LOSS BY WILDFIRE

How To Read Your Client's Standard Homeowner's Insurance Policy

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At 5:00 AM on Monday, the 9th of October, Adela and I were forced to evacuate our home on Sonoma Mountain as the Pressley Fire, an offspring of the Nuns Fire, reached our neighborhood. The fire burned to within 200 yards of our property before it was stopped. We were lucky, but many, many others were not. At least 44 deaths were caused by the Wine Country fires. The State of California estimates that some 8,400 houses, out buildings, agricultural and commercial structures were destroyed. Over 100,000 people have been displaced and one published report has total estimated insured losses for all California fires approaching $3 Billion.

In the wake of this catastrophe you may be asked to provide counsel as to what damage is covered and what is not covered under your client's insurance policies. I offer here a primer (or refresher), on some of the basics of standard homeowner policy language in the context of a wild fire loss. This article is not to be taken as legal advice regarding coverage available or potentially available to any particular policy holder under a particular policy. As I emphasize several times in this discussion, such coverage questions must be addressed on a case-by-case basis, with an appreciation of the specific facts bearing on each loss, the claims asserted by the policy holder and the complete terms of the subject policy.

This piece is, rather, intended to be an "issue spotting" aid for your policy review. I briefly discuss the different types of standard policy forms covering single family homes, condos, mobile/manufactured homes, and renter's insurance. We'll then move to a detailed review of a hypothetical claim for the loss of a home and personal property by wild fire, under the most widely sold standard homeowner's insurance form (HO 3).

I do not address here loss to commercial or industrial structures or to farm residences; those properties are not covered by the homeowner forms. Further, most homeowner's insurance policies provide coverage for both First Party claims and Third Party claims. First Party Claims implicate property loss suffered by the insured homeowner as a consequence of a covered natural event or another's negligence. An example of this would be a claim by a homeowner for the loss of his or her own house and contents in the recent wild fires. A Third Party claim is one in which another person alleges that a homeowner is responsible for bodily injury and/or property damage sustained by the claimant. An example of a Third Party claim would be a personal injury lawsuit brought by a guest against the homeowner for a dog bite injury inflicted by the homeowner's pet. This article focuses only on First Party issues that could be put in play by the fire loss; it does not address possible Third Party coverage situations.

Standard Homeowner Policies

The homeowner policy forms developed by the Insurance Services Office, Inc. ("ISO"), have been widely adopted by insurance carriers conducting business in California. The standard forms have been approved for use by the State of California's Department of Insurance and the policy language is well familiar to underwriters, adjusters, brokers and insurance agents, and to a lesser degree, the general public. Also, some of the terminology of these forms have been definitively interpreted by California courts. All this means that there is a broad consensus as to what any ISO policy does and does not cover. **Importantly, all of the ISO homeowner forms discussed below cover loss due to fire and smoke.**[1]

HO2, HO 3, HO 5 and HO 8 – Policies for Single Family, Duplex, Triplex & Fourplex Residences

Each of these policy forms cover damage to, or total loss of, the home ("dwelling"), detached out-buildings ("other structures"), and contents ("personal possessions"). Under the "Loss of Use" coverage section, each form provides reimbursement for living expenses if the residence premises is destroyed or is rendered temporarily uninhabitable. Reimbursement of fair rental value is available if the insured home is no longer habitable and was rented by the owner to tenant occupants at the time of loss. Finally, even if the covered property was not damaged, living expense reimbursement is provided if the homeowners were temporarily unable to live in the home due to mandatory evacuation orders ("Civil Authority Prohibits Use").

Also, these four policy forms cover costs related to debris removal, reasonable repairs to protect covered property (for example, shoring, or temporary roofing), damage to lawns, trees and shrubs and fire department service charges. For all of the coverages and reimbursable expenses discussed above, the amount of reimbursement can vary from policy to policy. Further, coverage and reimbursable expenses may also vary from one HO 3-based form, for example, to another, depending upon the terms of certain endorsements and exclusions to the policy, among other things. Generally speaking, the standard policy benefits move from the narrowest/poorest to the broadest/richest in this order: HO 8, HO 2, HO 3 and HO 5.

The HO 8 form is intended to provide very basic coverage for older homes whose architecture, building materials, electrical system and/or plumbing disqualify them from coverage under other standard forms. The HO 8 is a "named perils" policy; coverage is only triggered under this type of policy if the loss arises from a peril named in the policy (usually set out in a section entitled "Perils Insured Against"). HO 8 covers 10 named perils. As noted above, fire and smoke are among the covered named perils.

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[1] One ISO homeowner form (**HO 1**) is not discussed here. HO 1 provides only the most basic fire insurance coverage and is generally disfavored by mortgage lenders on the grounds that this insurance fails to adequately protect the lender's interests in the mortgaged property. Consequently, it is rarely encountered. The minimum permissible homeowner's coverage that can be sold in California is set out in Cal. Ins. Code Sec. 2070, *et seq*.

The HO 2 "broad form" is also a named perils policy. It covers loss arising from 16 identified perils. **The HO 3 "special form"** policy is the most commonly issued homeowner's insurance. The insurance provided by this form is a hybrid; coverage for the residence and other structures on the property is provided on an "open peril" basis, while coverage for personal possessions is afforded on a named perils basis. Open peril covers a broader range of causes of loss than named perils coverage. Open peril essentially means that a loss will be deemed covered, unless it is specifically excluded in the insurance contract. **The HO 5 "premier" form** is similar to the HO 3 contract and affords the broadest standard coverage available for homeowners. This form provides "open peril" coverage for not only the residence and other structures, but also for personal possessions.

HO 7 – Policy for Mobile and Manufactured Homes

The ISO **HO 7 form** is designed to provide insurance for mobile and manufactured homes. The HO 7 form tracks the HO 3 coverages closely, but can offer ancillary benefits for risks unique to mobile homes, such as loss incidental to moving the residence. This insurance covers losses to the residence, separate buildings (such as a car port or a storage shed), and personal possessions. Coverage is provided for debris removal, damage to shrubs and lawns, and Loss of Use.

HO 6 – Policy for Condominiums

The **HO 6 policy** form provides coverage for condominium homeowners. This is named perils coverage with 16 identified perils. As to coverage for the residence, this form is written only to cover alterations, appliances, fixtures and improvements within the homeowners' unit (with some incidental exceptions). Also covered under this form are personal property, trees and shrubs on the individual condo premises, Loss of Use, debris removal, reasonable repairs, fire department service charges and "items of real property which pertain exclusively to the 'residence premises'" (such as, for example, a private deck attached to the unit).

HO 4 – Policy for Renters

Renters can be covered for fire and smoke losses under the **HO 4 policy** form. This is a named perils form identifying 16 perils. Similar to the condo policy, this form covers only the insured renter's personal property, Loss of Use, debris removal, reasonable repairs, trees, shrubs and plants and fire department service charges.

The Scenario

Your homeowner clients are a married couple (he's a self-employed land surveyor, she works in the home and does the books for her husband's business), with one teenage child still living at home and a 22 year old, full-time college student, living in Long Beach. The homeowners lived in a development in northern Santa Rosa in a 20 year old, single-family house (3 bedrooms, 2 baths, about 1,500 square feet), on a 5,000 square foot lot. The home was purchased 10 years ago for $410,000, but was appraised last year at $589,000. The homeowners have about $140,000 left to pay on their mortgage. Besides the house, the lot also hosts a detached garage with a workshop, a gardening shed and an enclosure with a chicken coop-type structure in which the wife kept her pets, a Java Green Peacock and his peahen mate. The birds were purchased for about $800.

The contents of the home were consistent with the usual possessions of a middle-class family. These included typical kitchen appliances, a clothes washer and a dryer, three televisions, an audio system and four computers. The wife inherited a silver service, which she estimated to be worth $2,500. The husband and wife wore their wedding rings, but kept their other personal jewelry in dresser drawers in the master bedroom (total value about $5,000). About $1,000 in cash was stashed at the back of a closet for emergencies.

The teen had a library of video games, a tablet and a digital music player. The college student left a French Horn and trumpet at home, along with sheet music, her desktop and peripherals. The lion's share of the family's clothing was stored in the house; the remainder was packed away in the garage. In the front door entryway, packed for work the next day, the husband had a digital electronic theodolite survey tool, a Spectra Precision data collector, reference books, discs, thumb drives and work notes. The survey equipment was recently purchased at a total price of over $3,000.

In the garage workshop, the husband kept a table saw, a router and a miter saw. In addition, he kept a variety of other power and hand-held carpentry tools in two metal rolling tool boxes. The family also stored bicycles, sports equipment and personal records in the garage. The garage housed a two year old Chevy Equinox, insured under the couple's auto policy with Comprehensive coverage. Shovels, rakes, other gardening tools, a fertilizer spreader and fertilizer were stored in the gardening shed.

The homeowners have an 11 year old "beater" sedan, which was usually parked curbside at the front of the residence. Only Collision coverage is maintained for this vehicle. Finally, the husband's recently divorced brother (who did not live in the home), was temporarily storing his clothes, a few pieces of furniture, mementos and other miscellaneous items in the college student's vacant bedroom while he sorted out his circumstances.

In the early morning hours of October 9, 2017, the husband and wife were roused by choking smoke inside the house. By the time the teen was awakened and the family dressed, the roofs of both the garage and the house were in flames. Smoke filled the street; every neighbor's home that was visible was also on fire. In possession of only the clothes on their backs and the car keys, the family piled into the old sedan and fled for safety.

Seven days later, when they were able to return to their neighborhood, the family found complete destruction. The house, the garage and the other backyard structures were burned down. The landscaping was destroyed, as were the front and back lawns. The pet birds were dead. The floorplan of the garage could be traced around the burnt shell of the Chevy and the charred toolboxes. The layout of the home was marked by only the brick fireplace, the perimeter flower beds and the scorched washer and dryer. Everything else was ash.

Your clients have relocated from Santa Rosa to a two bedroom apartment in San Rafael. They now seek your guidance as to what loss is covered and what is not covered under their homeowner insurance policy.

Review The Policy's Declarations, Gather Information

You will need the complete insurance contract (basic policy form with all applicable exclusions and endorsements), to competently counsel your clients. While this seems obvious, the clients may not have the complete insurance policy in their possession at your first meeting. Instead, what they probably have, or what they can get quickly from their agent or their carrier, is the **Declarations Page** for their policy. Nonetheless, this is an important document that can get you started.

Policy Declarations

From the Declarations page you will be able to confirm the homeowners are identified as the "named insureds", the address of the covered property, the policy number (for reference in communications with the insurer), and the policy period (during which the loss must have occurred). The Declarations will set out the coverages your client has purchased, the limits of liability and the deductible, usually in a table format like this:

COVERAGES & LIMITS OF LIABILITY

Section I			
A. DWELLING	B. OTHER STRUCTURES	C. PERSONAL PROPERTY	D. LOSS OF USE
750,000	UP TO 10% OF THE LIABILITY LIMIT APPLICABLE TO COVERAGE "A"	UP TO 50% OF THE LIABILITY LIMIT APPLICABLE TO COVERAGE "A"	UP TO 30% OF THE LIABILITY LIMIT APPLICABLE TO COVERAGE "A" ACTUAL LOSSES SUSTAINED SHORTEST REASONABLE TIME

FOR LOSSES ARISING UNDER SECTION I, WE WILL PAY ONLY THAT PART OF THE LOSS IN EXCESS OF $1,000.

The above table tells you that the insurer may pay up to $750,000 to address property damage sustained by the client's dwelling house, above the $1,000 deductible. The insurance may also pay up to $75,000 (10% of the limits provided for Coverage "A"), to cover the destroyed garage/workshop, the gardening shed and the peacock coop. Personal property loss is potentially covered up to $375,000 (50% of the Coverage "A" limits). Finally, $225,000 (30% of the Coverage "A" limits), is available to defray your client's additional living expenses due to the fire loss (such as the rent for the apartment in San Rafael).

I wrote "may pay", and "potentially pay up to" in connection with the limits set out for Coverages A – C because, as we shall see, reimbursement for certain items may be limited to a fraction of their actual value by specific policy language. Also, the payout for the replacement of certain structures (including the house), and personal property, may be reduced by, *inter alia*, depreciation, again as set out in the policy. We will discuss this in detail as we review the actual policy language for loss settlement.

Usually set out beneath the Declarations' liability limits is a schedule of forms that make up the homeowner's insurance policy. It can look like this, with only some of the policy's forms listed here for illustrative purposes:

Coverage	Description	Premium
BASIC COVERAGE HO3 10/00	SPECIAL FORM	3,300.00
HO216 (01-00)	PREMISES ALARM/FIRE PROTECT.	
HO300CA 10/14	SPECIAL PROVISIONS – CA	
HO35 12/09	LOSS ASSESSMENT	3.00
IN2004 03/04	CONSUMER INFO	

The review of this schedule shows that the main policy form for our hypothetical is the HO 3, October 2000 iteration. [2] As can be seen, the forms listed below the HO 3 basic coverage may or may not apply to the circumstances of the claim at issue. The best practice, and the only sure way to determine whether an endorsement narrows or broadens policy benefits (or is relevant to the particular claim at all), is to analyze all of the form components of the policy.

The same Declarations page review should be undertaken for the clients' auto policy[ies] and for any personal umbrella coverage they may have. As you know, the personal umbrella may provide coverage in excess of the liability limits provided by the primary, HO 3 homeowner coverage. Furthermore, in some instances, the umbrella coverage may "drop down" to provide coverage for loss that is not covered by the primary homeowner's policy. Again, whether or not the policy drops down is determined by the umbrella's policy language, the loss and the specific facts of the claim.

Make the Claim, Inventory the Loss and Prepare for Further Inquiries

Hopefully, by the time of your first consultation, your clients have already submitted a claim for their losses to their homeowner carrier or to the carrier's insurance agent. If they have not already made their claim, they should do so ***immediately***. They should also request from the insurer or the agent complete copies of all component policy forms for each insurance purchased. Advise your clients to recover banking records showing that the premium for the insurance has been paid or that installment payments are up to date. Timely payment of the premium is a prerequisite to the insurance company's performance of its policy obligations. See, *e.g.*, HO 3, pg. 1/22, "Agreement".

Keep in mind that an insurance policy is a contract. Like most contracts, the terms of the policy impose duties and confer rights on *both* parties. Per the terms of the HO 3 form, the triggering of coverage can be conditioned on the homeowner's performance of certain duties following the loss. As the policy states, "we have no duty to provide coverage under this policy if the failure to comply with

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[2] We will now begin to refer to specific provisions of the HO3 in our discussion. The easiest way to follow the references is to download the policy from the internet and have it handy as you read along. The HO 3 policy is available at: www.iii.org/sites/default/files/docs/pdf/HO3_sample.pdf .

the following duties is prejudicial to us." See, HO 3 form, p. 13/22, Sec. I - Conditions, B. "Duties After Loss"). The duties include the following:

- Give prompt notice to the carrier or its agent,

- To the extent possible, protect the property from further damage. This includes making reasonable repairs to protect the property and keep all receipts and other records documenting repair expenses. In our scenario, the homeowners' property loss was total, leaving nothing to protect.

- Prepare an itemized inventory of damaged or lost personal property with a description, the number of each item lost and the estimated cost to replace each item. The homeowners in our case checked with relatives and friends for photos of holidays and family gatherings at the house. The photos may help them to substantiate particular losses and they served as reminders of lost personal property they initially missed just working off memory. The homeowners were advised to attach all available bills, receipts or other records providing back-up for the personal property loss claim. In our scenario, every paper record, disc and other hard media kept by the family was destroyed. Nevertheless, they may have relevant receipts, warranty and purchase price information for some items backed up to the Cloud, or available from their bank, lender, credit card provider or another third party.

- Cooperate with the insurance company in the investigation of the claim. This may include, as often as is reasonably required, a showing of the damaged property and the production of documents to the insurance company for copying. In our scenario, the homeowners took many photos of their property when they were first able to return to their neighborhood in order to document the loss sustained.

At some point, the insurance carrier will probably require the homeowners to submit a written, signed and sworn Proof of Loss, which sets forth, upon personal knowledge or good faith information and belief, the following:

- The time and cause of the loss,

- The interests of all "insureds" (we discuss this defined term *infra*), and all others in the insured property,

- All liens on the property,

- Other insurance which may cover the loss,

- Any changes in the title or occupancy of the property during the term of the policy,

- Specifications of damaged buildings and detailed repair estimates,

- The inventory of damaged property (discussed above), and

- Receipts for additional living expenses incurred and, if applicable, records supporting any fair rental value lost.

Finally, your clients should be aware that the HO 3 form requires the homeowners, upon the request of the insurer, to "[s]ubmit to examination under oath, while not in the presence of another 'insured', and sign the same." See, HO 3, p. 13/22, Section I – Conditions,(B)(7)(c). The subject matter of an Examination Under Oath ("EUO"), involves the facts, circumstances and the amount of the loss claimed. It is not requested in every claim; instead, it is usually requested when the loss, or an important component of the loss, is unsubstantiated or is suspect. As a general principle, the better documented a loss claim, the less likely the insurer will request an EUO.

An EUO is conducted like a deposition; it is testimony given under penalty of perjury and is usually conducted by an insurance company lawyer, with the questions and answers transcribed by a court reporter. An EUO request is usually accompanied by a document demand to the homeowner. California Insurance Code Sec. 2071.1 sets out the rights of an insured who is requested to give testimony in an EUO. The insurance company must include a copy of this code section with its request.

Analysis of the Hypothetical Homeowners' Claims under the HO 3 Policy

We assume that you have now received the complete homeowner policy covering the hypothetical loss. We'll assume also that the policy forms applicable to that loss are the standard HO 3 (October, 2000), as modified by HO 300A form. We quote the provisions of the HO 300A endorsement as they arise in the discussion below. You have determined that the homeowners did not purchase a personal umbrella. You have also determined that the homeowners have fully paid the policy premium and that the loss occurred within the term of this policy. See, HO 3 form, pg. 15/22, Section I - Conditions, P. Policy Period. You can now begin to evaluate how the insurance policies will respond to your clients' claim.

Definitions

The Definitions section of the policy is found on the first two pages of the HO3 policy form. We review here selected definitions important to our analysis:

The form policy definitions of "you", "your", "we", "us" and "our" are modified by the HO 300CA endorsement to read as follows:

A. In this policy, "you" and "your" refer to the "named insured" shown in the Declarations and the spouse if a resident of the same household. [¶] The term spouse includes:

1. A husband or wife; or

2. If unmarried, a:

a. A civil partner by Civil Union or Registered Domestic Partnership filed and recognized by the state; or

b. A "Domestic Partner"

The terms "we" "us" and "our" refers to the company issuing the insurance.

As defined in the same HO 300CA endorsement, a Domestic Partner is a single person living with "you" and sharing a common domestic life and whose relationship resembles a mutually exclusive partnership, such as that of a marriage. The Domestic Partner must be at least 18 years old, not a relative, is able to contract and shares with the opposite partner financial interdependence and a common residence. The endorsement lists some indicia, not discussed here, which the insurer will consider in evaluating a claim of Domestic Partner status.

Usually, both spouses are title holders and therefore, both are listed as "named insureds" on the Declarations. If, however, only one spouse is listed as the "named insured", this definition confers "insured" status on the other spouse, registered domestic partner or an unregistered partner in a monogamous relationship with the named insured. The husband and wife in our scenario are "named insureds" because both of them are identified as such in the Declarations.

Who is an "insured" within the meaning of the policy? For that definition we turn to the HO 3 policy form, pg. 1/22, Definitions, B.5., which reads in relevant part,

"Insured" means:

a. You and the residents of your household who are:

(1) Your relatives; or

. . .

b. A student enrolled in school full time, as defined by the school, who was a resident of your household before moving out to attend school, provided the student is under the age of :

(1) 24 and your relative . . .

This definition provides that the husband and wife (the "named insureds", as discussed above), the teenage child living at home, *and* the 22 year old college student, are "insureds" whose losses come within the policy's coverage. This is so notwithstanding the fact that the college student had not been a resident of the home for some time before the fire. If, however, the college student had dropped out of school, or was only taking classes part-time, or was 24 years and 6 days old, then she would not be considered an "insured" and her personal property loss (musical instruments, sheet music, *etc*.), would not fall within the policy's coverage.

At pg. 2/22, Definitions,B.11., the HO 3 form defines the term "residence premises" in relevant part as follows:

> 11. "Residence premises" means:
>
> a. The one family dwelling where you reside;
>
> . . .
>
> and which is shown as the "residence premises" in the Declarations.
>
> "Residence premises" also includes other structures and grounds at that location.

Accordingly, this definition includes as the "residence premises" the home ("one family dwelling"), the garage, the gardening shed and the coop ("other structures"), lawns and landscaping ("grounds"), on your clients' property, at the address or description listed on the Declarations page.

Finally, and importantly, the HO 300CA endorsement adds the following definition of, "Actual Cash Value" to the HO 3 policy.

> "Actual Cash Value" means:
>
> The cost to repair or replace covered property, at the time of loss or damage, whether that property has sustained partial or total loss or damage, with material of like kind and quality, subject to deduction for deterioration, depreciation or obsolescence.

Why is this definition important? At the point of paying out the loss, "actual cash value" will be contrasted with the concept of "replacement cost without deduction for depreciation". To illustrate "actual cash value" adjusting, assume a two year old laptop was accidentally broken while being moved. A claim is made. The insurer will begin settling the claim by first determining what a "similar like and kind" laptop would cost today. That sum (we'll say it is $600), is the **replacement cost**. The insurer will then make a determination as to the amount of depreciation sustained by the old computer prior to the accident – we'll assume the carrier found the laptop depreciated 35% in two years. The carrier will then settle the claim as follows: $600 (Replacement Cost) – $210 (Depreciation [$600 X .35]) = $390 "**actual cash value**" pay out. It is left to the homeowner to cover the difference between the cost of the new laptop and the insurance settlement.

The Perils Insured By the Policy

What does the homeowner's policy insure against? To find out, we turn to HO 3 form, pg. 8/22, Section I - Perils Insured Against, A.1. Paragraph A addresses Coverage "A" (the house) and Coverage "B" (Other Structures on the property). The policy language is very simple: "We insure against risk of direct physical loss to property described in Coverages A and B."

This statement is immediately followed by Sub-paragraph 2.a., which states: "We do not insure, however, for loss: [¶] Excluded under Section I – Exclusions . . ."[3] This is the open perils coverage formulation. You will recall from our review of the standard homeowner policies that the HO 3 is a hybrid form, where coverage for the home and other structures is on an open peril basis, while personal property is covered on a named perils basis. Again, pure open peril insurance essentially covers all cause of loss, unless specifically excluded, while loss under named perils insurance is only covered if the loss is caused by one or more of the identified perils.

The Coverage C – Personal Property perils language is set out at HO3 form, pg. 10/22 in Sec. I. – Perils Insured Against, B. The policy states as follows: "We insure for direct physical loss to the property described in Coverage C caused by any of the following perils unless the loss is excluded in Section I – Exclusions." Named Peril No.1 is "Fire or Lightening", while Named Peril No. 7 is "Smoke". Smoke is defined to mean "sudden and accidental damage from smoke . . . [¶] This Peril does not include loss caused by smoke from agricultural smudging or industrial operations."

Exclusions

We turn now to the Exclusions section, (HO 3, pp. 11/22 – 12/22, Section I – Exclusions A.1. – B.3.). Most of the Exclusions listed are inapplicable to the hypothetical wildfire loss, such as A.2. Earth Movement, 4. Power Failure, 6. War, B.3.a. Faulty Planning, *etc*.

However, Exclusion 1. Ordinance or Law, is potentially applicable to this case. See, HO 3, p. 11/22, Section I - Exclusions, A.1.a. – c. Under sub-paragraphs 1.a. and b., a loss of property value arising from compliance with an ordinance or law requiring the construction, demolition, remodel or repair of property, including removal of debris, is excluded from coverage. For example, an ordinance might be passed that required the demolition of an attractive stone wall running along the roadside perimeter of a homeowner's property. The ordinance was enacted to ensure that fire fighting vehicles have sufficient clearance when traveling on the road. The homeowner demolishes the stone wall, but his claim that the removal of the wall caused a diminution of his property's value will be excluded from coverage under Exclusion 1.

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[3] Following sub-paragraph 2.a. are a series of other causes of loss that are excepted from coverage, such as ice damage to building foundations, wear-and-tear, vandalism of a vacant building, *etc*. None of these are relevant to our wildfire claim. See, HO 3, pp. 8/22 – 9/22, Section I – Perils Insured Against, A.2.b. – c. These exceptions are <u>in addition</u> to the causes of loss excluded from coverage in the Exclusions section.

Excluded under sub-paragraph 1.c., is coverage for costs incurred or assessed by law against the insured to test for, monitor, clean up, remove, contain, treat, detoxify, neutralize, or in any way respond to the effects of pollutants. The sub-paragraph goes on to define "pollutants" very broadly. The bottom line is that the policy excludes from coverage the costs associated with evaluating, or cleaning up pollution discovered to be, or suspected be, on or below your clients' property.

We have no reason to suspect that pollutants have been released on the homeowners' property, and any reduction in the value of the property as a result of a change in zoning or a building code, or some other ordinance is, at this point, only a contingency.

The Coverages

Coverage A (Dwelling) and Coverage B (Other Structures).

The loss of the homeowners' house will be covered under Coverage A – Dwelling. The insurance company's undertaking is as follows: "1. We cover: [¶] a. The dwelling on the 'residence premises' shown in the Declarations, including structures attached to the dwelling . . . 2. We do not cover land, including land on which the dwelling is located." See, HO 3, p. 3/22, I – Property Coverages, A.1. – 2.

The carrier's Coverage B undertaking for other structures on the property not connected to the home (the garage, the gardening shed, the coop), is similar to the above and is set out as follows: "1. We cover other structures on the residence premises set apart from the dwelling by clear space. This includes structures connected to the dwelling by only a fence, utility line, or similar connection. [¶] 2. We do not cover: [¶] a. Land, including land on which the other structures are located . . ." See HO 3, p. 3/22, I – Property Coverages, B.1. – 3.

Importantly, sub-paragraph 3. of Coverage B provides that "the limit of liability for this coverage will not be more than 10% of the limit of liability that applies to Coverage A. Use of this coverage does not reduce the Coverage A limit of liability." Id.

The first important take away from these passages is that the insurance provided by Coverages A and B only covers physical injury and loss of use sustained by structures on the property; the land itself does not come within the ambit of coverage. A homeowner with a hobby vineyard might make a claim that the fire which swept his property ruined his plot's *terroir*, requiring the soil to be replaced or treated. In other words, the claim is that the land was damaged. He will find that there is no coverage for this loss under the homeowner's policy.

Secondly, as we discussed in our review of the Declarations, the limits available under Coverage B, sub-paragraph 3. are $75,000 (10% of the limits of Coverage A). This is the sum available to rebuild the property's other structures. Sub-paragraph 3. tells you that the $75,000 is additional coverage; that is, its use does not erode the $750,000 available to address the loss of the dwelling.

Coverage C – Personal Property.

This section sets out the carrier's undertaking for the coverage of personal property: "1. Covered Property [¶] We cover personal property owned or used by an 'insured' while it is anywhere in the world. After a loss and at your request, we will cover personal property owned by: [¶] a. Others while the property is on the part of the "residence premises" occupied by an 'insured'; . . ." HO 3 form, pg. 3/22, I – Property Coverages, C.1.a.

This provision affords coverage to the homeowner family's personal property located in the residence, the garage and the gardening shed. The husband's divorced brother is not an "insured" under the policy, but the homeowners can and will request that coverage be extended to the brother's personal property which was stored in the college student's bedroom.

As we know from our review of the Declarations, the limits for personal property coverage are 50% of Coverage "A" or $375,000. However, Coverage C., Sub-paragraph 3., imposes a number of "special limits of liability", or caps, on what may be recovered for certain items. Id. pp. 3/22 – 4/22 at C.1.b. – k.

Sub-paragraph 3.a. imposes a limit of $200 that will be paid out for money, bank notes, bullion, *etc.*, lost in the fire. So, the payout for the loss of the $1,000 in emergency money stashed in the closet will be limited to $200. Sub-paragraph 3.b. caps the insurance payout to $1,500 associated with lost deeds, accounts, manuscripts, personal records, passports and the like. The insureds will incur expenses in the recreation of these documents, and the $1,500 limits are intended to defray those expenses. Sub-paragraph 3.h. limits to $2,500 the payout for property on the premises used primarily for business purposes. This means the recovery for the loss of the husband's survey equipment (worth about $3,000), will fall short by at least $500. Note that loss by theft of jewelry carries a special liability limit of $1,500, and loss by theft of silverware and flatware is limited to $2,500. See Sub-paragraphs 3.e. and g. However, since this loss is by fire, and not theft, the special liability limits on these items (the homeowners' jewelry and the wife's inherited silver service), do not apply.

The policy states a number of important exceptions to the personal property coverage. See, HO 3, pp. 4/22 – 5/22, I – Property Coverages, C.4.a. – k. Under sub-paragraph a., property insured under another policy, or itemized on a schedule and insured under this policy, are not insured under Coverage C.[4] Sub-paragraph b. excepts from coverage animals, birds or fish. Thus, there is no insurance for the loss of the peacock and his mate. There is no personal property insurance, under sub-paragraph c. for motor vehicles. Accordingly, insurance resources to cover the loss of the Chevy Equinox, which burned in the garage, will have to come from the auto policy's Comprehensive coverage. If the family was able

[4] This language is a reference to either scheduled personal property or to a "floater". Scheduling, via an endorsement to the homeowner's policy, is a one way to obtain additional coverage for valuable personal property like jewelry, coins, firearms, *etc*. It will usually require the insured to obtain an appraisal (at his or her own expense), to set the value of the property. A floater is similar to a schedule, but is separate insurance. Both forms of extra protection require the payment of an increased or additional premium. Any property insured under a schedule or a floater is not insured under Coverage C.

to escape in Equinox, but the beater sedan (with only Collision insurance), was lost, then there would be no coverage under either the homeowner's or the Collision insurance for the sedan.

Sub-paragraph i. excepts from coverage "'business data, including such data stored in: [¶] (1) Books of account, drawings or other paper records; or [¶] (2) Computers and related equipment." This means that the data itself, and the expenses incident to recreating the data, in the husband's work-related electronic media and notes left in the entryway, are not covered.

Coverage D. – Loss of Use

Our homeowners will have to continue to pay the mortgage on their destroyed home, and be responsible for the rent on the San Rafael apartment, as they wait out the reconstruction process. They will seek coverage under the "Additional Living Expenses" section of Coverage D in order to offset the costs of the rent, replacement furniture, bedding, a television, a computer, additional commute costs, *etc.*

The Additional Living Expenses section reads as follows:

> If a loss covered under Section I makes that part of the "residence premises" where you reside not fit to live in, we cover any necessary increase in living expenses incurred by you so that your household can maintain its normal standard of living. [¶] Payment will be for the shortest time required to repair or replace the damage or, if you permanently relocate, the shortest time required for your household to settle elsewhere.

The HO 300CA endorsement adds the following to the Additional Living Expenses language cited above: "The maximum period for payment shall not exceed 12 consecutive months <u>or 24 consecutive months if the loss or damage relates to a state of emergency under California law</u>." (Underscore added) As you know, the Wine Country fires prompted a State of Emergency declaration by Governor Brown on October 9. That means the homeowners in our scenario may draw on this policy provision to pay the rent and other excess costs for two years as they await reconstruction of their house. Your clients may need every day of this two year period as experts are forecasting a multi-year rebuilding process because of the extent of the fire damage, and the scarcity of building materials and labor in the area. Of course, drawing on the Loss of Use coverage will erode the $225,000 in liability limits under Coverage D.

Additional Coverages

The HO 3 form includes four useful additional coverages addressing the loss at issue in the hypothetical. The debris removal coverage states that the insurer will pay the reasonable expense for the removal of debris of a covered building if the loss was caused by a Peril Insured Against. The hypothetical loss was, of course, caused by such a peril. Note that the monies expended on debris removal <u>will erode</u> the limits applicable to the damaged property. Thus, the cost of removing debris from the dwelling will erode the $750,000 limits applicable to that structure. Debris removal from the garage and other out buildings will erode the $75,000 liability limits for those buildings. If reconstruction of the buildings and debris removal exceed the liability limits for those buildings, the carrier will add 5% of the applicable limits to satisfy debris removal costs. See, HO 3, pg. 5/22, Section I – Property Coverages, E.1.

Under sub-paragraph E.3., as modified by HO 300CA, coverage is provided for trees, shrubs plants and lawns on the "residence premises" if their loss was caused by fire, among other things. The insurer will pay up to 5% of the liability limits for the dwelling (in this case, $37,500), for this loss. No more than $500 of this amount will be available for any one tree, shrub or plant. Importantly, this coverage is additional insurance, so it <u>does not</u> erode the $750,000 liability limits for the dwelling.

Under sub-paragraph E.4., again as modified by HO 300CA, the insurer will pay up to $500 for the homeowner's liability assumed by contract, agreement, ordinance or statute for fire department charges incurred to save or protect the house from fire. This coverage is additional insurance and no deductible applies.

Finally, sub-paragraph E.11., Ordinance or Law, provides coverage for additional costs incurred due to the enforcement of ordinances or laws regulating or requiring the construction, demolition, remodel or repair of a covered building damaged by fire, among other things. The homeowners can use up to 10% of the Coverage A liability limits ($75,000), to meet these increased costs. All or part of this coverage can be used to defray increased costs to remove debris imposed by ordinances or statutes. Importantly, the policy provides that this is additional insurance and <u>does not</u> erode the Coverage A limits for the dwelling. See, HO 3, pg. 8/22, Section I – Property Coverages, E.11.

You may have noticed that sub-paragraph E.11, which expands coverage, was unhelpfully given the same name ("Ordinance or Law"), as Exclusion 1., which restricts coverage and was previously discussed above. As noted, sub-paragraph E.11 is designed to defray costs associated with compliance with building codes and environmental laws. Exclusion 1 excludes from coverage the claimed loss of property value which allegedly results from compliance with the same or similar laws.

Loss Settlement

Now that you've determined what is and is not covered under the policy, you have reached the point of evaluating how much the insurance company will pay for the covered losses sustained. For this discussion, please refer to HO 3, pp. 13/22 – 14/22, Section I – Conditions, C. Loss Settlement.

Sub-paragraph 1. of Paragraph C. provides that,

> a. Personal property;
>
> b. Awnings, carpeting, household appliances, outdoor antennas and outdoor equipment, whether or not attached to buildings;
>
> c. Structures that are not buildings [*e.g.*, a pergola] . . .
>
> [are settled] at "actual cash value" at the time of loss but not more than the amount required to repair or replace.

This means that the homeowner family's lost personal property (all of it, clothing, computers, electronics, tools, sports equipment, the refrigerator, video games, carpets, lawn furniture, the divorced brother's stuff, etc.), will be compensated on an "actual cash value" basis.

As discussed in the Definitions section, this means that the insurer will determine the replacement cost for the subject items at the time of loss and then deduct from the replacement cost a sum reflecting an assumed amount of deterioration, depreciation or obsolescence. This calculus usually means the insured will receive less (in some cases, very much less), than the replacement cost for the lost item. Appraisals, receipts, warranties and photographs can help the homeowners make a case that no depreciation, or minimal depreciation, should be assessed against the value of their various items of personal property.

We now turn to loss settlement for Coverage A. (the dwelling) and Coverage B., (Other Structures). Under the ISO form's language, loss settlement for structures can be done on a replacement cost with no depreciation basis *or* loss settlement can be done on an actual cash value basis (where a deduction for depreciation is taken off the replacement cost), *or* under a loss settlement scheme in which a penalty may be assessed against the replacement cost. What determines which loss settlement method will be used?

If the liability limits purchased by the homeowner for coverage of the dwelling are **80% or more** of the full replacement cost immediately before the loss, the insurer in our hypothetical will settle the loss on a "replacement cost without deduction for depreciation" basis, up to the limit of liability for the building. This, of course, is the best result for the homeowners.

On the other hand, if the liability limits purchased by the homeowners are, at the time of loss, **less than 80%** of the full replacement cost of the building, then the insurer will settle the loss for the greater of the following two methods: Under the first option, the insurer will settle the loss on an **"actual cash value" basis**, in which the replacement cost of the structure is reduced by depreciation, up to the limit of liability. Under the second option **("Co-Insurance Penalty")**, the insurer will settle the loss using the following formula: REPLACEMENT COST OF THE LOSS X (BUILDING'S LIMIT OF LIABILITY/80% OF THE BUILDING'S REPLACEMENT COST) = INSURER'S PAYOUT. There is no depreciation calculated under the "Co-Insurance Penalty", and the insurer is not obligated to make any payment in excess of the liability limits.

We will illustrate the operation of the Co-Insurance Penalty with the following examples: The homeowners make a claim for fire damage to their dwelling in the amount of $300,000. Assume the replacement cost of the home is $1,000,000, but the dwelling is only insured up to $750,000. The insurance is 75% of the actual replacement cost, so loss settlement for a claim will be adjusted on either an "actual cash value" basis or a Co-Insurance Penalty basis. We calculate the Co-Insurance Penalty as follows: $300,000 (REPLACEMENT COST OF THE LOSS) X ($750,000 [BUILDING'S LIMIT OF LIABILITY] / $800,000 [80% OF THE BUILDING'S REPLACEMENT COST])= $300,000 X 0.9375 = $281,250 LOSS SETTLEMENT. For this claim, the penalty imposed for underinsuring the property is $18,750, even though there is sufficient insurance to cover the entirety of the loss.

Using the same assumptions regarding the replacement cost of the dwelling and the liability limits, we assume, this time, the dwelling was a total fire loss. In this circumstance, the Co-Insurance Penalty would be calculated as follows: $1,000,000 (REPLACEMENT COST OF THE LOSS) X ($750,000 [BUILDING'S LIMIT OF LIABILITY]/$800,000 [80% OF BUILDINGS' REPLACEMENT COST]) = $1,000,000 X .9375 = $937,500. However, the insurer is not obligated to pay more than the $750,000 liability limits, so the LOSS SETTLEMENT IS $750,000. The penalty imposed for underinsuring the property under this case would be $250,000. This is the simple product of not buying enough insurance.

What is going on here? The Co-insurance penalty is intended to encourage/compel the homeowner to fully participate in the project of insuring the building. The carriers want the homeowners to pay premiums large enough to maintain the appropriate liability limits for the covered property. "Appropriate liability limits" means enough limits to pay all, or almost all, the costs of replacing the dwelling. Why is that desirable? One rationale is that the maintenance of adequate insurance allows underwriters to accurately evaluate loss history and make appropriate underwriting decisions. Another rationale is that, it's a good thing, in and of itself, for the insured to have "skin in the game" and "co-insure" the property along with the insurer.

Whatever the rationale, the lesson is, homeowners who underinsure their property will find themselves in an unfavorable loss settlement environment. In practical terms, that means they will have insufficient insurance monies to be able to rebuild their house. This could be a result of simply buying a policy with insufficient limits. Or it could be a result of being penalized by the operation of the Co-Insurance Penalty, or it could be the result of being penalized by the depreciation aspect of an "Actual Cash Value" loss settlement. The going forward solution is to consult with a reputable builder before the next policy renewal to evaluate how much it will realistically cost to rebuild the structure and pay accordingly for increased liability limits.

Note that If the loss settlement for a covered building is made on an "actual cash value" basis, form HO 300CA provides a possible escape hatch with a revised sub-paragraph C.2.c.:

> If you receive a settlement under this policy for loss or damage to buildings on an "actual cash value" basis, you may then make an additional claim for payment on a replacement cost basis provided:
>
> 1) Repair or replacement is completed within 1 year of the date of the loss, unless you request in writing that this time limit be extended an additional 180 days; and
>
> 2) Repair or replacement is evidenced by the original of the replacement receipt, invoice or bill; and
>
> 3) You have not reached the applicable limit of liability under this policy.

Your clients should know that even if the insurer covers building loss on a replacement cost basis, it will not pay any more than the "actual cash value" of the damage until actual repair or replacement is complete. Once complete, the insurer will pay the difference between the "actual cash value" and the replacement cost. See, HO3, pg. 14/22, Section I. - Conditions, C.2.d.

Disputes Regarding Assessed Value

An ADR procedure is set out in the policy regarding disputes as to the amount of loss. The insured and the insurer will each select and pay for their own appraiser. The appraisers will mutually select an umpire. If the appraisers cannot agree on the umpire selection, the matter can be referred to a Superior Court judge to make the selection. Once this selection is made, the appraisers will each set the amount of the loss. If the appraisers agree, the insurer will pay the agreed sum. If they do not agree, their decisions will be submitted to the umpire. An agreement by any two of the three participants (the two appraisers and the umpire), will set the amount of the loss. As is probably apparent, ADR can be a time consuming procedure that can delay loss settlement. It can also be expensive. The policy provides that the insurer and the homeowner will bear equally any ADR expenses (other than the parties' retention of their respective appraisers), and the fees of the umpire. See, HO 3, pg. 14/22, Section I – Conditions, E.

Did the Clients Buy Enough Insurance?

What do you say in response to this question by our hypothetical homeowners: Are the $750,000 liability limits are enough to rebuild the house? The question implicates two temporal points of reference. The first point in time concerns the day before the homeowner's loss occurred. What would it cost to rebuild the property then? This is the notional question posed when the insurer evaluates whether the property is insured up to at least 80% of the rebuild costs. Again, those rebuild costs must be calculated based on prevailing conditions *before* the fire. The answer to this question will, as we've learned, determine whether loss settlement is on a replacement cost basis or an "actual cash value"/co-insurance penalty basis.

The question of whether $750,000 is enough to rebuild, when posed after the fire is out (the second point in time), is a question asked in a completely different environment. It is different because it is being asked in a place where demand is high (thousands of homes must be rebuilt ASAP), and supply is low (inadequate supplies of building materials, inadequate pool of labor power). This is a practical question and it is posed in the real world in which labor and material costs will be much higher than the day before the fire. The answer to the question posed with reference to first point in time could be "Yes", while the answer to the question concerning the second point in time could be "No".

If we assume that it will cost $375.00/sq. foot to rebuild the hypothetical homeowners' house, then the total rebuild cost will be $562,500 (1,500 sq.ft. X $375). This tracks closely with the home's $589,000 appraisal from 2016. The policy's Coverage A liability limits of $750,000 are in excess of 100% of the estimated rebuild costs. In fact, rebuild costs could creep up to $500/sq. foot and the Coverage A limits would still (barely), cover the reconstruction. With this information you can anticipate, with good confidence, that the loss of the house will be adjusted on a "replacement cost without deduction for depreciation" basis. You can also advise that the liability limits of Coverage A will *probably* be sufficient to cover actual reconstruction costs, given the information we currently have in hand.

Conclusion

Like me, you have probably found the homeowner's policy to be a not particularly "user friendly" instrument. If that is true for attorneys, it is that much more true for our lay clients. Insurance will be an essential ingredient in the North Bay's recovery efforts. You can do your clients a great service by walking them through the basic coverages and begin to shape their understanding and expectations as to what their insurance policy will and will not cover. Most importantly, you can counsel them as they assemble the back-up materials that will be needed to secure the best possible loss settlement as they look forward to reconstruction.

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