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Current issues in first-party property claims

"LIKE KIND AND QUALITY" AND OTHER ISSUES WHEN INSURERS PAY FOR PROPERTY DAMAGE TO THEIR INSUREDS' BUILDINGS

Up until the 1990s, first-party property claims were the distant second cousin to liability claims in the insurance industry. Liability claims and their many manifestations were the focus, and had been the focus, of the insurance industry for decades. No longer. Beginning in the 1990s, if not shortly before, the insurance industry began to turn its attention to how much it was paying for first-party property claims. These included homeowner claims for fire, water, and other damages, as well as commercial property claims for similar damages. As a result, insurers began to develop programs, policies, and procedures for the handling of first-party property claims that were aimed at reducing their claim payments. State Farm developed a program for the handling of roof claims, while insurers, including State Farm, also began to measure "leakage," or perceived overpayments in property claims.

One part of the insurance industry's new effort to control payments was the development of and focus upon new legal positions that the industry believed it could take in support of its claims payment reduction efforts. These new positions included (1) denying property claims where the only damage was perceived to be cosmetic (non-functional) damage which did not adversely impact the functionality of the property, and (2) refusing to replace or repair property with property of "like kind and quality," even though such replacement is required by the insurance policy. The purpose of this article is to address some of the case law development in these two areas.

Insurance industry refusal to pay for "cosmetic" losses

The Insurance Services Office ("ISO") Homeowners 3 ("HO 3") policy insuring agreement provides coverage "against direct physical loss to the property described" (ISO form HO 00 03 05 11 (2010), p. 9). Within the past few years, some insurers have contended that "direct physical loss" means "functional" loss or damage. According to these insurers, mere cosmetic damage or loss, such as from hail strikes which leave blemishes or similar marks on a roof, is not covered because it does not affect the "functionality" of the roof. Insureds have contested this position by arguing that first-party property insurance policies, such as the

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HO 3, do not limit coverage to "functional" loss or damage. Indeed, the word "functional" does not appear in those policies. Rather, "direct physical loss" refers to any type of loss or damage, whether it be "functional" or "cosmetic."

No California court has addressed this issue to date. Accordingly, it is necessary to turn to out-of-state decisions in which the courts have determined whether a first-party property policy provides coverage for cosmetic damage.

In *GHR Enterprises, Inc., et al. v. American States Insurance Co.*, 2014 WL 10538029 (D. So. Dakota, Sept. 30, 2014), a federal district court addressed a case in which the insured's building had sustained hail damage; however, American States, the insurer, refused to pay some of the claim because the damage was only cosmetic. The Court first noted that the word "damage" in the policy was not defined, and so accordingly defined it in its ordinary and popular sense. The court adopted the following definition of damage: "physical harm caused to something in such a way as to impair its value, usefulness, or normal function, commonly associated as causing unwelcome and detrimental effects" Based on this definition, the court concluded that "the hotel's roof was damaged, even if the damage did not affect the overall functionality of the roof."

The court then addressed whether American States' refusal to pay for the hail damage constituted bad faith. Here, the court noted that American States had retained an engineer who inspected the roof and reported that even though there were hail dents on the roof, there was no "functional damage." American States relied on the engineer's report in concluding that the roof sustained no damage. The court, however, ruled that a jury could find American States' reliance on the engineer's report as unreasonable because "the insurance policy does not distinguish between types of damage. The term 'damage' is not defined anywhere in the insurance contract and must be interpreted using its plain and ordinary meaning." Accordingly, the court held that the issue of whether American States acted in bad faith should be submitted to the jury.

In *Advance Cable Co., LLC v. Cincinnati Insurance Company* (7th Cir. 2015) 788 F. 3d 743, the court addressed a similar issue. Cincinnati Insurance Company, which insured Advance Cable's buildings, denied coverage for hail damage to the roofs because the hail damage did not constitute "direct physical loss." The court first addressed the meaning of the phrase "direct physical loss," and concluded that the word "direct," which is not defined in the policy, must be "meant to exclude situations in which an intervening force plays some role in the damage." The court found no intervening force that caused the damage. It then addressed the meaning of "[l]oss or harm." It rejected Cincinnati's position that the loss or harm must be functional or reduce the value of the property, observing that "it bears no relation to the language of the policy. It noted that there is no exception to the definition of 'loss' for cosmetic damage, or any other kind of particular damage, and had Cincinnati wished to exclude cosmetic damage from coverage, it should have written the policy that way.

In a companion case to *Advance Cable*, a district court addressed coverage for cosmetic damage in *Welton Enterprises, Inc., v. Cincinnati Ins. Co.* (W.D. Wis.) 131 F. Supp. 3d 827. There, defendant Cincinnati insured numerous commercial buildings owned by its insured, Welton Enterprises. Welton contended that the roofs of the buildings were damaged by hail. Cincinnati contended that the denting of the roofs was "purely cosmetic and is not visible from the ground," and therefore, did not constitute "direct physical loss" under Cincinnati's policy. Cincinnati argued that there was no "loss or damage because the hail did not harm the roof enough to diminish its function or value." Cincinnati relied upon a report from its engineer, who concluded that the roof denting was "relatively minor" and could not be "view[ed] from ground level." The court rejected Cincinnati's position and followed the decision in *Advance Cable*, writing that "even without a quantifiable 'loss' in value or function, there may still be 'damage' that triggers coverage."

Finally, in *Great Plains Ventures v. Liberty Mutual Fire Ins. Co.* (D. Kansas 2016) 161 F. Supp. 3d 970, the insured, Great Plains Ventures, owned several buildings, the roofs of which it contended were damaged by hail. Liberty Mutual had its engineer inspect the roofs. He concluded that the hail did not cause "functional damage" to the roofs, and that what cosmetic damage there was, was "not visible from the ground." Based on this report Liberty Mutual denied coverage for the "minor impact or blemishes" to the roofs caused by the hail. Relying upon the decision in *Advance Cable*, the court concluded that the "phrase 'physical loss or damage' unambiguously includes the cosmetic hail damage to Plaintiff's Coverage Property."

The foregoing decisions are in accordance with the California rule of insurance contract interpretation that insuring agreements are to be interpreted broadly and that terms are not to be added to the policy; rather, the policy must be given its plain meaning without any additions or changes. (See *RLI Insurance Company v. City of Visalia,* (E.D. Cal. 2018) 297 F.Supp.3d 1038,1049, *and AIU Ins. Co. v. Superior Court*, (1990) 51 Cal.3d 807, 821-822). Accordingly, the California practitioner should be able to make the argument, in accordance with California law, that property insurance policies provide coverage for cosmetic losses.

The insurance industry's resistance to paying for "like kind and quality"

Homeowners' policies commonly provide that the insurer must only pay for repair or replacement of property with "like kind and quality." Indeed, the 2011 version of the HO 3 provides:

> If, at the time of loss, the amount of insurance in this policy on the damaged building is 80 percent or more of the full replacement cost of the building immediately before the loss, we will pay the cost to repair or replace, without deduction for depreciation, but not more than the least of the following amounts:
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(2) The replacement cost of that part of the building damaged with material of like and quality and for like use.

Although not many courts have addressed the meaning, let alone the application, of "like kind and quality," those which have, provide guidance to claims handlers on how to apply this language in their handling of first-party personal lines property claims. The following decisions provide some guidance to practitioners when addressing issues that arise when the "like kind and quality" provision is applied to a particular case.

Like kind and quality for auto body repairs

California courts have only defined "like kind and quality" in the context of automobile repairs. In *Ray v. Farmers Insurance Exchange* (1988) 200 Cal.App.3d 1411, 1416, the court defined "like kind and quality" as meaning placing "the automobile in substantially the same condition it was before an accident." The court then held that placing the vehicle in substantially the same condition as it was in prior to the accident did not include restoring its "market value." (*Id*. at p. 1417). In *Lebrilla, et al. v. Farmers Group Inc. (*2004) 119 Cal.App.4th 1970, 1082, held that "like kind and quality," again in the context of automobile repairs, did not include the automobile's "age or extent of use."

Similarly, the California Insurance Code and Regulations do not expressly define "like kind and quality." California Regulations require that "where the insurer is required to pay the expense of repairing, rebuilding or replacing the property destroyed or damaged with other of like kind and quality, the measure of recovery is determined by the actual cash value of the damaged or destroyed property, as set forth in California Insurance Code Section 2051." (10 CCR § 2695-9(f)(1).) California Insurance Code Section 2051 addresses how an insurer must determine actual cash value. (Cal. Ins. Code § 2051.) Neither the Code or Regulations address what constitutes like kind and quality in the first instance. Accordingly, California authority does not provide guidance on how to apply like kind and quality to damage to a building or structure.

Toward a more specific definition of like kind and quality

Here, it is necessary to turn to out-of-state court decisions in which the courts have sought to define "like kind and quality." In *Custom Controls Company v. Ranger Insurance, et al.*, 652 S.W.2d 449 (Tex. App., 1983), the insured/plaintiff sustained a fire loss. The insured was in the business of manufacturing process control systems, and four completed well-head control panels were destroyed in the fire. The insured submitted a claim to its insurer, Ranger Insurance, which only offered to pay a portion of the amount claimed by the insured for the loss of the panels. The insured sought recovery of the market value of the panels, while Ranger offered to pay the cost to remanufacture the panels.

In determining how much the insurer owed, the court concluded that it had to determine the meaning of the policy provision requiring replacement with "material of like kind and quality." The court held that "like kind and quality" means that "one must restore the property to substantially its same condition as it was immediately prior to being damaged." Under this definition the court held that Ranger only owed the cost to remanufacture the panels.

The *Custom Controls* court did not rely upon dictionary or other definitions of "like" and "kind" in reaching its decision. In contrast, the Texas Court of Appeals in *Republic Underwriters Insurance Company v. Mex-Tex, Inc.* 106 S.W.2d 174 (Tex. App., 2003), rev. on other grounds, *Republic Underwriters Ins. Co. v. Mex-Tex. Inc.,* 150 S.W.3d 423 (Tex., 2004) noted that "like kind and quality" is not defined in the policy, and therefore turned to the popular or recognized meanings of the words. The Court engaged in an extensive review of definitions from various sources in arriving at its definition of "like kind and quality":

> According to *Webster's*, the word "like" can mean "same or nearly the same," "equal or nearly equal," or "something similar." *Webster's Third International Dictionary* (1993). We are also informed that it is "a general word indicating resemblance or similarity ranging from virtual identity in all characteristics to a chance resemblance in only one." *Id.* Additionally, several of its many synonyms include "similar," "analogous," "comparable," and "identical." So, as can be seen, these descriptions hardly denote specificity. Again, the plain meaning of "like" can range anywhere from identical to a mere resemblance, and that is indeed quite a spectrum. Nevertheless, Republic itself provides us reason to narrow that spectrum when the term is used in an insurance contract like that at bar. As the insurer argued in its brief, when replacing damaged or lost property, "in some cases an identical substitute cannot be found." "In such a case the insurance company cannot pay for an exact replacement but must find something substantially similar," says the insurer. That makes sense. If an insurer were obligated to replace damaged property with identical property and the quantum of identical property were small or non-existent, then it may not be able to perform its commitment or could only do so at an unexpected economic hardship. To mitigate against this result, logic would dictate that *we construe "like" to have parameters less restrictive than those inherent in the word "identical."*

(*Id*., p. 179; emphasis added)

Similarly, in *Hoffman v. Foremost Signature Ins. Co.* (D. Ore. 2013) 989 F.Supp. 2d 1070, 2080, also turned to other definitions to arrive at the meaning of "like kind and quality."

> This Court first turns to the dictionary definitions. The term "like" is defined as "possessing the characteristics of; resembling closely; similar to." American Heritage Dictionary of the English Language (4th ed.2000); *see also* The Oxford-English Dictionary Vol. Viii, 944 (2d ed.2001) ("Having the same characteristics or qualities as some other . . . thing"). The term "kind" is defined as "[a] natural quality, property or characteristic." The Oxford- English Dictionary Vol. VIII,

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436 (2d ed.2001); *see also* American Heritage Dictionary Of The English Language (4th ed.2000) ("3. Fundamental, underlying character as a determinant of the class to which a thing belongs."). The term "quality" is defined as "[a]n inherent or distinguishing characteristic; a property." American Heritage Dictionary of the English Language 1431 (4th ed.2000); *see also* The Oxford-English Dictionary Vol. XII, 971 (2d ed.2001) ("the nature, kind, or character (of something)"). Collectively, *these definitions require a replacement dwelling to possess similar qualities and/or characteristics to that of the lost dwelling*.

(Emphasis added.)

Although the foregoing definitions offer some guidance on the meaning of "like kind and quality," they also leave room for further interpretation in the application of the phrase for the practitioner, the decisions in which "like kind and quality" is actually applied to a specific factual pattern are likely of greater assistance. Accordingly, we turn to other out-of-state decisions in which the courts have made a determination of what "like kind and quality" is in the context of claims for damage to property.

The application of "like kind and quality"

"Like kind and quality" and matching issues

In *National Presbyterian Church, Inc. v. GuideOne Mutual Insurance Company* (D.Conn. 2015) 82 F.Supp.3d 55, the insured's church was damaged in an earthquake According to the court:

> The church's exterior is comprised of hundreds of limestone panels, some of which were cracked or otherwise damaged by the earthquake. So the church filed an insurance claim to repair the damage. But the church fears that merely replacing the damaged panels would diminish the aesthetic qualities of the façade, as the new, unweathered panels could have noticeably different coloration than the remaining panels. Thus, the church believes that GuideOne, its insurer, is required to pay for repairs that not only fix the structural damage, but also create a matching façade. Both parties seek a declaratory judgment as to the matching issue.
>
> In reaching its decision on the matching issue, the court considered policy language similar to "like kind and quality."
>
> Moreover, a term equivalent to "like kind and quality" is referenced in *each* of the loss payment provision options (incorporating the valuation condition), those that qualify as "property" and those that do not – and that phrase could, itself, be read to require matching. "[A] reasonable person could understand," for instance, "that 'comparable material'" – a description used in this policy's valuation condition, Ins. Policy at 67 – "means material that is the same color as the damaged property." Similarly, "other property of like kind and quality" could be read to mandate property that looks the same. Imagine that an insurance company pays for repairs to one wall of an insured's dining room. The room's paint color – a light blue – is no longer manufactured. If the insurance company were to insist on a bright red or even dark blue paint – of the same quality and manufacture – just for that single wall, no one would feel that the insured had been made whole; only repainting the whole room would do that. Unless, that is, the policy had put forth an exclusion to that effect – which GuideOne certainly knows how to do, *see* Pl.'s Mem. at 16 (pointing out that the policy language quoted above expressly excludes costs incurred as a result of local ordinances), but declined to do here.

(*Id*., 82 F.Supp.3d at 60.)

"Like kind and quality" and the replacement home

When an insured replaces their burned-down mobile home with a traditionally constructed or "stick-built" home, is the replacement home of "like kind and quality"? That was the issue before the Court in *Hoffman v. Foremost Signature Ins. Co*. (E.D. Mo., 2017) 2017 WL 4778580.

The insured contended that the new "stick-built" home was "sufficiently similar to a manufactured home" because both are "single family dwellings with four walls" and "a roof" (*Id*., p. 6). The insurer, on the other hand, contended that the "stick-built" home is simply too different from a manufactured home to be of "like kind and quality." (*Id*.)

The court held for the insurer:

> Plaintiff's broad interpretation of "of like kind and quality" equates this restriction with the term "dwelling" and thereby eliminates the second restriction entirely. In other words, if all dwellings are "of like kind and quality" because they provide "four walls" and a "roof," then this contractual restriction is meaningless and any timely replacement with a new "dwelling" is effective under the contract. For example, if plaintiff had replaced her manufactured home with a bunker or houseboat, such a "shelter" would qualify under her interpretation as "of like kind and quality." Such a result is unreasonable when considered in light of the type of insurance being provided, i.e., "manufactured home insurance," and the underlying purpose of replacement coverage, i.e., to restore property without deducting value loss caused by depreciation. Accordingly, plaintiff's interpretation is unreasonable.

(*Ibid*.)

On the other hand, an insurer's proposed replacement structure may not constitute "like kind and quality" to the insured's original dwelling. In a case involving the replacement of a dwelling, the insured's home was totally destroyed by fire. (*J. Brouillette v. Fireman's Fund Insurance Company*, 563 So.2d 1343 [La. App., 1990].) The insurer offered to repair the home for $28,500, whereas the insured sought recovery for $52,000. (*Id*., p. 1344.) The court held that the insurer's proposed repair was not of "like kind and quality."

> [T]he notice of Fireman's Fund's intent to exercise its option to rebuild did not reflect an intent to rebuild a house of like kind and quality.

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> Fireman's Fund intended to replace a $52,000 home with a $28,500 home. The evidence and testimony revealed that Fireman's Fund's estimate of cost to rebuild did not include replacement of the fireplace, the hardwood floors, appliances, or the sewage system and did not provide for use of like quality materials for replacement.

(*Id*. at p. 1345.)

"Like kind and quality" and government regulations

In *Northbrook Property & Casualty Insurance Company v. R&J Crane, Inc.*, 765 So.2d 836 (Fla. App., 2000), the insured's crane had been damaged in high winds. (*Id*., p. 837.) The insured contended that the crane had to be replaced because the Occupational Safety and Health Administration ("OSHA") regulations required replacement. (*Id*.) Northbrook contended that the crane could be repaired and did not need to be replaced. (*Id*.)

The Court observed,

> Similarly, the OSHA regulations governing the crane and boom become part of the contract of insurance. OSHA requires that the employer comply with all of the manufacturer's specifications and *limitations* applicable to the operation of the crane and boom. The manufacturer of the crane and boom in this case requires that a damaged section of the boom must be replaced, not repaired, before making any lifts, and a senior product design manager for the manufacturer testified that the damage to the boom was beyond what was allowed in the boom repair manual. As OSHA has required that the crane and boom be used in accordance with the manufacturer's directions, the crane cannot be repaired and still comply with the OSHA regulation.

(*Id.,* p. 839.)

Accordingly, the court held that "[i]f an employer cannot operate the crane without violating safety regulations, then of what use is the repaired crane? In such a state, a repaired crane is not property 'of like kind and quality.'" (*Id*., p. 840.)

Based on the foregoing, a policy that promises repair or replacement of "like kind and quality" promises to put the insured "substantially" back into the position he or she was prior to the accident. The term "like kind and quality" should be interpreted broadly to include all factors which go into restoring the damaged property to its pre-loss condition. This includes consideration for all the features contained in a building, the appearance of the building and government requirements which regulate the quality of construction and similar matters.

Conclusion

The first-party property insurance issues discussed above are arising with greater frequency in litigation between policyholders and their insurers. Since California courts are generally solicitous of the rights of policyholders, the fact that courts in other jurisdictions have issued favorable decisions is a likely indication that you can obtain similar outcomes for your California clients. Best of luck!

Charles Miller is a licensed attorney in California. Since 1990, his practice has been devoted to insurance law. Prior to 1990, Mr. Miller was employed in the insurance industry for 18 years, where he worked as an insurance claims representative and claims manager. Mr. Miller has been retained in more than 15 states and territories, including in Canada, as an expert on insurance industry practices and standards, as well as on various insurance policy coverage issues. He can be reached at cmiller.ilc@earthlink.net.