Volume 16
Number 3 *Spring 1982*

*pp.*483-509

Spring 1982

Invitation to Arson: Indiana's Interpretation of Actual Cash Value

Carol Kaesebier

NOTES

INVITATION TO ARSON: INDIANA'S INTERPRETATION OF ACTUAL CASH VALUE

INTRODUCTION

Arson is the cause of one-fourth to one-half of all fires and results in more than 1,000 deaths and two billion dollars in property losses annually.[1] Unfortunately, when an insurance policyholder is allowed to recover an amount in excess of his loss, it may serve as an invitation to arson. If his building is obsolete, in an undesirable location, or unmarketable because of the economy, he may see arson as a way out—he simply "sells" his building to the insurance company.

The amount of recovery under a basic fire insurance policy is determined by the "actual cash value" of the destroyed property. Due to the insurance carrier's desire to avoid bad publicity and the policyholder's need for his money, the amount of recovery is seldom litigated.[2] When it is, however, the court must define the phrase "actual cash value."

The Indiana Court of Appeals was called on recently to define actual cash value.[3] In a very confusing opinion, the court purported to define actual cash value as replacement cost, but actually used a very different standard in reaching its decision. Not only might this decision invite arson and cause increased premium rates; it may also raise serious questions as to what standard is to be used to define actual cash value in Indiana.

The purpose of this note is to analyze the practical effects of the Indiana interpretation of actual cash value. After examining the

---

1. Karp, *The "Wishbone Offense"—A Two-Pronged Attack Against Arson*, 14 FORUM 205 (1978).

2. Schulman, *Insurance Valuation and Adjustment of Fire Losses on Dwellings: California Law vs. Southern California Practice*, 5 U.C.L.A. L. REV. 248, 259 (1958). Note, *Valuation and Measure of Recovery Under Fire Insurance Policies*, 49 COLUM. L. REV. 818, 823 (1949) [hereinafter cited as *Valuation Under Fire Insurance Policies*].

3. Travelers Indemnity Co. v. Armstrong, ___ Ind.App. ___, 384 N.E.2d 607 (1979).

interpretations used in other jurisdictions, this note will suggest adoption of an interpretation which avoids the problems of excess recovery and is fair to the insurer and insured. Finally, it will urge the Indiana Supreme Court to clarify the standard to be used in Indiana.

THE SIGNIFICANCE OF ACTUAL CASH VALUE

The phrase actual cash value is used in nearly all property insurance policies. It appears in the New York standard fire insurance policy[4] which is typical of all policies written on the basis of actual cash value.[5] The applicable provision reads:

> . . .[T]his Company . . . to an amount not exceeding the amounts above specified, does insure the Insured . . . to the extent of *actual cash value* of the property at the time of loss, but not exceeding the amount which it would cost to repair or replace property with materials of a like kind and quality within a reasonable time after loss. . . .[6]

If read literally, the provision is a limitation on the insurer's liability.[7] The majority of courts, however, interpret the "actual cash value" phrase as the measure of recovery.[8] Accordingly, recovery under a fire insurance policy is determined by the actual cash value of the destroyed property.[9]

---

4. N.Y. INS. LAW § 168(5) (McKinney Supp. 1980).

5. This policy is used verbatim in thirty-four states and adopted with minor variations (not relevant to this discussion) in eleven states. The forms used in Massachusetts and Texas include the actual cash value phrase. The Minnesota form uses "actual value" which has been held snynonomous with actual cash value. The New York standard form was adopted as the approved policy in Indiana in 1955. BURNS ADMIN. R. & REG. § (27-1-13-1)-1 (1955). Its required use was repealed in February 1979 to allow insurers to use the new "plain-talk policies," which will continue to use the "actual cash value" phrase. The New York standard policy may still be used as well as any other policy submitted to and approved by the Department of Insurance. The form used in each state and the authority under which it is required is listed in INSUR. L. REP. (CCH) Fire & Casualty Cas. 2003-04.

6. N.Y. INS. LAW § 168(5) (McKinney Supp. 1980) (emphasis added).

7. Elberon Bathing v. Ambassador Ins. Co., 77 N.J. 1, 7, 389 A.2d 439, 442 (1978); McAnarney v. Newark Fire Ins. Co., 247 N.Y. 176, 181, 157 N.E. 902, 904 (1928); Lampe Market Co. v. Alliance Ins. Co., 71 S.D. 120, ____, 22 N.W.2d 427, 428 (1946); Crisp v. Security Nat'l Ins. Co., 369 S.W.2d 326, 328 (Tex. 1963); 44 AM. JUR. 2d *Insurance* § 1636 (1969).

8. Eagle Fire Ins. Co. v. Snyder, 392 F.2d 570, 570 (10th Cir. 1968); Worchester Mutual Fire Ins. Co. v. Eisenberg, 147 So. 2d 575, 576 (Fla. 1962); Agoos Leather Co. v. American & Foreign Ins. Co., 342 Mass. 603, ____, 174 N.E.2d 652, 654 (1961).

9. Bonbright & Katz, *Valuation of Property to Measure Fire Insurance Losses*, 29 COLUM. L. REV. 857, 863 (1929) [hereinafter cited as Bonbright].

Considerable controvery exists, however, as to the exact definition of actual cash value. Courts in various jurisdictions have developed three basic standards to determine the actual cash value of property:[10] 1) fair market value;[11] 2) replacement cost less depreciation;[12] and 3) the board evidence rule.[13] While the first two are self-explanatory, the broad evidence rule needs clarification. Under this standard the court is not tied to any one rigid test. Rather, the court hears all evidence relevant to the determination of the value of property, including market value, replacement cost, depreciation, age and condition of the building, the use to which the building is put, the adaptability of the property to other uses, and any other factors relevant to a determination of value.[14] While it appears the trend is toward use of the broad evidence rule,[15] there is no general consensus as to which standard best accomplishes the desired end of indemnity.

The Principle of Indemnity

Since the principle of indemnity underlies all property insurance contracts,[16] courts have tried to develop a definition of actual cash value that adheres to that principle.[17] According to the principle of

---

10. Annot., 61 A.L.R.2d 711 (1958).

11. Under the fair market value standard, actual cash value is the difference between market value immediately before and after the loss. Jefferson Ins. Co. v. Superior Court, 3 Cal. 3d 398, 475 P.2d 880, 20 Cal. Rptr. 608 (1970); Forer v. Quincy Mut. Fire Ins. Co., 295 A.2d 247 (Me. 1972).

12. Smith v. Allemania Fire Ins. Co., 219 Ill. App. 506 (1920). In the case of partial loss, a minority of jurisdictions use replacement cost without allowance for depreciation. *See* note 68 *infra*.

13. Elberon Bathing v. Ambassador Ins. Co., 77 N.J. 1, 389 A.2d 439 (1978); McAnarney v. Newark Fire Ins. Co., 247 N.Y. 176, 157 N.E. 902 (1928); Lampe Market Co. v. Alliance Ins. Co., 71 S.D. 120, 22 N.W.2d 427 (1946).

14. *Elberon*, 77 N.J. at 11, 389 A.2d at 443-44, *McAnarney*, 247 N.Y. at 184, 157 N.E. at 905; *Lampe*, 71 S.D. at ____, 22 N.W.2d at 428.

15. At least twenty-seven states have adopted the broad evidence rule in some form. *See* note 111 *infra*.

16. This statement is limited to "open" property insurance policies, such as a New York standard fire insurance policy. An "open" policy is one that does not set the value of the property in the policy, but leaves the measure of loss to be determined after the loss has occurred. The face amount of the policy is an upper limit of recovery. Bonbright, *supra* note 9, at 861. Valued policies conclusively fix the amount the insured will recover in case of a total loss at the face value of the policy. Under replacement insurance the insurers' liability is governed by the cost to rebuild with new materials at the time of the loss. Both replacement insurance and valued policies may violate the principal of indemnity by allowing a recovery in excess of actual loss.

17. 6 APPLEMAN, INSURANCE LAW & PRACTICE § 3823 (1972) [hereinafter cited as APPLEMAN]; Bonbright, *supra* note 9, at 863; KEETON, BASIC TEXT ON INSURANCE LAW §§ 3.1,

indemnity, the proper measure of damages for a loss covered by fire insurance is the sum necessary to put the insured in the same financial position he would have been in had no loss occurred.[18] The adequately insured person should incur neither gain nor loss by virtue of recovery under a fire insurance policy.[19] Therefore, the definition of cash value should allow an insured to recover the value of his loss, yet prevent him from receiving a windfall.[20]

Recovery in excess of loss creates a "moral hazard."[21] If the insured is allowed to recover an amount greatly in excess of the property's real worth, it tempts him to cause the loss himself or fail to guard against it. For instance, an insured may own a building which has a high replacement cost, but due to a deteriorating neighborhood, its value may be much less. It may be impossible to operate a business profitably at the present location, rent the building to another party, or sell the building without a loss. If the insured is allowed to recover an amount in excess of the true commercial value of the building, such recovery becomes an incentive for arson. The owner may decide that he would be better off if his property burned down.

While indemnity allows an insured to recover the value of the destroyed property, it does not require that he always recover enough to replace the property. To suggest that it does confuses indemnity with restitution.[22] Indemnity requires only an amount, in money, which will compensate for the actual loss. A recovery sufficient to replace the property may often result in a windfall for the insured and, thus, violate the principle of indemnity.[23] If a fifty-year-old house is

---

3.9 (1971) [hereinafter cited as KEETON]. *See* Castellain v. Preston, 11 Q.B.D. 380, 386 (1883):

> The very foundation, in my opinion, of every rule which has been applied to insurance law is this, namely, that the contract of insurance contained in a marine or fire policy is a contract of indemnity only, and that this contract means that the assured, in case of a loss against which the policy has been made, shall be fully indemnified, but shall never be more than fully indemnified. That is the fundamental principle of insurance, and if ever a proposition is brought forward which is at variance with it, that is to say, which either will prevent the assured from obtaining a full indemnity, or which will give to the assured more than a full indemnity, that proposition must certainly be wrong.

18. APPLEMAN, *supra* note 17; Borden v. General Ins. Co., 157 Neb. 98, ____, 59 N.W.2d 141, 147 (1953).

19. Mercer v. St. Paul Fire Ins. Co., 318 So. 2d 111, 115 (La. App. 1975).

20. KEETON, *supra* note 17, at § 3.1b.

21. *Elberon*, 77 N.J. at 8, 389 A.2d at 442; Bonbright, *supra* note 9; REIGEL & MILLER, INSURANCE PRINICIPLES AND PRACTICES, 358-59 (3d ed. 1947).

22. Bonbright, *supra* note 9, at 859.

23. KEETON, *supra* note 17; *Elberon*, 77 N.J. at 8, 389 A.2d at 442; Braddock v. Mem-

destroyed by fire, the loss to the insured is not equivalent to the cost of a new house. Restitution may require a new house, but indemnity requires only that he receive the value of a fifty-year-old house.[24] Any other interpretation would allow the insured to receive a windfall and may encourage arson. Since fire insurance policies are contracts of indemnity, it is important to keep these principles in mind when analyzing the Indiana interpretation of actual cash value.

The Definition of Actual Cash Value in Indiana

Until 1979, Indiana courts had not expressly adopted one standard which would determine the actual cash value of the destroyed property.[25] It can be argued, however, that the Indiana Court of Appeals adopted the market value test by implication in *Atlas Construction Co. v. Indiana Insurance Co.*[26] In *Atlas*, the court was asked to invalidate an appraisal award based on fair market value. It held that fair market value was a proper method for determining actual cash value in making an appraisal.[27] In dicta, the court stated that actual cash value had always meant fair market value in Indiana, citing a California decision[28] which expressly rejected the replacement cost

---

phis Fire Ins. Corp., ___ Tenn. ___, ___, 493 S.W.2d 453, 468 (1973). *But cf.* Harper v. Pennsylvania Mut. Ins. Co., 199 F. Supp. 663, 664 (E.D. Va. 1961); Fedas v. Insurance Co. of Pa., 300 Pa. 555, ___, 151 A. 285, 288 (1930); Farmers Mut. Protective Ass'n v. Amerek, 404 S.W.2d 599, 600 (Tex. 1966).

24. Note, *An Insurance Policy Providing for Replacement of Fire Damaged Structures with New Materials*, 96 U. PA. L. REV. 841 (1948). It may be argued that recovery insufficient to replace the house entirely fails to indemnify the insured completely. But KEETON, *supra* note 17, at § 3.1b states that partial reimbursement does not offend the principle of indemnity. Generally, property insurance does not reimburse the insured for loss of profits, rents, business, or possible liability for failure to comply with contracts caused by property loss. *E.g.*, Kingsley v. Spofford, 298 Mass. 469, ___, 11 N.E.2d 487, 491 (1937); Hewins v. London Assurance Corp., 184 Mass. 177, 179, 68 N.E. 62, 63 (1903). If a contract of indemnity requires complete recovery for all losses incurred, these incidental losses would necessarily be covered. Keeton states that the principle of indemnity requires only that recovery not exceed loss, not that the benefit be no less than the loss.

25. In *Wea Township v. Cloyd*, 46 Ind. App. 49, 54, 91 N.E. 959, 961 (1910), the court held that actual cash value was the fair market at the time of loss. However, the court was not interpreting an insurance contract but rather determining the value of sheep destroyed by wild dogs.

26. 160 Ind. App. 33, 309 N.E.2d 810 (1974). This case has been cited for holding that Indiana used the fair market standard. Comment, *Arson Fraud: Criminal Prosecution and Insurance Law*, 7 FORDHAM URB. L.J. 541, 572 (1979) [hereinafter cited as *Arson Fraud*].

27. Atlas Constr. Co. v. Indiana Ins. Co., 160 Ind. App. 33, 39, 309 N.E.2d 810, 814 (1974).

28. Jefferson Ins. Co. v. Superior Court, 3 Cal. 3d 398, 475 P.2d 880, 20 Cal. Rptr. 608 (1970).

standard and instead adopted the fair market value standard. While the court suggested that it might acknowledge the broad evidence rule when the question was properly before the court, the definition of "actual cash value" was not itself an issue in the case.[29]

The definition of "actual cash value" was one of the issues before the court in *Travelers Indemnity Co. v. Armstrong.*[30] In that case a 100-year-old rental house insured for $15,000 under a New York standard fire insurance policy was damaged by fire. The house had been remodeled at various times, with some remodeling done as recently as a year and a half before the fire. Both parties agreed that the cost to repair the house with new material was $8,700, but they disagreed as to what the amount of recovery should be. The insurance carrier argued that actual cash value was the replacement cost less depreciation. The insured argued the loss should be measured by the cost required to replace the damaged property. The trial court instructed the jury that the insurance policy required the insurer to pay the full direct loss, within the limits of the policy, and that the policy contained no provisios which required or authorized a reduction of coverage below the amount of the full direct loss.[31] The jury awarded the entire cost to repair, $8,700. The appellate court upheld the instruction, stating that "the phrase actual cash value, within the context of the fire insurance policy in the case at bar, means an amount sufficient to restore, repair, or replace the property destroyed."[32] Thus, the standad to be used in measuring actual cash value in Indiana is replacement cost without allowance for depreciation.

Equating actual cash value with replacement cost violates the principle of indemnity in many cases, by allowing recovery in excess of loss.[33] As noted earlier, if the insured recovers the cost of a new house when his fifty-year-old house burns, he receives a windfall, and is, in fact, encouraged to cause the loss himself or take fewer precautions to prevent the destruction.

For these reasons, it is almost universally accepted that depreciation must be considered in determining the amount of recovery.[34] The

29. *Atlas*, 160 Ind. App. at 39-40, 309 N.E.2d at 814.
30. Travelers Indem. Co. v. Armstrong, ___ Ind. App. ___, 384 N.E.2d 607 (1979).
31. *Id.* at ___, 384 N.E.2d at 616.
32. *Id.* at ___, 384 N.E.2d at 615.
33. *See* note 23, *supra* and accompanying text.
34. Bonbright, *supra* note 9, at 878, 879. *Valuation Under Fire Insurance Policies, supra* note 2, at 823, 826 n.60. "If the principle of indemnity be adhered to depreciation must be considered in loss adjustment so the insured will not receive the equivalent of a new building for the loss of an old one."

minority of jurisdictions which use the replacement cost standard without allowance for depreciation[35] limit its use to partial loss cases.[36] However, unless use of the replacement cost standard is limited to those partial loss cases where repair or replacement with new materials does not significantly increase the value of the property, its use will violate the principle of indemnity in many partial loss cases also.[37]

The *Travelers* decision did not limit the interpretation of actual cash value in any way. The court held that "actual cash value, within the context of the fire insurance policy in the case at bar means an amount sufficient to restore, repair or replace the property destroyed."[38] The insurance policy in *Travelers* was a basic fire insurance policy. Therefore, the replacement cost standard would seem to apply to all losses covered by a standard fire insurance policy, whether that requires replacement of three shingles on a fifty-year-old roof or complete replacement of a fifty-year-old house.

Despite the definite language in Travelers regarding the definition of actual cash value, there may still be confusion as to what the standard actually is. It may be argued that the court actually applied the broad evidence rule rather than the replacement cost standard in reaching the decision. The court considered evidence of replacement cost, depreciation, extent of remodeling, expert opinion of market value, and the use and functional efficiency of the property. Consideration of such evidence is consistent with use of the broad evidence rule, but most of it would be excluded if replacement cost was the sole measure of recovery. The broad evidence rule does not preclude use of the replacement cost standard where it would achieve indemnity. However, if the court were truly using the broad evidence rule, they would not announce that the replacement cost standard applied to all losses covered by a standard fire insurance policy as the *Travelers* court did. This raises serious questions as to what interpretation of actual cash value is to be used in future Indiana cases.

The full impact of the *Travelers* decision will be more readily understood after a discussion of the interpretations of actual cash value used in other jurisdictions. All of the interpretations are considered in light of their ability to achieve indemnity.

INTERPRETATIONS OF ACTUAL CASH VALUE

Fair Market Value

Some courts have defined actual cash value as "fair market value."[39] Under this standard, recovery is determined by the difference

between the fair market value of the property immediately before and after the loss.[40] If there is not an established market, the market value is the amount a prospective purchaser and a willing seller would hypothetically agree on in fair negotiations.[41]

The fair market value standard has been criticized, with the majority of courts rejecting it as the sole measure of recovery in real property cases.[42] They argue that a building has no recognized market value because each building is unique and incapable of replacement in any market.[43] Furthermore, buildings independent of the land on which they stand are never the subject of market sales.[44] A building and land together may have a joint value entirely different from the value of each when considered separately.[45] Because a building may be adapted to a single use, its value on the market reflects its lack of adaptation to another use. In such cases market value fails to reflect the full value of the property to the owner, and therefore, fails to indemnify the owner for his actual loss.[46] Under the fair market value

35. *Valuation Under Fire Insurance Policies, supra* note 2, at 826. *See* note 68 *infra.*

36. A partial loss is one where the building is not so badly damaged by fire that its identity or specific character is destroyed and the remaining part could be substantially restored to its original condition. Springfield Fire & Marine Ins. Co. v. Ramey, 245 Ky. 367, ____, 53 S.W.2d 560, 563 (1932).

37. *Elberon*, 77 N.J. at 8, 389 A.2d at 442; Braddock, ____ Tenn. at ____, 493 S.W.2d at 468; Howland, *Depreciation and Partial Losses*, INS. L.J. 685, 688-89 (1953); Williams, *The Principle of Indemnity: A Critical Analysis*, INS. L.J. 471, 472 (1960); *Valuation Under Fire Insurance Policies, supra* note 2, at 826 n.60.

38. *Travelers*, ____ Ind. App. at ____, 384 N.E.2d at 616.

39. Annot., 61 A.L.R.2d 711, 715 (1958).

40. Jefferson Ins. Co. v. Superior Court, 3 Cal. 3d 398, 475 P.2d 880, 90 Cal. Rptr. 608 (1970); Aetna Life & Cas. Co. v. Little, 384 So. 2d 213 (Fla. 1980); Shield v. Insurance Co. v. Kemp, 117 Ga. App. 538, 160 S.E.2d 915 (1968); Forer v. Quincy Mut. Fire Ins. Co., 295 A.2d 247 (Me. 1972); Tinsley v. Aetna Ins. Co., 199 Mo. App. 693, 205 S.W. 78 (1918); Grantham v. Farmers Mut. Ins. Co., 174 Neb. 790, 119 N.W.2d 519 (1963); Clouse v. St. Paul Fire & Marine Ins. Co., 152 Neb. 230, 40 N.W.2d 820 (1950); Butler v. Aetna Ins. Co., 64 N.E. 764, 256 N.W. 214 (1934); Mew v. J. & C. Galleries, Inc., 564 S.W.2d 377 (Tex. 1978); U.S. Fire Ins. Co. v. Striklen, 556 S.W.2d 575 (Tex. 1977).

41. *Forer*, 295 A.2d at 249; *Butler*, 64 N.D. at ____, 256 N.W. at 219.

42. *Valuation Under Fire Insurance Policies, supra* note 2, at 820; State Ins. Co. v. Taylor, 14 Colo. 499, 510-11, 24 P. 333, 337 (1890); *Smith*, 219 Ill. App. at 512; Britven v. Occidental Ins. Co., 234 Iowa 682, 686, 13 N.W.2d 791, 793 (1944); *Elberon*, 77 N.J. at 10, 389 A.2d at 443, *McAnarney*, 247 N.Y. at 17, 157 N.E. at 903-04; Merchants Ins. Co. v. Frick, 5 Ohio Dec. 47 (1873); Third Nat'l Bank v. American Ins. Co., 27 Tenn. App. 249, ____, 178 S.W.2d 915, 924 (1943).

43. *McAnarney*, 247 N.Y. at 183, 157 N.E. at 902.

44. *Elberon*, 77 N.J. at 10, 389 A.2d at 443; *Smith*, 219 Ill. App. at 512.

45. *Smith*, 219 Ill. App. at 512.

46. Bonbright, *supra* note 9, at 880.

standard, if there is no market demand for a property, theoretically it would have no market value and there would be no loss if the property was destroyed.[47] For all of these reasons, the fair market value standard often fails to achieve indemnity in real property cases and should not be used as the sole measure of recovery.

Replacement Cost Less Depreciation

Actual cash value is defined as replacement cost less depreciation in several jurisdictions.[48] This is the cost to replace a building with new material minus a deduction for physical depreciation.[49] The advantages of this standard are definiteness and ease of determining the amount of recovery.[50] Using this standard the insurer, as well as the insured, can easily determine the amount of insurance to carry and the amount of recovery to expect in case of loss. The "replacement cost less depreciation" standard achieves indemnity in most cases by allowing recovery of loss, yet preventing windfalls.[51]

The "replacement cost less depreciation" standard has the disadvantage, however, of inflexibility.[52] Under this standard the only evidence considered to determine the actual cash value is the replacement cost and the amount of depreciation. In unusual situations, the true commercial value may be much less than the replacement cost less depreciation.[53] This standard, however, may prohibit evidence of

---

47. *Smith*, 219 Ill. App. at 512.

48. Reliance Ins. Co. v. Orleans Parish School Bd., 322 F.2d 803 (8th Cir. 1963); Boise Ass'n of Credit Men v. U.S. Fire Ins. Co., 44 Idaho 249, 256 P. 523 (1927); Smith V. Allemania Fire Ins. Co., 219 Ill. App. 506 (1920); Lee v. Providence Wash. Ins. Co., 82 Mont. 264, 266 P. 640 (1928); Reichfield Oil Corp. v. Harbor Ins. Co., 85 Nev. 185, 452 P.2d 462 (1969); Paterson-Leitch Co. v. Insurance Co. of North America, 366 F. Supp. 749 (N.D. Ohio 1973); Braddock v. Memphis Fire Ins. Corp., ___ Tenn. ___, 493 S.W.2d 453 (1973); Manhattan Fire & Marine Ins. Co. v. Melton, ___ Tex. ___, 329 S.W.2d 338 (1959); Annot., 61 A.L.R.2d 711, 715 (1958).

49. In jurisdictions using the "replacement cost less depreciation" standard, depreciation has often been limited to physical depreciation rather than obsolescence or other factors which might reduce the value of the property. Although courts instruct the jury to consider depreciation, they generally have not instructed the jury as to the way the amount of depreciation should be ascertained or measured. Courts using the broad evidence rule, however, are willing to look at all factors that affect value such as obsolescence. *Valuation Under Fire Insurance Policies, supra* note 2, at 879.

50. Ingram, *Reducing the Incentive for Arson: The "Broad Evidence Rule"*, 29 DRAKE L. REV. 761, 766 (1979) [hereinafter cited as Ingram].

51. *Id.*

52. *Id. Valuation Under Fire Insurance Policies, supra* note 2, at 821. *Elberon*, 77 N.J. at 10, 389 A.2d at 443.

53. Note, *Valuation Under Fire Insurance Policies, supra* note 2, at 822; Chicago Title & Trust Co. v. U.S. Fidelity Guaranty Co., 376 F. Supp. 767, 770 (N.D. Ill. 1973),

functional or structural obsolescence,[54] a contract to demolish the building,[55] a contract to sell at a price much less than replacement cost less depreciation,[56] a location in a slum neighborhood,[57] or simply an inability to sell the property because of market conditions.[58] When such evidence is not considered, it may allow recovery greatly in excess of loss and furnish an incentive for arson.

The problems created by use of the "replacement cost less depreciation" standard in all cases are exemplified by *Chicago Title & Trust Co. v. U.S. Fidelity Guaranty Co.*[59] In that case the insured purchased a brick building in a Chicago slum neighborhood for $7,000. The building, insured for $50,000,[60] was run down, but had an actual

---

rev'd, 511 F.2d 241 (7th Cir. 1975); where the building was sold for $7,000, but had a replacement cost of $60,000 ($119,000 less 45% depreciation).

54. A building is considered obsolete when a reasonable owner would not rebuild it in case of destruction. Ingram, *supra* note 50, at 766 n.37. Wisconsin Screw Co. v. Fireman's Fund Ins. Co., 193 F. Supp. 96 (E.D. Wis. 1960); *aff'd*, 297 F.2d 697 (7th Cir. 1962) (where machinery and tools were no longer produced having been replaced by different machines); First Nat'l Bank v. Boston Ins. Co., 17 Ill. App. 2d 159, 149 N.E.2d 240 (1958), *aff'd*, 17 Ill. 2d 147, 160 N.E.2d 802 (1959) (where the building was a twenty-five room mansion in a slum neighborhood); McAnarney v. Newark Fire Ins. Co., 247 N.Y. 176, 157 N.E. 902 (1928) (where the building was a brewery unusable due to Prohibition and unadaptable to any other use).

55. Royal Ins. Co. v. Sister of Preservation, 430 F.2d 756 (9th Cir. 1970); Paterson-Leitch Co. v. Insurance Co. of North America, 366 F. Supp. 749 (N.D. Ohio 1973); Gendron v. Pawtucket Mut. Ins. Co., 384 A.2d 694 (Me. 1978), Board of Educ. v. Hartford Fire Ins. Co., 124 W. Va. 163, 19 S.E.2d 448 (1942).

56. *First Nat'l Bank*, 17 Ill. App. 2d 159, 149 N.E.2d 240 (1958), *aff'd*, 17 Ill. 2d 147, 160 N.E.2d 802 (1959); Eagle Square Mfg. Co. v. Vermont Mut. Fire Ins. Co., 125 Vt. 221, 212 A.2d 636 (1965).

57. *Chicago Title & Trust Co.*, 376 F. Supp. at 770.

58. Ingram, *supra* note 50, at 766 n.42.

59. 376 F. Supp. 767 (N.D. Ill. 1973), *rev'd*, 511 F.2d 241 (7th Cir. 1975).

60. The insurance policy was issued under a Fair Access to Insurance Requirements (FAIR) plan. FAIR plans were implemented in 1968 in an attempt to ameliorate urban deterioration by providing insurance to property owners denied insurance in the voluntary market. Housing and Urban Development Act of 1968, 12 U.S.C. § 1749bbb-1-§ 1749bbb-21 (1976) as amended by Pub. L. 95-557, 92 Stat. 2097 (1978). It became apparent that urban areas could not prosper without access to property insurance for businesses and homeowners, and that many insurers would not insure in these areas due to the high risk. The theory behind the plan was that if businesses and homeowners could get insurance they would repair the buildings instead of letting them deteriorate further. As this case indicates, where the insured can collect a great deal more than the repaired building would be worth, there may be no incentive for the insured to repair the building. He may simply keep the money. Where the difference between the commercial value of the building and the insurance recovery is too great, it becomes a strong incentive for arson. For a complete discussion of FAIR plans, *see FAIR PLANS: History, Holtzman and the Arson-for-Profit-Hazard*, 7 FORDHAM URB. L.J. 617 (1979).

cash value of $60,500 (replacement cost of $119,500 less 45% depreciation). The building was damaged by fire, and the owner collected $18,500 from the insurer, despite the fact that he had paid only $7,000 for it. The owner did not spend the insurance proceeds to repair the building, but sold it for $4,400. The new owner applied to have the insurance transferred, but before any action was taken, the building suffered a second fire. Although the new owner had paid only $400 of the contract price and the building was under a "board and secure order,"[61] the owner sought over $43,000 (the replacement cost less depreciation).

The Illinois District Court pointed out it would be ludicrous to allow such a large recovery for an economically useless building. They also noted, however, that evidence of market value, purchase price, or economic obsolescence normally were not allowed under the rigid replacement cost less depreciation test.[62] The court solved the problem by simply finding the owner had no insurable interest in the building, although she quite obviously had a nominal interest.[63] On appeal, the Seventh Circuit Court of Appeals reversed, holding that the owner did have an insurable interest in the building.[64] The court, however, refused to allow recovery of "replacement cost less depreciation," even though that was the standard followed in Illinois. It pointed out that such recovery would violate the policy of confining insurance contracts to indemnity:

> The policies would be offended by a contract requiring the insurer to pay the amount of reproduction cost, less depreciation, in the event of loss when there is a gross disparity between that amount and the value of the building measured on any rational basis, such as market value, economic utility, or utility of the owner. Such a contract would be predominantly a gambling contract, would reward and thereby tempt the destruction of property and would not be confined to indemnity.[65]

---

61. In this case the city had instituted an action alleging numerous code violations and seeking demolition of the building. At a hearing in that action the city inspector testified that the building was vacant and open. The court ordered a "D and H (dangerous and hazardous) inspection" and continued the hearing. After inspection, the inspector testified that the building was still open, vacant, severely damaged, and in a dangerous and hazardous condition. The court then ordered the building to be boarded and secured. *Chicago Title and Trust Co.*, 511 F.2d at 243.

62. *Chicago Title & Trust Co.*, 376 F. Supp. at 771.

63. *Id.*

64. *Chicago Title & Trust Co.*, 511 F.2d at 246.

65. *Id.* at 247.

The court looked to all the relevant evidence and held that recovery should be limited to the amount that had been paid on the contract, any amount still owing, and amounts expended for any repairs. The court, in effect, solved the problem by applying the broad evidence rule.

This case, as well as several other Illinois cases,[66] are good examples of the problems encountered by jurisdictions that use the inflexible "replacement cost less depreciation" standard. Blind application of this standard may result in recovery in excess of loss in cases where there are unusual circumstances such as obsolescence.[67] Excess recovery may also occur, even in situations where there are no unusual circumstances, when "replacement cost" standard, without allowance for depreciation, is used to define actual cash value.

Replacement Cost

Replacement cost without allowance for depreciation is used to define actual cash value in a minority of jurisdictions.[68] The jurisdic-

66. Illinois adopted the "replacement cost less depreciation" standard in *Smith v. Allemania Fire Ins. Co.*, 219 Ill. App. 506 (1920). Consistent with this ruling a federal court held that intent to tear down a building was a collateral matter having no bearing on actual cash value. Knuppel v. American Ins. Co., 269 F.2d 163, 166 (7th Cir. 1959). Even where the owner had actually contracted for demolition of the building, the court refused to allow such evidence. Garcy Corp. v. Home Ins. Co., 490 F.2d 479 (7th Cir. 1974). Where, however, the demolition had actually begun, the court recognized that to allow recovery of replacement cost less depreciation would produce an unjust result. The court held that the standard did not apply to buildings in the process of demolition since they had no value. Aetna State Bank v. Maryland Cas. Co., 345 F. Supp. 903 (N.D. Ill. 1972). In a similar case, where there was a contract to demolish and demolition had begun, the court held the insured had no insurable interest and therefore the standard did not apply. Lieberman v. Hartford Fire Ins. Co., 6 Ill. App. 3d 948, 287 N.E.2d 38 (1972). Finally, in *Chicago Trust & Title*, the court admitted the insured had a nominal interest, but considered all the evidence affecting the value of property and in a sense applied the broad evidence rule.

67. Bailey v. Gulf Ins. Co., 406 F.2d 47 (10th Cir. 1969); American Ins. Co. v. Treasurer, School Dist. No. 37, 273 F.2d 757 (10th Cir. 1959); American Ins. Co. v. Bateman, 125 Ga. App. 189, 186 S.E.2d 547 (1971); Eagle Square Mfg. Co. v. Vermont Mut. Fire Ins. Co., 123 Vt. 221, 212 A.2d 636 (1965).

68. Harper v. Pennsylvania Mut. Fire Ins. Co., 199 F. Supp. 663 (E.D. Va. 1961); Commercial U. Ins. Co. v. Regals, 355 So. 2d 684 (Ala. 1978); Sperling v. Liberty Mut. Ins. Co., 281 So. 2d 297 (Fla. 1973); North River Ins. Co. v. Godley, 55 Ga. 52, 189 S.E. 577 (1936); McIntosh v. Hartford Fire Ins. Co., 106 Mont. 434, 78 P.2d 82 (1938); Farber v. Perkiomen Mut. Ins. Co., 370 Pa. 480, 88 A.2d 776 (1952); Farmers Mut. Protective Ass'n v. Cmerek, 404 S.W.2d 599 (Tex. 1966). Although Third Nat'l Bank v. American Equitable Ins. Co., 27 Tenn. App. 249, 178 S.W.2d 915 (1943), held that depreciation should not be deducted in a partial loss case, it was apparently overruled by Braddock v. Memphis Fire Ins. Corp., ___ Tenn. ___, 493 S.W.2d 453 (1973).

tions using the "replacement cost" standard argue that recovery insufficient to allow the insured to repair or replace the property completely fails to indemnify the insured. These courts look to the "use" value of the destroyed property and argue that the property must be restored to its original condition.[69] This position fails, however, to recognize that a "fire insurance policy is not a contract to insure property against fire, but to insure the owner of the property against loss by fire"[70] When determining the value of the loss, the focus should be on the loss to the insured, not on the loss to the property.

Actual cash value of property is not necessarily the same as replacement cost in all situations. If a fifty-year-old house is destroyed by fire, the loss to the owner is not the cost of replacing the old house with a new one. If he receives an amount sufficient to replace the old house with a new one, he has received a windfall, violating the principle of indemnity.[71] Similarly, if a fifteen-year-old roof, with a life expectancy of twenty years, blows off a house, the value of the loss to the owner is not the cost of a new roof.[72] If the insured receives the cost of a new roof, it would result in a net gain and, again, violate the principle of indemnity.

Since it is almost universally accepted that depreciation must be deducted from replacement cost in total loss cases,[73] jurisdictions applying the "replacement cost" standard limit its use to partial loss cases. These jurisdictions justify the distinction between partial[74] and total[75] loss cases by the argument that in partial loss cases the property is merely repaired and not increased in value. Therefore, there is no need to deduct depreciation. In total loss cases, on the other hand, the property is replaced entirely with new material, and is, therefore, substantially increased in value.[76] Thus, a deduction for depreciation is required.

---

69. Fedas v. Insurance Co. of Pa., 300 Pa. 555, 563-65, 151 A. 285, 288 (1938).

70. Borden v. General Ins. Co. of America, 57 Neb. 98. ____, 59 N.W.2d 141, 147 (1953); Ingram, *supra* note 50, at 773.

71. Note, *An Insurance Policy Providing for Replacement of Fire Damaged Structures with New Materials*, 96 U. PA. L. REV. 841 (1948) [hereinafter cited as *An Insurance Policy*].

72. Williams, *infra* note 77, at 478.

73. *Valuation Under Fire Insurance Policies, supra* note 2, at 823.

74. *See* note 36 *supra*.

75. It is a total loss of the building if the parts that remain cannot be utilized to advantage in restoring the building to the condition it was in before the loss. O'Keefe v. Insurance Co., 140 Mo. 558, 41 S.W. 922, 923 (1897).

76. Schulman, *Insurance Valuation And Adjustment of Fire Losses on Dwellings:*

The distinction between repair and replacement, however, is not so clear.[77] There are cases where repair will substantially increase the value of the property. When a fifteen-year-old roof is destroyed and entirely replaced with a new one, it obviously increases the value of the property. If the interior of a fifty-year-old house is gutted by fire, repair of the interior with new materials increases the value of the house. While these are partial loss cases, there is still the opportunity for the insured to receive a net gain. If there is no deduction for depreciation, it creates a "moral hazard" just as the potential for net gain does in the total loss case.

It is true that where damage is slight and total repair will not result in significant betterment, the distinction between partial and total losses may be valid. In those cases there is little justification for deducting depreciation.[78] In other cases, however, the distinction between total and partial losses has been criticized.[79] There are partial loss cases where repair will be extensive enough to result in betterment of the property and give the owner a net gain if no depreciation is deducted.[80] Furthermore, using a different measure of recovery in partial and total loss cases could lead to the anomalous result of allowing an insured to recover more for a partial loss than for a total loss.[81] If a building insured for $250,000 with an actual cash value of $200,000 ($500,000 replacement cost less depreciation) sustains a total loss, the insured would recover $200,000. If there is damage to only fifty percent of the building, the insured would collect the replacement cost of $250,000 and still have half of a building.[82]

Unless repairs result in no significant betterment to the property, there is no real justification for distinguishing between total and partial loss.[83] If, as a minority of jurisdictions suggest, recovery of an amount insufficient to repair or replace the property completely in

---

California Law v. Southern California Practice, 5 U.C.L.A. L. REV. 248, 256 (1958) [hereinafter cited as Schulman].

77. Williams, *The Principle of Indemnity: A Critical Analysis*, INS. L.J. 471, 478 (1960) [hereinafter cited as Williams].

78. Howland, *Depreciation and Partial Losses*, INS. L.J. 685, 688-89 (1953) [hereinafter cited as Howland]; *Valuation Under Fire Insurance Policies, supra* note 2, at 826.

79. *Elberon*, 77 N.J. at 14 n.5, 389 A.2d at 445 n.5.

80. *Elberon*, 77 N.J. at 7-8, 389 A.2d at 443; *Braddock*, ____ Tenn. ____, 493 S.W.2d at 460.

81. Cotton, *The Factor of Replacement Cost in Fire Insurance*, INS. L.J. 34, 37 (1956); *Valuation Under Fire Insurance Policies, supra* note 2, at 826 n.60.

82. *Id.*

83. Howland, *supra* note 78, at 688.

a partial loss fails to indemnify the insured, it would follow that an amount insufficient to replace the property in a total loss case would also fail to indemnify the insured. But it is almost universally recognized that recovery of replacement cost less depreciation indemnifies the insured in total loss cases.[84]

> On one phase of the question the courts have always been clear. They have invariably insisted that an old building may not be valued at its replacement cost new except after the deduction of an allowance for physical depreciation. This doctrine is so well recognized that parties desiring a high valuation no longer take the trouble to challenge it before a court.[85]

The 1918 New York standard fire insurance policy expressly stated that depreciation should be deducted. It insured "to the extent of actual cash value (ascertained with property deduction for depreciation)."[86] The 1918 version was modified by deleting the parenthetical clause on depreciation in the 1943 Revision because "actual cash value cannot be computed without consideration of depreciation."[87] It was felt that the phrase "to the extent of actual cash value" was adequate in itself and capable of no other meaning than that depreciation was necessarily included in the ascertainment of actual cash value.[88]

Use of the replacement cost standard in all partial loss cases will lead to windfalls and thus furnish an incentive for arson in many cases. As one court put it:

> To allow the insured to recover the original value of real estate that has depreciated, . . . would be for the insurance company to pay for losses that were not caused by the fire. Such prodigality would simply furnish an incentive for destruction of property, because more could be recovered from insurance than the undamaged property was worth. Even under present conditions, it is found that business depreciations, which reduce the values of buildings and stocks in goods, are sometimes accompanied by large in-

84. *Valuation Under Fire Insurance Policies, supra* note 2, at 823.

85. Bonbright & Katz, *Valuation of Property to Measure Fire Insurance Losses*, 29 COLUM. L. REV. 857, 863 (1929).

86. 4 BIRDSEYE, CUMMING & GILBERTS CONSOLIDATED LAWS OF N.Y. § 121 (2d ed. 1917).

87. *Valuation Under Fire Insurance Policies, supra* note 2, at 826 n.60.

88. Note, *The 1943 Standard Fire Insurance Policy*, 39 ILL. L. REV. 66, 70 (1944).

> creases in the fire losses. Such conditions furnish an incentive for fire.[89]

Under the replacement cost standard, the insured may receive replacement cost of the building even though the true value is much less. This is clearly contrary to the principle of indemnity.

It has been argued that the replacement cost theory is consistent with the indemnity concept of insurance.[90] This argument is based on the idea that the insured is being indemnified for the loss of an object's *use* value, rather than the value of the life remaining to the property.[91] Under this view the insurer does not fulfill its function of making the insured whole, if depreciation is deducted from replacement cost, since it would be impossible for the insured to return to his former position without additional expense.[92]

This argument does not stand up to close scrutiny. Regardless of how it is phrased, the replacement standard contemplates a substitution of new for old. This does not always give the insured a gain, as in the case of replacement of three shingles. However, many instances where the insured recovers replacement cost will involve a "gain potential."[93] Gain is always contrary to a strict theory of indemnity.[94]

Undeniably, a recovery which is insufficient to completely repair or replace property after a fire may put a severe financial strain on an insured when he can least afford it. In response to this, insurers write what is known as "replacement cost insurance."[95] The policies provide that in the case of loss, the full repair cost will be paid without deduction for depreciation. Such policies originally called "depreciation insurance,"[96] insure for the difference between actual cost value and replacement cost.[97] Replacement cost insurance is more expensive than the standard fire insurance coverage. The fact that such

---

89. REIGEL & MILLER, INSURANCE PRINCIPLES AND PRACTICES, 358-59 (3d ed. 1947).
90. Schulman, *supra* note 76 at 261.
91. Schulman, *supra* note 76, at 256.
92. Schulman, *supra* note 76, at 257, Fedas, 300 Pa. at ____, 151 A. at 288.
93. Williams, *supra* note 77, at 473.
94. *Id.*
95. Columbia College v. Pennsylvania Ins. Co., 250 S.C. 237, 157 S.E.2d 416 (1967).
96. Under depreciation insurance the insured collected cash representing the amount a property had depreciated in addition to its actual value. If he did not rebuild, he made a profit. Under replacement insurance he has to repair in order to collect, limiting the incentive for arson. *Valuation Under Fire Insurance Policies, supra* note 2, at 832 n.96.
97. *Columbia College*, 250 S.C. at ____, 157 S.E.2d at 423.

a policy is available, as a distinct, more expensive coverage, indicates that actual cash value is not synonomous with replacement cost. Furthermore, to recover the full replacement cost under a "replacement cost" policy, the insured must actually repair or replace the property; otherwise he is limited to the actual cash value of the property. This, too, indicates that actual cash value does not mean replacement cost. Replacement cost policies also have a requirement that insurance on the building must be a certain percentage (usually eighty to one hundred) of the replacement cost of the building.[98] This requirement imposes part of the risk on the insured in the case of partial loss.[99]

The requirement that the insured actually replace or repair the property in order to receive the replacement cost limits the incentive for arson by limiting the opportunity for windfall. If actual cash value is defined as replacement cost, it effectively transforms *all* fire insurance policies into "replacement policies."[100] Unlike true "replacement policies," however, there is no additional premium paid for the expanded coverage. Nor is there the protective requirement that the insured must actually repair or replace the property. Transforming all insurance policies into replacement cost policies will raise insurance rates for everyone and furnish an incentive for arson.[101]

Defining actual cash value as replacement cost is also inconsistent with the language and intent of the standard fire insurance policy.[102] Such policies insure "to the extent of actual cash value of the property . . ., but not exceeding the amount it would cost to repair or replace the property. . . ."[103] Repair or replacement costs are an upper limit on the insurer's liability, not an absolute measure of

---

98. Note, *An Insurance Policy, supra* note 71, at 843.

99. One author has explained the purpose of the coinsurance clause this way:

> Insurance rates are based on a definite ratio between insurance and value. However, where the face amount of a policy is less than the amount necessary to compensate fully for a total loss, a partial loss will frequently be within the face amount and will be fully covered. Since most losses are partial, property owners will tend to underinsure. As a result those who underinsure will ordinarily receive for a lower premium protection equal to that afforded those who insure up to the full amount. In order, therefore, to secure equitable distribution of fire insurance protection and a fair premium return from each property owner, coinsurance clauses are employed.

Note, *Valuation Under Fire Insurance Policies*, 49 COLUM. L. REV. 818, 829 (1949).

100. Elberon Bathing v. Ambassador Ins. Co., 77 N.J. 1, 7, 389 A.2d 439, 442 (1978).

Note, *An Insurance Policy, supra* note 71, at 848.

101. *Elberon*, 77 N.J. at 8, 389 A.2d at 442.

102. *Id.*

103. N.Y. INS. LAW § 168(5) (McKinney Supp. 1980).

recovery.[104] Equating actual cash value with replacement cost renders the limiting phrase meaningless.

The majority of jurisdictions require a deduction for depreciation in partial loss cases. This prevents windfalls and, therefore, follows the principle of indemnity.[105] In situations where repair will not result in an increase in value, there is little justification for deducting depreciation.[106] Courts generally recognize this exception, but the problems created by rigid rules could be avoided by use of the broad evidence rule.[107]

The Broad Evidence Rule

In 1928, the New York Supreme Court was required to define actual cash value. In *McAnarney v. Newark Fire Insurance Co.*,[108] the insured owned a brewery which he had purchased for $8,000. The building was no longer used for any purpose due to passage of the Prohibition Act. The owner had tried to sell it but had failed to receive any offer over $6,000 because it was unadaptable to any other use. The building was destroyed by fire and the owner sought recovery of $42,000. The insurer refused to pay the entire amount and the owner sued. The insurer argued that the actual cash value was market value

104. Mercer v. St. Paul Fire & Marine Ins. Co., 318 So. 2d 111, 115 (La. App. 1975); *McAnarney*, 247 N.Y. at 183, 157 N.E. at 904; *Elberon*, 77 N.J. at ____, 389 A.2d at 442. *But see* Commercial Union Ins. Co. v. Regals, 355 So. 2d 685, 686 (Ala. 1978) (where the court held that the actual cash value phrase is a limit on liability, and the limiting phrase established the measure of recovery as the reasonable cost of repairs). Several Texas cases hold that the actual cash value phrase is the measure of recovery in total loss cases, but that in partial loss cases the phrase "but not exceeding the cost to replace or repair" is the measure of damages. Farmers Mut. Protective Ass'n v. Cmerek, 404 S.W.2d 599 (Tex. 1966); Lerman v. Implement Dealers Mut. Ins. Co., 382 S.W.2d 285 (Tex. 1964); Gulf Ins. Co. v. Carroll, ____ Tex. ____, 330 S.W.2d 227 (1959).

105. Reliance Ins. Co. v. Orleans Parish School Bd., 322 F.2d 802 (8th Cir. 1963); Paterson-Leitch Co. v. Insurance Co. of N. America, 366 F. Supp. 749 (N.D. Ohio 1973); State Ins. Co. v. Taylor, 14 Colo. 499, 24 P. 333 (1890); Boise Ass'n of Credit Men v. U.S. Fire Ins. Co., 44 Idaho 249, 256 P. 523 (1927); Smith v. Allemania Fire Ins. Co., 219 Ill. App. 506 (1920); McIntosh v. Home Mut. Ins. Ass'n, 198 Iowa 1038, 200 N.W. 694 (1924); Great American Ins. Co. v. Crume, 266 Ky. 729, 99 S.W.2d 742 (1936); Schreiber v. Pacific Coast Fire Ins. Co., 195 Md. 639, 75 A.2d 108 (1950); Nicolson v. Bankers & Shippers Ins. Co., 164 Miss. 523, 145 So. 349 (1933); Lee v. Providence Washington Ins. Co., 82 Mont. 264, 266 P. 644 (1928); Johnstone v. Home Ins. Co., ____ Mo. ____, 34 S.W.2d 1029 (1931); Voges v. Mechanics Ins. Co., 119 Neb. 553, 230 N.W. 105 (1930); Elberon Bathing v. Ambassador Ins. Co., 77 N.J. 1, 389 A.2d 439 (1978); Braddock v. Memphis, ____ Tenn. ____, 493 S.W.2d 453 (1973).

106. Howland, *Depreciation and Partial Losses*, INS. L.J. 685, 688 (1953).

107. Annot., 61 A.L.R.2d 711 (1958).

108. 247 N.Y. 176, 159 N.E. 902 (1928).

which would include consideration of obsolescence. The trial court instructed the jury that actual cash value was the cost to replace the buildings less physical depreciation and that the building's obsolescence was wholly immaterial to the determination of actual cash value. The jury found that the actual cash value was $55,000. On appeal, the court held that neither market value or replacement cost less depreciation was the sole measure of recovery.[109] The court reasoned:

> [W]here insured buildings have been destroyed, the trier of fact may, and should, call to its aid, in order to effectuate complete indemnity, every fact and circumstance which would logically tend to the formulation of a correct estimate of the loss. It may consider original cost and cost of reproduction; the opinions upon value given by qualified witnesses; the declarations against interest which may have been made by the assured; the gainful uses to which the buildings might have been put; as well as any other fact reasonably tending to throw light upon the subject.[110]

Although the *McAnarney* court was not the first to use the broad evidence rule, because of the influence of the court the decision led the way to adoption of the broad evidence rule in many jurisdictions.[111]

---

109. *Id.* at 183, 159 N.E. at 904.

110. *Id.* at 184, 159 N.E. at 905.

111. The following jurisdictions have expressly adopted the broad evidence rule, *citing McAnarney*: Reliance Ins. Co. v. Orleans Parish School Bd., 322 F.2d 803 (8th Cir. 1963); Nebraska Drillers Inc. v. Westchester Fire Ins. Co., 123 F. Supp. 678 (D. Colo. 1954); Garvey v. Old Colony Ins. Co., 153 F. Supp. 755 (D.N.C. 1957); Harper v. Pennsylvania Mut. Fire Ins. Co., 199 F. Supp. 663 (D. Va. 1961); Castaldi v. Hartford County Mut. Fire Ins. Co., 21 Conn. Supp. 265, 154 A.2d 247 (1959); Worchester Mut. Fire Ins. Co. v. Eisenberg, 147 So. 2d 575 (Fla. 1962); Lumberman's Underwriting Alliance v. Jessup, 100 Ga. App. 518, 112 S.E.2d 337 (1959); Britven v. Occidental Ins. Co., 234 Iowa 682, 13 N.W.2d 791 (1944); American States Ins. Co. v. Mo-Lex, Inc., 427 S.W.2d (Ky. 1968); Gendron v. Pawtucket Mut. Ins. Co., 409 A.2d 656 (Me. 1979); Schreiber v. Pacific Coast Fire Ins. Co., 195 Md. 639, 75 A.2d 108 (1950); Agoos Leather Co. v. American and Foreign Ins. Co., 342 Mass. 603, 174 N.E.2d 652 (1961); Brooks Realty, Inc. v. Aetna Ins. Co., 276 Minn. 245, 149 N.W.2d 494 (1967); Lee v. Providence Washington Ins. Co., 82 Mont. 264, 266 P. 640 (1928); Pinet v. New Hampshire Fire Ins. Co., 100 N.H. 346, 126 A.2d 262 (1956); Elberon Bathing Co. v. Ambassador Ins. Co., 77 N.J. 1, 389 A.2d 439 (1978); McAnarney v. Newark Fire Ins. Co., 247 N.Y. 176, 159 N.E. 902 (1928); Butler v. Aetna Ins. Co., 64 N.D. 764, 256 N.W. 214 (1934); National-Ben Franklin Fire Ins. Co. v. Short, 207 Okla. 673, 252 P.2d 495 (1953); Lampe Market Co. v. Alliance Ins. Co., 71 S.D. 120, 22 N.W.2d 427 (1946); Fulton Fire Ins. Co., 315 S.W.2d 9 (Tenn. App. 1958); Crisp v. National Ins. Co., 369 S.W.2d 326 (Tex. 1963); Eagle Square Mfg. Co. v. Vermont Mut. Fire Ins. Co., 125 Vt. 221, 212 A.2d 636 (1965); Morgan v. Union Automobile Ins. Co., 150 Wash. 443, 273 Pac. 527 (1929); Board of Educ. v. Hartford Fire Ins. Co., 124 W. Va. 163, 19 S.E.2d 448 (1942); Doelger & Kirsten, Inc. v. National Union Fire Ins. Co., 42 Wis. 2d 518, 167 N.W.2d 198 (1969).

When evidence of all relevant factors is allowed, the insured recovers for his loss, but does not receive a windfall. Actual cash value is then defined as economic value rather than replacement cost.[112] The broad evidence rule does not prevent consideration of market value or replacement cost less depreciation. Such factors may be considered along will all other evidence, and under certain circumstances either of those standards may be used alone.[113] Market value and replacement cost are guides in making the determination, rather than "shackles."[114] Under the broad evidence rule, evidence of obsolescence,[115] contracts for sale,[116] or demolition[117] may be considered to prevent windfalls that could occur under the rigid "replacement cost less depreciation" test.[118] Similarly, the court can allow evidence that will increase the value of the property.[119]

Under the broad evidence rule, if a party has competent evidence that shows the inadequacy of the market value or replacement cost less depreciation, the jury will be allowed to consider the special circumstances. This results in a more equitable distribution of insurance proceeds and furthers the public policy which favors indemnity.

There are arguments against using the broad evidence rule. It is not as definite as the replacement cost standard. For example, no exact figure as to the value of property is available when insurance is acquired. This may result in violations of the public policy against over- and under-insuring property.[120] However, in the majority of cases

---

112. *McAnarney*, 247 N.Y. at 184, 159 N.E. at 905.

113. *Elberon*, 77 N.J. at 13, 389 A.2d at 444.

114. American States Ins. Co. v. Mo-Lex, Inc., 427 S.W.2d 236, 238 (Ky. 1968).

115. *See* note 54 *infra*. Wisconsin Screw Co. v. Fireman's Fund Ins. Co., 193 F. Supp. 96 (E.D. Wis. 1960), *aff'd*, 297 F.2d 697 (7th Cir. 1962); *McAnarney*, 247 N.Y. 176, 159 N.E. 902 (1928).

116. Eagle Square Mfg. Co. v. Vermont Mut. Fire Ins. Co., 125 Vt. 221, 212 A.2d 636 (1965) (where court allowed evidence of contract for sale).

117. Royal Ins. Co. v. Sister of Preservation, 430 F.2d 759 (9th Cir. 1970); Gendron v. Pawtucket Mut. Ins. Co., 384 A.2d 694 (Me. 1978) (where the court allowed evidence of a lease which called for gas station to be razed within a year); Board of Educ. v. Hartford Fire Ins. Co., 124 W. Va. 163, 19 S.E.2d 448 (1942).

118. Barley v. Gulf Ins. Co., 406 F.2d 47 (10th Cir. 1969) (refusal to admit evidence of city order to demolish); American Ins. Co. v. Treasurer, School Dist. No. 37, 273 F.2d 757 (10th Cir. 1959) (refusal to admit evidence of plan to demolish); Paterson-Leitch Co. v. Insurance Co. of N. America, 366 F. Supp. 749 (N.D. Ohio 1973).

119. Eshan Realty Corp. v. Stuyvesant Ins. Co., 25 Misc. 2d 828, 202 N.Y.S.2d 899 (1960), *modified on other grounds*, 12 A.D. 2d 818, 210 N.Y.S.2d 256 (1961), where the court allowed evidence that the building might be renovated into a very useful property to enter into computation of actual cash value, even though the building had previously been abandoned.

120. *Arson Fraud, supra* note 26, at 572.

where there are no unusual circumstances surrounding the property, the replacement cost less depreciation figure will probably reflect a figure close to the "value" of the property. Most insurers use this figure to estimate insurance needs and in determining the value of the loss.[121]

Some opposed to the broad evidence rule have expressed fear that consideration of other factors might "open a field of speculation and conjecture that would cloud the issue of actual loss in a maze of collateral issues."[122] However, evidence that comes in under the broad evidence rule must meet the same tests that all evidence must meet.[123] If such evidence is not relevant to the issue or is too speculative, it will not be admitted. The judge must rule on the sufficiency of evidence under many circumstances during any trial. Thus, the broad evidence rule raises no unique problems, but simply augments the usual methods of determining loss. For example, when obsolescence is pleaded, if there is insufficient evidence, then the evidence may not be heard by the jury.

Others argue that the insurer should not be allowed to take advantage of collateral issues to escape liability.[124] They argue that since the insurers have been paid for the risk, often for many years, they should not escape paying the entire amount of the policy when there is a loss. If an insured has paid for $40,000 worth of insurance, it is posited that the insurer should not escape payment of the full amount by showing that the building is in a deteriorated neighborhood and the insured could not sell it for more than $10,000, or that the insured has actually contracted to sell it for $2,000. While there may be some merit to this argument, it should be emphasized that the face value of the policy is not the measure of recovery, but a limit on insurers' liability.[125] Suppose, for example, a person has contracted to sell his house for $20,000 and it is destroyed by fire before the contract is executed. It is difficult to argue that he has actually lost more than $20,000, regardless of the amount for which it is insured.

It should be reemphasized that insurance policies are contracts of indemnity. The focus when determining the value of loss should

121. *Valuation Under Fire Insurance Policies, supra* note 99, at 835.

122. American Ins. Co. v. Treasurer, School Dist. No. 37, 273 F.2d 757, 759 (10th Cir. 1959); Ingram, *supra* note 48, at 835.

123. Marcus, *Actual Cash Value, Illinois and the Broad Evidence Rule: "A Modest Proposal,"* 59 ILL. B.J. 1000, 1013-14 (1971).

124. *First Nat'l Bank*, 17 Ill. App. 2d at 170, 149 N.E.2d at 424.

125. Borden v. General Ins. Co. of America, 157 Neb. 98, ____, 59 N.W.2d 141, 148 (1953).

be on the loss to the insured, not on the loss to the property. It may be true that insurers are ostensibly receiving a windfall if they are allowed to pay less than the full amount of the policy. However, because a "moral hazard" is created by allowing the insured to recover in excess of his loss, allowing the insurer to pay less than the full amount seems to be the lesser of two evils. The insured has been compensated for his actual loss. If the insurer receives the windfall, theoretically it should benefit all insureds by reducing insurance costs. Allowing the insured to receive the windfall creates an incentive for arson and increases the cost of insurance for everyone.

Certainly, the insurer should not be able to grossly overinsure and then escape liability by showing the property is worth much less.[126]

---

126. Valued policy laws were originally passed to discourage the insurer from overinsuring property. *See* Alexander, *The Wisconsin Valued Policy Law*, 10 WIS. L. REV. 248 (1935). However, valued policies have generally been criticized as violating the principle of indemnity since they allow an insured to recover a set amount, regardless of the actual value of the property. *See* KEETON, *supra* note 17, at § 3.8. Keeton suggests that the principle of indemnity would be better served if valued policy laws were repealed.

Although the treatment of the problem of overinsurance is beyond the scope of this Note, it may be noted that theories of waiver or estoppel might apply to insurers to bind them to the value of the property as represented by the face value of the insurance. *See* Schulman, *Insurance Valuation and Adjustment of Fire Losses on Dwelllings: California Law v. Southern California Practice*, 5 U.C.L.A. L. REV. 248, 253-54 (1958). 17 APPLEMAN, INSURANCE LAW & PRACTICE § 9565 (1945). Estoppel has been applied to the insurer in cases where the agent has incorrectly filled in the insurance application as well as to proof of loss cases. Similarly, waiver has been applied to bind the insurer to the agent's waiver in cases of increased hazard, proof of loss, and even waiver of the policy provision barring waiver. These theories have not been applied to the area of valuation in actual litigation. However, one could argue that since the agent usually suggests or determines the amount of insurance, the insurer is estopped to deny the amount of insurance as the value of the property; or that the insurer waived its right to insist on another measures of value.

In Smith v. Aetna Ins. Co., ___ Mo. ___, 269 S.W. 682 (1924), the court held that the insurer was estopped to deny the value placed on the property by the agent. However, this was a valued policy where the law explicitly provided that the face amount of the policy is the value of the property. The case of the open policy would seem to present a different question. In Triel v. National Liberty Ins. Co., 71 F. Supp. 761 (E.D. Pa. 1947), the insured asked the insurer to appraise the replacement cost of the property and the insurer did so. Three years later when the property burned, the insurer appraised the replacement cost at a higher amount. The insured argued that the insurer should be estopped to deny the replacement cost it had set earlier. The court held, however, that the replacement cost of property changes, and that the initial appraisal was valid only for that day. In Borden v. General Ins. Co., 157 Neb. 98, 59 N.W.2d 141 (1953), the court held that under an open policy the amount of the policy was not equivalent to the value of property, but was only an upper limit on recovery. It held that the insurance agent's statement as to the value of the property did not bind the insurer and could not be admitted into evidence. Schulman argues that the agreed-upon full amount of coverage should

Generally, any tendency to overinsure is limited to some extent by the fact that any time an insured fails to recover the full amount of the policy after a total loss, it is bad publicity for the insurer.[127] Furthermore, most insurers feel that litigation of a claim is likely to result in the jury awarding the face value of the policy.[128]

The trend is toward the use of the broad evidence rule. Courts recognize the advantages of using it. As one court summarized:

> To put the matter in other words, the courts, when faced with a choice between applying some standardized rigid rule such as replacement cost minus physical depreciation or of adopting some more flexible test which can be modified in such a way as to accord more nearly with the principle of indemnity, have generally preferred the latter alternative even though it has involved the sacrifice of administrative convenience and of simplicity.[129]

The use of rigid rules, such as the *Travelers* decision advocates, leads to excess recovery in many cases and "invites" arson.

PRACTICAL EFFECTS OF THE INDIANA DECISION

In *Travelers,*[130] the court purported to define actual cash value as replacement cost without allowance for depreciation. It acknowledged that fire insurance contracts are contracts of indemnity whereby the insurer "undertakes to make the insurerd whole for the loss of the insured property caused by fire."[131] The court reasoned that the purpose and functional efficiency of the property must be considered in defining actual cash value. It held that payment of an amount which is insufficient to restore or replace the functional efficiency provided by the property before the loss does not comply with the undertaking to make the insured whole.[132]

The court was actually arguing that indemnity requires replacement of the property in all cases. It failed to acknowledge that the purpose of insurance is to insure the owner, not the property, against

---

at least bind the company as a starting point in the adjustment procedure. Schulman, *supra* note 76, at 255.

127. *Valuation Under Fire Insurance Policies, supra* note 99, at 833 n.108.

128. *Id.*

129. Pinet v. New Hampshire Fire Ins. Co., 100 N.H. 346, 126 A.2d 262, 265 (1956).

130. Travelers Indemnity Co. v. Armstrong, ____ Ind. App. ____, 384 N.E.2d 607 (1979).

131. *Id.* at ____, 384 N.E.2d at 613.

132. *Id.* at ____, 384 N.E.2d at 615.

loss.[133] The court was, in effect, arguing that the property should be made whole, not just the insured.

The principle of indemnity requires that the insured be put in the same position financially as he would have been had no fire occurred. The insured must not be put in a better position.[134] If the insured is to receive an amount sufficient to replace the property in every case, there will be many situations where the insured will receive a windfall.[135]

Although *Travelers* dealt with a partial loss, the court did not limit use of the "replacement cost" standard to partial loss cases, as the other jurisdictions following the minority view have done. If pure replacement cost is to be the standard followed in all cases, it will lead to windfall profits or at least net gain in many cases. Anyone that has property which has depreciated due to age, decay of the neighborhood, functional obsolescence, or merely a slow economy will stand to receive a net gain if that property is destroyed by fire. Certainly this situation furnishes an invitation to arson.[136]

The seriousness of this possibility cannot be understated.[137] In four years the number of estimated arson cases had quadrupled.[138] Members of Congress have urged enactment of federal legislation to enhance public awareness of the dimension of the arson problem.[139] The social cost of arson includes not only loss of human life, but also higher insurance premiums, loss of revenues and jobs, and further deterioration of urban areas. The problem is especially serious in the slum neighborhoods of large cities, where the decay of property itself has furnished an incentive for arson. The homeowner who cannot sell his house because of the neighborhood or the businessman who has lost so much business he can no longer meet expenses may simply decide to "sell" his property to the insurance company. As a practical matter, the temptation is great when such people may actually generate a gain from such a losing proposition. The risks are so great in decayed inner city areas that insurers are reluctant or refuse to insure homeowners or businesses in those neighborhoods.[140] These

133. *See* note 70 *supra*, and accompanying text.
134. *See* note 89 *supra*, and accompanying text.
135. *See* note 33 *supra*, and accompanying text.
136. *See* note 89 *supra*, and accompanying text.
137. *See* note 1 *supra*, and accompanying text.
138. Ryan, *The Arson Triangle*, 14 FORUM 184 (1978).
139. Karp, *supra* note 1, at 205.
140. *FAIR Plans: History, Holtzman and the Arson-for-Profit Hazard*, 7 FORDHAM URB. L.J. 617 (1979).

problems are only aggravated by use of a single rigid standard in all cases. While there are cases where the "replacement cost" standard will achieve indemnity, there are many cases where it will allow excess recovery.

Limiting the decision to partial losses does not completely solve the problem.[141] There is no valid reason for making the distinction between partial and total loss cases except in the case where repair will not result in an increase in value;[142] this is the only instance where a deduction for depreciation is not necessary to avoid creation of a moral hazard. But this exception hardly justifies recovery of replacement cost for all losses or even for all partial losses. Defining actual cash value as replacement cost in all cases turns all fire insurance policies into "replacement cost" policies.[143] This is certain to raise insurance premiums for everyone in Indiana. The consumer will suffer if this decision stands; he ultimately pays for the cost of arson through higher premiums.

It may well be that the facts in the *Travelers* case warranted an award of pure replacement cost.[144] Had the court adopted the broad evidence rule, it could have considered all the evidence and simply decided that in this particular case no deduction for depreciation was necessary. Use of the broad evidence rule does not preclude use of market value, replacement cost less depreciation, or even replacement cost. It merely allows all evidence to be considered and the standard which most nearly accomplishes indemnity in the particular case to be applied. But unlike using one rigid standard in all cases, using the broad evidence rule prevents windfalls by allowing all evidence relevant to a determination of value.

The *Travelers* court did not decide that the relevant evidence

---

141. Howland, *Depreciation and Partial Losses*, INS. L.J. 685, 685 n.1 (1953).

142. *See* note 78 *supra*, and accompanying text.

143. *See* note 95 *supra*, and accompanying text. It is interesting to note that the insured's home in the *Travelers* case was covered by a "replacement cost" policy while the rental property involved in the case was covered under a standard fire insurance policy. This points out the irony of defining actual cash value in standard fire insurance policies as replacement cost. The insured paid less for the coverage on the rental property and would not have been required to repair the property in order to receive the replacement cost. Yet, she would receive the same recovery as she would under the replacement policy in the event of loss.

144. It is not the purpose of this note to criticize the amount of the award in the *Travelers* case. It is possible that under the broad evidence rule the amount of recovery would have been the same. It may well have been that the replacement would not result in significant increase in the value of the property or that the remodeling was so extensive and so recent that no deduction for depreciation was justified.

in that particular case required use of the replacement cost. It did not limit use of the replacement standard to partial loss cases. The court held "that actual cash value, within the context of the fire insurance policy in the case at bar, means an amount of money . . . sufficient to restore, repair, or replace the property destroyed."[145] The fire insurance policy in *Travelers* was the standard fire insurance policy used by all insurers in Indiana. Therefore, actual cash value in all Indiana fire insurance policies means replacement cost.

There is some question, however, whether the *Travelers* court intended replacement cost to be the sole standard in all situations. In future cases, it may be argued that the court intended to adopt the broad evidence rule. The court considered not only replacement cost, but also depreciation, extent and date of remodeling, functional efficiency of the property, and expert opinion of market value. If the court was using pure replacement cost, most of this evidence was technically irrelevant. All of it, however, would be relevant under the broad evidence rule. If the court adopted the broad evidence rule, it could allow use of the pure replacement cost standard when it was justified. It would also allow the jury to consider evidence of depreciation, obsolescence, contracts for sales, and contracts to demolish, thereby preventing windfall recoveries.

The use of the broad evidence rule is not, however, consistent with the flat statement that "the phrase actual cash value, within the context of the fire insurance policy in the case at bar means an amount sufficient to restore, repair, or replace the property destroyed."[146] Nor is it consistent with the jury instruction that the "policy contained no provisions which *required* or *authorized* a reduction of coverage below the amount of the full direct loss."[147] These rigid rules are simply inconsistent with the flexible standard of the broad evidence rule.

This conflict between the standard the *Travelers* court purported to apply and the standard which the court actually seemed to apply leaves serious question as to what standard is to be used in Indiana. The Supreme Court must clarify what the standard is in Indiana. It is urged that adoption of the broad evidence rule would achieve indemnity and equitable distribution of insurance proceeds in the majority of cases. Therefore, the court should follow the majority of jurisdictions and adopt that rule. If the court refuses to adopt the

145. *Travelers*, ___ Ind. App. at ___, 384 N.E.2d at 615.
146. *Travelers*, ___ Ind. App. ___, 384 N.E.2d at 615.
147. *Id.* at ___, 384 N.E.2d at 616.

broad evidence rule, it should limit the use of the pure replacement standard to partial loss cases where damage is slight and recovery of full replacement cost will not result in significant betterment. There is simply no precedent for applying a pure replacement cost standard in all cases.

CONCLUSIONS

The insurance contract is a contract of indemnity. Therefore, actual cash value should be defined so as to allow an insured to recover his loss, but prevent net gain. The *Travelers* definition of actual cash value as replacement cost fails to do so. It allows the insured to recover in excess of his loss in many cases. Thus, the Indiana Court of Appeals created an "invitation to arson."

The Indiana Supreme Court should adopt an interpretation of actual cash value that avoids this result. The "replacement cost less depreciation" standard works well in many cases, but in certain situations it, too, allows excess recovery. The "market value" standard, on the other hand, often fails to indemnify the insured for his loss. In contrast, the broad evidence rule allows the court to consider all the evidence. This leads to an equitable distribution of insurance proceeds and achieves indemnity in the majority of cases. Therefore, the court should explicitly adopt the broad evidence rule and limit the use of the replacement cost standard to cases where repair will not result in significant betterment.

If the Supreme Court upholds the Court of Appeals, it should clarify exactly what standard is to be used in future cases. It should specifically state whether the Court of Appeals adopted the broad evidence rule and define the limits, if any, on the use of the "replacement cost" standard. The decision, as it stands now, constitutes an "invitation to arson."

Carol Kaesebier