 OK 66, 151 P.3d 92, 96 n.8 (Okla. 2006)).

Property insurance is the oldest form of commercial insurance, dating to shipping in the Middle Ages.[27] By the late 1950s, comprehensive homeowners' policies that incorporated multiple types of coverage in one policy were created.[28] Typically, homeowners insurance today covers the dwelling, personal property and contents, and some forms of liability.[29] Businesses often buy property insurance as part of a commercial multi-peril or commercial package policy, which provide comprehensive protection in a single policy.[30]

There are three types of coverage available in property insurance policies: replacement cost coverage, ACV coverage, or a combination of both. Replacement cost policies are designed to protect a policyholder from receiving less as a result of depreciation, and "reimburse[] an insured for the full cost of repairs, if she repairs or rebuilds the building, even if that results in putting the insured in a better position than she was in before the loss."[31] Replacement costs are typically limited to the policy's dollar amount.[32] An ACV policy is "a pure indemnity contract; its purpose is to make the insured whole, but never to benefit him because a [covered event] occurred."[33] The terms "repair cost" or "replacement cost" are not typically defined in a property insurance policy.[34]

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[27] TOM BAKER, INSURANCE LAW AND POLICY 249 (Editors, 2nd Ed. 2009)

[28] Mitchell F. Crusto, *The Katrina Fund: Repairing Breaches in Gulf Coast Insurance Levees*, 43 Harvard J. on Legis. 329, 334 (2006).

[29] BAKER, *supra* note 27.

[30] Typical perils insured against in commercial property insurance include, *inter alia*, "fire, lightening, glass breakage, tornado, windstorm, hail, water damage, explosion, riot, civil commotion, rain, or damage from aircraft or vehicles." New Hampshire Insurance Department, *Market Competition in the Commercial Property Insurance Marketplace (2010-2011)*, available at http://www.nh.gov/insurance/pc/documents/comprop_ma.pdf (last accessed April 13, 2013).

[31] NEW APPLEMAN ON INSURANCE, §47.04[b][1] (Jeffrey Thomas, *et al.*, eds., Law Library Edition 2012).

[32] *Id.*

[33] 12 Couch on Ins. § 175:19 (citing Court View Centre, L.L.C. v. Witt, 753 N.E.2d 75 (Ind. Ct. App. 2001)).

Most property insurers provide replacement cost coverage, but policies rarely oblige an insurance company to pay more than ACV as of the time of the loss unless and until the insured property is actually repaired or replaced.[35] Where an insured property is not repaired or replaced, insurers must provide the ACV of the repairs. The following language is typical of a homeowners' policy provision for property loss settlement:

> **Loss Settlement**. Covered property losses are settled as follows:
>
> …
>
> b. We will pay the cost to repair or replace buildings under Coverage A subject to the following:
>
> (1) Until actual repair or replacement is completed, we will pay the **actual cash value of the damage to the buildings, up to the policy limit**, not to exceed the replacement cost of the damaged part of the buildings for equivalent construction and use on the same premises;
>
> (2) You must make claim within 180 days after the loss for any additional payment on a replacement cost basis.
>
> Any additional payment is limited to the amount you actually and necessarily spend to repair or replace the damaged buildings with equivalent construction and for equivalent use on the same premises[.][36]

ACV, undefined in the above policy, generally refers to the current cost to repair or replace covered property with like materials, adjusted for physical deterioration.[37]

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[34] Eshoo, *supra* note 14.

[35] *Id.*

[36] Salesin v. State Farm Fire & Cas. Co., 229 Mich. App. 346, 361, 581 N.W.2d 781, 788 (1998)

[37] NEW APPLEMAN ON INSURANCE, §47.04[1] (Jeffrey Thomas, *et al.*, eds., Law Library Edition 2012).

Since the term is usually undefined, courts use one of three rules to determine ACV.[38] Under the market value rule, the ACV of the property considers what a willing buyer would give and what a willing seller would accept for the property in the market, and awards the difference between the market value of the property before and after the loss.[39] Under the replacement cost less depreciation rule, depreciation is deducted from the estimated cost of repair or replacement of the damaged property to determine the ACV.[40] Finally, under the broad evidence rule, every fact and circumstance that logically tends to establish a correct estimate of the true economic value of the property must be considered.[41] At least twenty four states follow the broad evidence rule,[42] ten follow the market value rule,[43] and four follow the replacement cost less depreciation rule.[44] Two states define ACV as replacement cost including depreciation, and ten states have no first party property cases that address the issue.[45]

II. Debate on Contractor Overhead and Profit

The debate on coverage for GCOP is traced to a dispute over coverage on a homeowners insurance policy issued by State Farm Fire & Casualty Insurance Company in Kentucky. In

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[38] Elberon Bathing Co., Inc. v. Ambassador Ins. Co., Inc., 77 N.J. 1, 9 (1978).

[39] NEW APPLEMAN ON INSURANCE, §47.04[1] (Jeffrey Thomas, *et al.*, eds., Law Library Edition 2012).

[40] *Id.*

[41] *Id.*

[42] The states that follow the broad evidence rule are: Colorado, Connecticut, Florida, Idaho, Indiana, Iowa, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Montana, New Hampshire, New Jersey, New York, North Carolina, Oklahoma, Rhode Island, South Carolina, South Dakota, Tennessee, Vermont, Virginia, and Wisconsin. FIRST PARTY PROPERTY CLAIMS DESK REFERENCE 40-46 (Edward J. Ryan, ed., 2nd ed. 2010).

[43] The states that follow the fair market value rule are: Alabama, California, Delaware, Georgia, Maine, Missouri, Nebraska, New Mexico, North Dakota, and Washington. *Id.*

[44] The states that follow the replacement cost less depreciation rule are: Illinois, Louisiana, Ohio, and Texas. *Id.*

[45] *Id.*

Snellen v. State Farm Fire & Cas. Co.,[46] a fire damaged home was covered by replacement cost insurance issued by State Farm. The policy, almost identical to the State Farm HO5 Policy included, *supra*, provided that State Farm would only "pay the cash value of the damage, up to the policy limit, until actual repair or replacement is completed."[47] No repairs were undertaken on the property, so the insured's recovery was limited to ACV under (c) (2) of the policy.

ACV was not defined under the policy, and State Farm withheld GCOP, permits, and depreciation. State Farm argued that under the replacement cost policy, the insured must actually incur an expense of replacement before the total amount payable for the replacement is paid.[48] Because GCOP are not incurred until paid, according to State Farm, "the insurance carrier is entitled to withhold those portions of adjusted loss until the insured actually pays"[49] for them.

The court agreed. It noted that Kentucky courts have varyingly applied the replacement cost less depreciation rule, the broad evidence rule, and the fair market value rule. Finding "no exclusive method for determining [ACV] of damage to buildings,"[50] the Court placed emphasis on arriving at the true value of the damage, suggesting it was embracing the fair market value rule. The court extended this rationale to GCOP, reasoning that "since the goal is to arrive at the [ACV] of the damage, non-damage factors which are applicable only in the instance of repair or

[46] 675 F. Supp. 1064 (W.D. Ky. 1987).

[47] Snellen v. State Farm Fire & Cas. Co., 675 F. Supp. 1064, 1065-66 (W.D. Ky. 1987)

[48] William F. Merlin & Mary Kestenbaum, *Withholding Profit and Overhead is Wrong if Insurance Companies are Trying to Act Right*, Gunn Merlin, P.A. (2002), http://www.propertyinsurancecoveragelaw.com/uploads/file/Withholding%20Overhead%20and%20Profit%20is%20Wrong.pdf

[49] *Id.* at 16.

[50] *Snellen*, 675 F. Supp. at 1068.

replacement such as clean up, profit, overhead, and permits, were properly deducted."[51] Reasoning that the foregoing factors have no relevance to the value of the damage but instead only to the cost incurred to rebuild, the court upheld State Farm's exclusion of GCOP in its calculation of ACV.

Following this ruling, "many other carriers started to withhold [GCOP] as a matter of routine claims practice."[52] In Florida, the issue was brought to light by Hurricane Andrew when consumer complaints spurred the Florida Dept. of Insurance to issue a bulletin prohibiting anything less than full replacement cost.[53] After Hurricane Ike swept through Texas, the Texas Department of Insurance received 47 complaints involving GCOP over the next year.[54] As a general rule, following *Snellen*,[55] "claim for contractor's profit and overhead [were] typically rejected by the insurance company in situations where the insured repairs the property himself because the insured has not employed a general contractor."[56]

III. When GCOP Must Be Included

At the outset, it is important to acknowledge that insurance companies generally do not exclude GCOP in determinations of ACV settlements where a general contractor is actually used and repairs or replacements are made.[57] The dispute surrounding GCOP, instead, centers on

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[51] *Id.* at 1068.

[52] Merlin, *supra* note 48 at 17.

[53] *Id.*

[54] Purva Patel, *Homeowners Push insurers to pay them as contractors*, Houston Chronicle (Nov. 1, 2009), http://www.chron.com/business/article/Homeowners-push-insurers-to-pay-them-as-1743808.php

[55] 675 F. Supp. 1064

[56] *A Different Perspective on Payment of Profit and Overhead When Insureds Do Repair*, Claims J. (May 5, 2008), http://www.claimsjournal.com/news/national/2008/05/05/89715.htm

[57] *See*, e.g., *id.* at 4 (noting that "even under the minority view, GCO&P may still be a reimbursable expense if the services of a general contractor are actually employed to coordinate or supervise the repair or replacement.").

whether an insurer is obligated to include GCOP in a calculation of ACV for a building claim settlement irrespective of whether the property was actually repaired or replaced, and by extension irrespective of whether a general contractor was actually hired. In general, this issue arises where the insured does not intend to repair or replace the insured property, and thus does not intend to hire a general contractor. On this issue, two divergent views exist, at least in part dependent on the rule governing calculation of ACV.[58]

A. Minority View

In the minority of jurisdictions, GCOP are not properly included as ACV unless "actually incurred."[59] As discussed, *supra*, the genesis for this view comes from *Snellen*.[60] The minority view considers GCOP "non-damage" factors that have no relation to the value of the damaged property. Instead, GCOP, represent only a cost that would be incurred if repair or replacement took place. Alternatively, some insurers argue that the inclusion of GCOP, where it was not actually used, could result in an insured receiving what amounts to a windfall if permitted to recover a cost that may never actually be incurred.[61]

Hess v. North Pacific Ins. Co.,[62] a 1993 case, is sometimes cited in support of the minority view,[63] but has been subsequently limited and distinguished. In *Hess*, the court was asked to interpret a provision of a fire policy which stated "We will pay no more than the [ACV]

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[58] *Id.* at 3; *See also* Eshoo, *supra* note 24 at 3-4.

[59] Snellen v. State Farm Fire & Cas. Co., 675 F. Supp. 1064 (W.D. Ky. 1987)

[60] *Id.*

[61] Eshoo, *supra* note 14.

[62] Hess v. North Pacific Ins. Co., 122 Wash. 2d 180, 189, 859 P.2d 586, 590 (1993)

[63] *See, e.g.*, Burchett v. Kansas Mut. Ins. Co., 30 Kan. App. 2d 826, 828-29, 48 P.3d 1290, 1292 (2002); Hill, *supra* note 26 at 4.

of the damage unless: (a) actual repair or replacement is complete[d.]"[64] The court interpreted this as unambiguously establishing a limiting principal "that the company would only pay the [ACV] until repair or replacement was completed."[65] Because the insured did not intend to replace the home, he was entitled only to ACV under the policy. The court seemingly relied on the fair market value rule, which is followed in Washington, to find that the defendant was not entitled to collect the full cost to repair the structure but instead only entitled to recover the value of the property as it stood following the covered event.[66] Accordingly, the court held that an insured under a fire policy was not entitled to recover the full replacement costs of his destroyed dwelling unless actual repair or replacement was undertaken and completed and upheld the insurer's ACV calculation.[67]

But in *Hess*, the plaintiff's fatal flaw was seeking full replacement costs under the policy, instead of accepting the policy provision that required payment of ACV where no repairs were made. Instead, the plaintiff could have argued that the ACV under the policy should have included GCOP. In *Holden v. Farmers Ins. Co. of Washington*,[68] the court addressed the inclusion of sales tax in the ACV calculation of property damaged by fire, but not replaced. Like GCOP, sales tax was a cost not incurred until actual rebuilding took place and so was subject to dispute. The policy coverage at issue provided for the settlement of losses according to the fair market value of the damaged property, and the insurer argued that FMV "necessarily excludes transaction costs, such as sales tax, because these extra costs do not add to the value of an

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[64] *Id.*

[65] *Id.*

[66] *Id.*

[67] *Id.*

[68] 169 Wash. 2d 750, 239 P.3d 344 (2010).

object."[69] The court disagreed, and found that whether an ACV claimant actually replaces damaged property has no logical bearing on the property's FMV.[70] More importantly, the court noted that *Hess*[71] concerned "the interpretation of a replacement cost coverage provision, not an ACV provision."[72] Accordingly, the court said, any discussion of ACV in that case is non-binding dicta.

B. Majority View

In the majority of jurisdictions, GCOP is a reimbursable expense in property claims, even where no actual repairs were undertaken, if use of a general contractor is reasonably likely. This view was articulated recently in *Mills v. Foremost Ins. Co.*,[73] where the Eleventh Circuit approved class certification for a class of plaintiffs denied GCOP payments in ACV payments. In *Mills*, a mobile home insured by Foremost Ins. Co. was damaged by Hurricane Frances.[74] The policy defined ACV as "the cost to repair or replace property with new materials of like kind and quality" less certain depreciation.[75] Foremost withheld GCOP and taxes from a partial payment, and the insureds filed suit on behalf of all of Foremost's mobile home insurance policyholders in Florida who submitted claims to their mobile homes caused by hurricanes in 2004.[76]

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[69] 169 Wash. 2d at 758, 239 P.3d at 348 (2010).

[70] *Id.* at 758.

[71] 122 Wash. 2d 180

[72] *Holden*, 169 P.3d at 349.

[73] 511 F.3d 1300 (11th Cir. 2008).

[74] Tred Eyerly, *Coverage Class Action Survives Insurer's Motion for Summary Judgment*, Ins. L. Hawaii (March 2, 2009), http://www.insurancelawhawaii.com/insurance_law_hawaii/2009/03/class-action-suit-for-coverage-survives-motion-to-dismiss.html

[75] *Mills*, 511 F.3d at 1305.

[76] Eyerly, *supra* note 73.

After the District Court dismissed the case, holding that the plaintiffs were required to show that they had actually hired a general contractor in order to receive GCOP,[77] the Eleventh Circuit reversed. The court looked to the policy definition of ACV, and analyzed whether "the cost to repair or replace property with new materials" properly included GCOP. Finding that the language did not suggest that completion of repair or replacement was a condition precedent to payment on an ACV claim, the court applied the broad evidence rule and found that GCOP "are well-recognized types of costs routinely charged."[78] Accordingly, the court held that "if it was *reasonably likely* that the plaintiffs' repairs would involve a general contractor, then it did not matter under the [ACV] definition … whether or not the plaintiffs actually hired a general contractor to be entitled to the additional payment."[79]

The Court in *Mills* rightly noted that the "weight of authority on the issue" supported the result.[80] In New York, where courts follow the broad evidence rule, the court has held that an insurer may not automatically deduct GCOP from an ACV payment.[81] In *Mazzocki v. State Farm Fire & Cas. Corp.*,[82] homeowners suffered storm damage to property insured under the standard HO5 policy included *supra*. In a class action suit, the homeowners alleged that the insurer's exclusion of the profit and overhead expenses of a general contractor in calculating the ACV of the plaintiffs' damaged properties constituted a breach of State Farm's homeowners' policies. The court, looking to other jurisdictions for guidance, found that "replacement cost"

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[77] *Id.*at 511.

[78] *Mills*, 511 F.3d at 1306.

[79] Nat'l Sec. Fire & Cas. Co. v. DeWitt, 85 So. 3d 355, 365 (Ala. 2011) (emphasis added).

[80] *Mills*, 511 F.3d at 1306.

[81] Mazzocki v. State Farm Fire & Cas. Corp., 1 A.D.3d 9, 12, 766 N.Y.S.2d 719, 722 (2003).

[82] *Id.* at 722.

under the policy could be reasonably interpreted to include GCOP when it is reasonably likely that a general contractor will be needed to repair or replace the damage.[83] Therefore, the court found that State Farm was obligated to include GCOP both in its calculation of replacement cost, and in ACV, whenever a general contractor was likely to be needed.[84]

In Texas, "[i]t is [also] settled law that insurers may not deduct, or withhold, GCOP … from an ACV payment."[85] Texas follows the replacement cost less depreciation rule, and defines replacement costs as "any cost that an insured is reasonably likely to incur in repairing or replacing a covered loss."[86] Because GCOP are factored into policy limits and contractors' bids, Texas courts consider them reasonably likely to be incurred. Accordingly, Texas courts require GCOP included in an ACV settlement. In Pennsylvania, [87] which also follows a variation of the replacement cost less depreciation rule, courts have repeatedly held that an "insured is entitled to overhead and profit where use of a general contractor would be reasonably likely, even if no contractor is used or no repairs are made." In Arizona, courts also follow the majority rule. [88]

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[83] *Id.*

[84] *Id.*

[85] Tolar v. Allstate Texas Lloyd's Co., 772 F. Supp. 2d 825, 831 (N.D. Tex. 2011) (citing Ghoman v. New Hampshire Ins. Co., 159 F.Supp.2d 928, 936 (N.D.Tex.2001).

[86] *Tolar*, 772 F. Supp. 2d at 831.

[87] *See, e.g.*, Mee v. Safeco Ins. Co. of Am., 2006 PA Super 257, 908 A.2d 344 (Pa. Super. Ct. 2006); Gilderman v. State Farm Ins. Co., 437 Pa. Super. 217, 649 A.2d 941 (1994)

[88] *See, e.g.*, Bond v. Am. Family Mut. Ins. Co., 2008 WL 477873 (D. Ariz. Feb. 19, 2008) (finding that "[d]efendant's policy required [the insurer] to include general contractor overhead and profit in the [ACV] payments it did make[.]"); Tritschler v. Allstate Ins. Co., 213 Ariz. 505, 144 P.3d 519 (Ariz. Ct. App. 2006); Lukes v. Am. Family Mut. Ins. Co., 455 F. Supp. 2d 1010 (D. Ariz. 2006) (rejecting an argument that an insurer does not have to pay sales tax in an ACV payment unless and until the Plaintiff actually replaces the contents).

In Michigan, which also follows the replacement cost less depreciation rule, courts have taken an even more inclusive stance on ACV. In *Salesin v. State Farm Fire & Cas. Co.*,[89] the policyholder's home was insured under the State Farm HO5 policy included *supra* when a leaking washing machine hose caused water damage to his home. The policyholder asserted that State Farm wrongfully withheld $5,581.79 in GCOP when adjusting the loss, arguing that "the term [ACV] allows the deduction of depreciation but not of contractor's overhead and profit."[90] State Farm relied on *Snellen*[91] for "the proposition that the term [ACV] allows the deduction of both depreciation and contractor's overhead and profit."[92]

As with most policies, ACV in the policy in *Salesin* was undefined. The court applied the applicable rule in Michigan, the replacement cost less depreciation rule. Finding that the policyholder had paid a premium for a full replacement cost policy, the court could not meaningfully distinguish GCOP and other contingent estimated costs for replacement in the policy. The court reasoned that because all repair or replacement costs are contingent, it would be "no more logical to exclude the former, on the grounds that it is a "non-damage factor," than … the latter."[93] Accordingly, the court held that State Farm owed the insured GCOP, despite the fact that the policyholder would "almost certainly" not incur that expense.[94]

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[89] 229 Mich. App. 346, 581 N.W.2d 781 (1998)

[90] *Id.* at 367.

[91] Snellen v. State Farm Fire & Cas. Co., 675 F. Supp. 1064 (W.D. Ky. 1987)

[92] *Salesin*, 581 N.W.2d at 784.

[93] *Id.* at 791.

[94] *Id.*

The standard for determining whether services of a general contractor are reasonably likely will almost certainly raise questions of fact to be determined on a case-by-case basis,[95] but some cases also suggest use of the three trade rule. The three-trade rule states that GCOP should be paid if more than three trade categories of specialty contractors or subcontractors are needed.[96] In *Burgess v. Farmers Ins. Co., Inc.*,[97] the insured argued that once "a determination [is made] that three trades are implicated in the repair of the property … it is presumed that a general contractor is necessary to coordinate, supervise, and oversee the repair."[98] The case was settled after the court upheld the class certification, though, and the court did not reach the issue of whether the three trade rule is an accepted industry standard.[99] Additional cases raising the issue have also been settled final to resolution of the issue.[100]

IV. Recommendations

A. GCOP Should be Included in All Jurisdictions

As an advocate for the insured, public insurance adjusters must support the majority view that GCOP must be included where use of a general contractor is reasonably likely. The majority view is supported by legal authority and considerations of fairness and efficiency, and will allow the insured to recover the actual amount due under his or her replacement cost policy.

First, as discussed above, the weight of case law supports the view that GCOP should be included where use of a general contractor is reasonably likely. In addition, the view expressed

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[95] Mazzocki v. State Farm Fire & Cas. Corp., 1 A.D.3d 9, 766 N.Y.S.2d 719 (2003).

[96] Eshoo, *supra* note 14 at 8.

[97] 151 P.3d 92 (Okla. 2006)

[98] Hill, *supra* note 26 at 2.

[99] *Burgess*, 151 P.2d at 94.

[100] *See* Cormier v. State Farm Gen. Ins. Co., Case No. CJ-2002-930 (Comanche County, Okla.) (as cited in Hill, *supra* note 26 at 5.

in the minority view cases has been expressly repudiated by a number of state insurance commissions.[101] In Texas, the Department of Insurance issued a bulletin which states that "[t]he deduction of prospective contractors´ overhead and profit and sales tax in determining [ACV] under a replacement cost policy is improper, is not a reasonable interpretation of the policy language, and is unfair to insureds."[102] In Colorado, the Division of Insurance issued a bulletin stating its position that "[i]nsurers shall be prohibited from deducting contractors' overhead and profit in addition to depreciation when policyholders do not repair or replace the structure."[103] The Colorado Div. of Ins. also addressed the limiting provisions discussed *supra*, finding that the provision does not permit deduction for GCOP in calculating ACV.

Public adjusters must also support the majority view because it allows for efficient resolution of building claims disputes for replacement cost policies. Under the rule of *contra proferentum*, if a provision in an insurance policy is subject to more than one reasonable interpretation, it is considered ambiguous and must be construed against the insurer.[104] Given the discussion *supra*, it seems clear that at least two reasonable interpretations of the standard provisions in the typical property insurance policy regarding GCOP payments are possible.

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[101] Kentucky Dept. of Insurance market conduct examinations are not readily accessible prior to 2009, but it has been reported that, following the decision in Snellen, the Kentucky Dept. of Insurance examined Allstate Insurance Company regarding the exact same issue, and "found Allstate's actions of withholding overhead and profit to be improper." Merlin, *supra* note 48 at 26.

[102] Texas Department of Insurance, COMMISSIONER´s BULLETIN NO. B-0045-98, available at http://www.tdi.texas.gov/bulletins/1998/b-0045-8.html (last accessed April 13, 2013).

[103] Colorado Div. of Insurance, *Bulletin No. B-5.1. Calculation of Actual Cash Value: Prohibition Against Deducting Contractors' Overhead and Profit from Replacement Costs Where Repairs are Not Made* (May 8, 2007), http://www.colorado.gov/cs/Satellite?blobcol=urldata&blobheadername1=Content-Disposition&blobheadername2=Content-Type&blobheadervalue1=inline%3B+filename%3D%22B-5.1+Calculation+of+Actual+Cash+Value%3A+Prohibition+Against+Deducting+Contractors%27+Overhead+and+Profit+from+Replacement+Cost+Where+Repairs+are+Not+Made+.pdf%22&blobheadervalue2=application%2Fpdf&blobkey=id&blobtable=MungoBlobs&blobwhere=1251852589112&ssbinary=true

[104] Eshoo, *supra* note 14 at 7.

Accordingly, in any litigation challenging exclusion of GCOP under a standard policy, a court would be required to construe the policy strictly in favor of the insured and against the insurer. Because the issue of GCOP under a standard policy is capable of two reasonable interpretations, and because any provision subject to more than one reasonable interpretation will be construed against the insurer, simply construing the provisions as against the insurer in all jurisdictions will eliminate needless litigation and promote judicial efficiency.

Also, the minority view's argument for exclusion is illogical. The minority rule seeks to exclude contractor profit and overhead as "non-damage" factors which will be incurred only if rebuilding takes place. But all cost factors in a policy that allows for an actual case value settlement in lieu of actual replacement or repair will be incurred only if rebuilding or repair takes place. At the time of settlement of a claim where no rebuilding or repair has taken place, the insured has not incurred the cost of labor and materials any more than he has incurred GCOP. In fact, if an insured chooses not to repair or replace the property at all, the insured would not incur any expenses. Because insureds are able to collect a large amount of non-incurred expenses under the minority view, it is illogical for insurers to exclude other, non-incurred expenses in replacement cost calculation.[105]

Finally, public insurance adjusters must support the majority view on inclusion of GCOP as a matter of basic fairness. Insurance companies are not allowed to charge premiums that exceed the risk to which they apply.[106] Under a replacement cost policy, the cost of GCOP must be included in the premium because GCOP is covered where the expense is actually incurred. So, the insurer would be receiving a premium whose cost includes insurable values that may

[105] Eshoo, *supra* note 14 at 7.

[106] Merlin, *supra* note 48 at 26.

never be paid. This receipt of a premium in excess of risk covered would result in "an illegal windfall"[107] for insurance companies under the minority rule.

B. Changing Existing Practices with Bad Faith Claims

While the majority of courts have consistently invalidated withholding of GCOP in ACV calculations, they have not sufficiently deterred the practice through bad faith suits and class actions. As such, public insurance adjusters must become the enforcement mechanism, and remain vigilant and be prepared to dispute settlements withholding GCOP as improper.

The majority of states recognize a first-party bad-faith claim at common law, either based on tort of contract theory,[108] so the remedy is widely available. Further, public adjuster demands have been relied on previously for allowing a claim of bad faith. In *Tritschler*, the court relied on the exchange between Tritschler's public adjuster and Allstate, where the adjuster specifically questioned Allstate's basis for withholding GCOP, when it denied Allstate's motion for summary judgment on the claim of bad faith.[109] If Tritscher had not hired a public insurance adjuster, and that public adjuster had not directly asked Allstate for its legal basis for withholding GCOP, the court most likely would have granted Allstate's motion. While some class certifications have been allowed by courts on bad faith claims, the class action suits are often settled and do not provide precedent for GCOP inclusion.[110] As such, it is important for public insurance adjusters to demand inclusion of GCOP, which will require insurers to either offer

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[107] Texas Department of Insurance, *supra* note 101.

[108] Every state, except Florida, Georgia, Illinois, Kansas, Louisiana, Maine, Maryland, Michigan, Minnesota, Missouri, New York, Oregon, Pennsylvania and Tennessee recognize first-party bad-faith at common law based on either a tort or contract theory. Merlin, *supra* note 48 at 13.

[109] Tritschler v. Allstate Ins. Co., 213 Ariz. 505, 517, 144 P.3d 519, 531 (Ariz. Ct. App. 2006).

[110] Although settlements regarding GCOP are sometimes protected by confidentiality, *see* Gonzales v. State Farm, Superior Court of California, County of Los Angeles, Case No. 981564 (Joint Settlement Agreement requiring payment of overhead and profit as part of ACV) (1998).

GCOP, state its basis for withholding GCOP – a basis that the majority of jurisdictions have rejected – or remain silent and risk exposure to a bad faith claim.

Conclusion

General contractor profit and overhead has been and likely will continue to be a contentious issue among policyholders and insurers. But the consensus of the courts is beginning to emerge. Where an insured is reasonably likely to require a general contractor, the majority of courts that have addressed the issue require inclusion of GCOP in a property claim. Simply put, withholding GCOP encourages protracted litigation, violates basic fairness, and has no logical basis. But while the courts have consistently invalidated withholding of GCOP, they have not sufficiently deterred the practice through bad faith suits and class actions. Insurance companies will continue the practice unless it is foreclosed entirely. To combat this, public insurance adjusters must support the inclusion of GCOP and, if insurance companies continue to withhold these payments, must be prepared to dispute those payments as improper.