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REPLACEMENT COST COVERAGE: A LEGAL PRIMER

Johnny Parker^{**}

Replacement cost coverage protects against a very real and inevitable loss not protected by actual cash value policies—depreciation. Property insurers, early on, determined that, in order to make replacement insurance economically feasible, contractual obligations, in addition to those imposed by traditional actual cash value policies, had to be placed upon the insured. In order to achieve this commercial idiom, replacement cost provisions were drafted to require actual repair or replacement of damaged or destroyed premises as a condition precedent to the payment of the replacement cost proceeds. Insurance is affected with a quasi-public interest; consequently, its providers must always balance the commercial idiom against the interests of society in attaining coverage. Whether an acceptable balance has been struck is always a matter ripe for litigation. This Article discusses the theoretical and practical distinctions between replacement cost and actual cash value policies. Thereafter, it examines the judicial interpretations accorded to loss settlement provisions. The ultimate objective of this Article is to explore the delicate balance struck by the insurance industry in the context of replacement cost policies and the legal implications where the scales tilt too far in favor of the insurance industry's interests.

INTRODUCTION

The insurance industry has developed two distinct types of casualty protection for residential and commercial property. The first protection, actual cash value coverage, insures the premises to the extent of its actual cash value. Actual cash value coverage, commonly referred to as basic coverage, recognizes that the insurer is entitled to deduct reasonable depreciation from the value of the loss.¹ The second protection, replacement cost coverage, provides

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1. Three general formulas have been developed for measuring actual cash value: (1) market value; (2) replacement cost new less depreciation; and (3) the broad evidence rule. Market value generally means the price agreed upon by

protection to the extent of the full cost of repair or replacement without deduction for depreciation.² Both actual cash value and replacement cost coverage provisions are common features of property insurance contracts.

The primary objective of property insurance is indemnity. "The actual cash value policy is a pure indemnity contract."³ Its purpose is to make the insured whole, but never to benefit him because a loss occurred.⁴ In other words, to indemnify means simply to place the insured back in the position she enjoyed prior to loss. Since most property depreciates with time, the formula, replacement cost new less depreciation, has, from an insurance industry perspective, become synonymous with actual cash value.⁵ The concept of re-

an owner willing to sell and a buyer willing to buy, neither of whom is under a compulsion to act. The criticism of the market value formula is that a building ordinarily has no recognized market value independent of the land upon which it sits. Consequently, valuation experts ordinarily rely upon a residual market value for a structure by deducting from the market value of the whole parcel the appraised market value of the land. For a discussion of the replacement cost new less depreciation formula, see *infra* note 5 and accompanying text. The broad evidence rule is a flexible formula that "consider[s] all evidence [that] an expert would consider relevant to an evaluation," including "both fair market value and replacement cost new less depreciation." *Elberon Bathing Co. v. Ambassador Ins. Co.*, 389 A.2d 439, 444 (N.J. 1978). For further discussion, see B. David Hinkle, *The Meaning of "Actual Cash Value,"* 539 INS. L.J. 711, 718-19 (1967), and Note, *Valuation and Measures of Recovery Under Fire Insurance Policies*, 49 COLUM. L. REV. 818, 822-23 (1949) [hereinafter *Valuation*] (citing *McAnarney v. Newark Fire Ins. Co.*, 159 N.E. 902, 905 (N.Y. 1928)).

2. Replacement coverage entitles the insured to receive the amount necessary to rebuild a structure or replace its content in a new condition, without deducting for depreciation. "Recovery is allowed, in the words of many courts, on a new for old basis." Leo John Jordan, *What Price Rebuilding?*, BRIEF, Spring 1990, 17, 17.

3. *Travelers Indem. Co. v. Armstrong*, 442 N.E.2d 349, 352 (Ind. 1982).

4. Traditional insurance coverage was for the actual or fair cash value of the property. The owner was indemnified fully by the payment of the fair cash value, which in effect was the market value, because that was what the owner lost if the insured building was destroyed. See 6 JOHN ALAN APPLEMAN & JEAN APPLEMAN, *INSURANCE LAW AND PRACTICE* § 3823 (1972).

5. See ROBERT J. PRAHL, *INTRODUCTION TO CLAIMS* 87 (1988). Although the term actual cash value is found in many property insurance policies, it is quite common for the phrase not to be defined in those policies. The generally-accepted meaning of the term "actual cash value" is replacement cost new less depreciation. Depreciation is the reduction in value of tangible property. Two kinds of depreciation are recognized by the insurance industry: (1) physical depreciation, which refers to wear and tear, deterioration, and decay that are inevitable over time; and (2) economic depreciation or obsolescence, which means a loss in value due to changes in technology, style, or composition of the area. Not all courts recognize obsolescence as a depreciable item. See *id.*

There has been much litigation regarding how actual cash value should be determined and what it means. Consequently, the case law of the respective jurisdiction should be consulted when attempting to ascertain the meaning of actual cash value. The broad evidence rule is the most accepted test for actual cash value. See, e.g., *Ohio Cas. Ins. Co. v. Ramsey*, 439 N.E.2d 1162, 1165, 1169 (Ind. Ct. App. 1982); *Mamou Farm Servs., Inc. v. Hudson Ins. Co.*, 488 So.

placement cost new less depreciation is also compatible with the principle of indemnification.⁶ If, for example, an insured's twenty-five-year-old home is destroyed by fire and the property insurance proceeds allow her to construct a new home with the same kind and quality of materials, the insured has obviously been placed in a better position after the loss than before. As a result of the new for old exchange, the insured has experienced a profit from the loss. This is clearly inconsistent with the principle of indemnification. Consequently, actual cash value provisions prevent the insured from receiving a profit or betterment by allowing the insurer to deduct depreciation from the cost of the new house.

The following example better illustrates the meaning and effect of actual cash value. Assume a house has a 100-year life expectancy and is twenty-five years old when it is destroyed by fire. The house was purchased for \$100,000 when originally built twenty-five years ago and would cost \$200,000 to replace today. One-fourth of the house's useful life has expired. As a result, the replacement cost new less depreciation equals actual cash value formula entitles the insurer to take a depreciation deduction of \$50,000, or 25% of the cost to replace the structure. Thus, the actual cash value of the

2d 259, 262-63 (La. Ct. App. 1986); *Elberon Bathing Co. v. Ambassador Ins. Co.*, 389 A.2d 439, 444 (N.J. 1978); *Zochert v. National Farmers Union Property & Cas. Co.*, 576 N.W.2d 531, 533-35 (S.D. 1998).

The vast majority of courts agree that not to allow a deduction for the depreciation of real property would violate the principle of indemnity. See *Insurance Co. of N. Am. v. City of Coffeyville*, 630 F. Supp. 166, 169-71 (D. Kan. 1986); *Manduca Datsun, Inc. v. Universal Underwriters Ins. Co.*, 676 P.2d 1274, 1276-77 (Idaho Ct. App. 1984); *Travelers Indem. Co. v. Armstrong*, 442 N.E.2d 349, 355 (Ind. 1982); *Surratt v. Grain Dealers Mut. Ins. Co.*, 74 N.C. App. 288, 293-94, 328 S.E.2d 16, 20 (1985); *Ditch v. Yorktowne Mut. Ins. Co.*, 493 A.2d 782, 784 (Pa. Super. Ct. 1985); *Heer v. South Dakota*, 432 N.W.2d 559, 565-66 (S.D. 1988); Wendy Evans Lehmann, Annotation, *Depreciation As Factor in Determining Actual Cash Value for Partial Loss Under Insurance Policy*, 8 A.L.R.4TH 533, 537 (1981) (noting that, regardless of the valuation method used, it is "generally held" that depreciation is an appropriate or requisite factor in determining cash value).

It should be noted that some states prohibit the deduction of depreciation on partial losses. See, e.g., *Sperling v. Liberty Mut. Ins. Co.*, 281 So. 2d 297, 298 (Fla. 1973); *Thomas v. American Family Mut. Ins. Co.*, 666 P.2d 676, 679 (Kan. 1983); *Farber v. Perkiomen Mut. Ins. Co.*, 88 A.2d 776, 77-79 (Pa. 1952); cf. *London v. Insurance Placement Facility*, 703 A.2d 45, 49-50 (Pa. Super. Ct. 1997) (allowing deduction of depreciation on partial losses). Commentary on the role of depreciation suggests that

[t]he most striking development in the partial loss cases has been the emergence of a minority view that recovery may be had for the cost of reconstruction without any depreciation allowance. The rationale of these cases is that if a depreciation deduction is taken, the insured will realize a sum [that is] insufficient to pay for repairing the property at the time of loss.

Valuation, *supra* note 1, at 826, quoted in *Travelers Indem. Co.*, 442 N.E.2d at 355.

6. See *supra* note 5.

house and the amount the insured would be entitled to receive is \$150,000, replacement cost new (\$200,000) less depreciation (\$50,000). As reflected in the illustration, actual cash value, with its emphasis on indemnification, leaves a shortfall which must be financially absorbed by the insured if she desires to rebuild the same structure with the same kind and quality of materials.

Unlike actual cash value coverage, replacement cost coverage goes "beyond the concept of indemnity and simply recognize[s] that even expected deterioration of property is a risk which may be insured against."⁷ Thus, the insured, if she actually replaces or repairs the damaged property, is entitled to the full cost of that repair or replacement. "Replacement cost insurance . . . is not a pure indemnity agreement."⁸ Rather, it is optional coverage which is generally more expensive due to the nature and certainty of depreciation, the risk covered.⁹ The insurance industry takes "into account the one great hazard in providing this kind of coverage: the possibility for the insured to reap a substantial profit."¹⁰

The purpose of replacement cost coverage has been explained as follows:

Though the concept underlying the use of actual cash value as a Property insurance standard is sound, beyond challenge, the business has for many decades recognized that its strictest application can and does leave uninsured a very real source of potential loss. A property owner may indeed realize a betterment through the reconstruction of a damaged building, but that betterment may be one for which he cannot at the time of loss afford to pay. In other words, one's building may be, say 25% depreciated at the time of loss, but he needs sufficient funds with which to replace the building and the depreciation may represent nothing more to him at that time than an accounting entry. To be prepared for this contingency, he must have some sort of reserve. Otherwise, whatever the theory—depreciation, betterment, use, indemnity—this man is faced

7. Jordan, *supra* note 2, at 17.

8. *Travelers Indem. Co.*, 442 N.E.2d at 353.

9. A further level of insurance is provided by:

[d]epreciation insurance, sometimes called Replacement cost insurance, [which] pays for full replacement cost new of the insured property, without deduction for depreciation. It provides indemnity for the expenditures the insured is obliged to make over and above the amount of the loss covered by full insurance under the standard fire policy in order to restore the property to its full usefulness as before the loss or damage. Depreciation insurance substitutes a figure representing the cost of replacement new for the term "actual cash value."

Higgins v. Insurance Co. of N. Am., 469 P.2d 766, 772 (Or. 1970) (en banc) (quoting JOHN H. MAGEE & DAVID L. BICKELHAUPT, *GENERAL INSURANCE* 309 (7th ed. 1964)).

10. *Travelers Indem. Co.*, 442 N.E.2d at 353.

with an eminently *practical problem* which may quite realistically be viewed as an *insurable risk of loss*.¹¹

In essence, even though replacement cost insurance violates the principle of indemnity—because the insured receives a betterment—its availability is justified because most homeowners simply cannot afford to pay the cash difference between the replacement cost and the actual cash value of damaged property. Of greater concern to the insurance industry, however, is the fact that the “old for new” effect of replacement cost coverage encourages moral hazard.¹² The moral hazard concern led to the development of the most important limitation to the recovery of repair or replacement cost.¹³ This limitation precludes liability under a replacement cost coverage provision unless and until the damaged or destroyed property is actually repaired or replaced.¹⁴

Replacement cost provisions, even in the sole jurisdiction which found such a provision to violate public policy, are generally construed to be clear and unambiguous.¹⁵ Consequently, the general

11. *Higgins*, 469 P.2d at 772.

12. Moral hazard is concerned with conditions that would encourage an individual to destroy or not care for insured property he or she owns. According to insurance standards, “[m]oral hazard exists when the insured’s character or circumstances affecting his or her life at a given time increase the possibility of loss. Pressing financial obligations combined with a chance to profit from an insurance loss can create moral hazard.” PRAHL, *supra* note 5, at 34.

13. Commentators explain that the reason for the actual replacement requirement is to prevent the insured from making a substantial profit. See 6 APPLEMAN & APPLEMAN, *supra* note 4, § 3823, at 28 n.66.57 (Supp. 1998). The possibility of unwarranted and substantial profit is a major cause and significant consideration in determining the likelihood of moral hazard.

14. See *Huggins v. Hanover Ins. Co.*, 423 So. 2d 147, 150 (Ala. 1982); *State Farm Fire & Cas. Co. v. Patrick*, 647 So. 2d 983, 983 (Fla. Dist. Ct. App. 1994); *National Tea Co. v. Commerce & Indus. Ins. Co.*, 456 N.E.2d 206, 211 (Ill. App. Ct. 1983); *Pierce v. Farm Bureau Mut. Ins. Co.*, 548 N.W.2d 551, 554 (Iowa 1996); *Smith v. Michigan Basic Property Ins. Ass’n*, 490 N.W.2d 864, 867 (Mich. 1992); *Harrington v. Amica Mut. Ins. Co.*, 645 N.Y.S.2d 221, 223 (App. Div. 1996); *Bratcher v. State Farm Fire & Cas. Co.*, 961 P.2d 828, 831 (Okla. 1998); *Higgins*, 469 P.2d at 774; *Whitmer v. Graphic Arts Mut. Ins. Co.*, 410 S.E.2d 642, 646 (Va. 1991); *Hess v. North Pac. Ins. Co.*, 859 P.2d 586, 590 (Wash. 1993) (en banc); cf. *Ferguson v. Lakeland Mut. Ins. Co.*, 596 A.2d 883, 885 (Pa. Super. Ct. 1991) (holding that “the replacement requirement [was] unconscionable despite the clear and unambiguous language of the policy”); *Reese v. Northern Ins. Co.*, 215 A.2d 266, 268 (Pa. Super. Ct. 1965).

15. See, e.g., *Patrick*, 647 So. 2d at 983 (finding that the trial court erred “in ignoring the plain language of the replacement cost policy”); *National Tea Co.*, 456 N.E.2d at 211 (finding that “the policy is clear and unambiguous”); *Bratcher*, 961 P.2d at 831 (holding that the trial court correctly followed “plain meaning” of provision); *Higgins*, 469 P.2d at 774 (determining “the language employed in the policy under consideration [to be] sufficiently clear”); *Ferguson*, 596 A.2d at 885 (finding language of policy “clear and unambiguous”); *Hess*, 859 P.2d at 592 (“We hold that the policy at issue is not ambiguous.”); cf. *Sayes v. Safeco Ins. Co. of Am.*, 567 So. 2d 687, 690 (La. Ct. App. 1990) (finding replacement cost provision ambiguous).

rule that interpretation, construction, or legal effect of an insurance contract is a matter to be determined by the court as a question of law¹⁶ has been uniformly adhered to in replacement cost coverage litigation.¹⁷ This rule is probably responsible for the almost uniform rules of law that have developed in this area. Therefore, the rule that interpretation of an insurance contract is a question of law should be given considerable attention in planning trial strategy since this rule effectively shields insurance companies from much of the uncertainty generally associated with the jury trial process.¹⁸ The rule that insurance contract interpretation is a question of law also restricts the ordinarily broad discretion of trial judges since appellate courts do not accord questions of law the same degree of deference given to questions of fact.¹⁹ Circumvention of this rule of-

16. See *Maynard v. State Farm Mut. Auto. Ins. Co.*, 902 P.2d 1328, 1329 (Alaska 1995); *University Mechanical Contractors v. Puritan Ins. Co.*, 723 P.2d 648, 650 (Ariz. 1986); *Farm Bureau Mut. Ins. Co. v. Whitten*, 911 S.W.2d 270, 271 (Ark. Ct. App. 1995); *Miller v. American Home Assur. Co.*, 47 Cal. App. 4th 844, 848 (1996); *General Ins. Co. of Am. v. Smith*, 874 P.2d 412, 414 (Colo. Ct. App. 1993); *Aetna Life & Cas. Co. v. Bulaong*, 588 A.2d 138, 142 (Conn. 1991); *E.I. du Pont de Nemours & Co. v. Allstate Ins. Co.*, 686 A.2d 152, 155 (Del. 1996); *Jones v. Utica Mut. Ins. Co.*, 463 So. 2d 1153, 1157 (Fla. 1985); *National Tea Co.*, 456 N.E.2d at 210; *Tate v. Secura Ins.*, 587 N.E.2d 665, 668 (Ind. 1992); *Pierce*, 548 N.W.2d at 555; *Farmers Ins. Co. v. Rosen*, 839 P.2d 71, 74 (Kan. Ct. App. 1992); *Globe Indem. Co. v. Jordan*, 634 A.2d 1279, 1282 (Me. 1993); *Vizzini v. Insurance Co. of N. Am.*, 273 A.2d 137, 140 (Md. 1971); *Noel v. Metropolitan Property & Liab. Ins. Co.*, 672 N.E.2d 119, 120 (Mass. App. Ct. 1996); *Taylor v. Blue Cross/Blue Shield*, 517 N.W.2d 864, 868 (Mich. Ct. App. 1994); *Iowa Kemper Ins. Co. v. Stone*, 269 N.W.2d 885, 886-87 (Minn. 1978); *American States Ins. Co. v. Broeckelman*, 957 S.W.2d 461, 465 (Mo. Ct. App. 1997); *Wellcome v. Home Ins. Co.*, 849 P.2d 190, 192 (Mont. 1993); *American Family Ins. Group v. Hemenway*, 575 N.W.2d 143, 147 (Neb. 1998); *Wright v. Loon Mountain Recreation Corp.*, 663 A.2d 1340, 1342 (N.H. 1995); *Adron, Inc. v. Home Ins. Co.*, 679 A.2d 160, 165 (N.J. Super. Ct. App. Div. 1996); *Sheehan v. State Farm Fire & Cas. Co.*, 658 N.Y.S.2d 61, 62 (App. Div. 1997); *Harrington*, 645 N.Y.S.2d at 227; *Hanneman v. Continental W. Ins. Co.*, 575 N.W.2d 445, 449 (N.D. 1998); *Nationwide Mut. Fire Ins. Co. v. Guman Bros. Farm*, 652 N.E.2d 684, 686 (Ohio 1995); *McLeod v. Tecorp Int'l, Ltd.*, 865 P.2d 1283, 1286 (Or. 1993); *Riccio v. American Republic Ins. Co.*, 683 A.2d 1226, 1233 (Pa. Super. Ct. 1996), *aff'd*, 705 A.2d 422 (Pa. 1997); *Zochert v. National Farmers Union Property & Cas. Co.*, 576 N.W.2d 531, 532 (S.D. 1998); *Rainey v. Stansell*, 836 S.W.2d 117, 118 (Tenn. Ct. App. 1992); *Vanguard Ins. Co. v. Stewart*, 593 S.W.2d 736, 739 (Tex. Civ. App. 1979), *aff'd*, 603 S.W.2d 761 (Tex. 1980); *Viking Ins. Co. v. Coleman*, 927 P.2d 661, 663 (Utah Ct. App. 1996); *Hess*, 859 P.2d at 589; *School Dist. v. Wausau Ins. Co.*, 488 N.W.2d 82, 87 (Wis. 1992).

17. *But see Garnett v. Transamerica Ins. Servs.*, 800 P.2d 656 (Idaho 1990). Over the objection of the insurance company the trial court gave the issue of whether the insurer had breached the replacement cost coverage provision of the policy to the jury. *See id.* at 664-65. The Idaho Supreme Court affirmed. *See id.* at 658.

18. The uncertainty of the jury trial process is viewed by the insurance industry as an inherent evil to be avoided if at all possible. *See id.* at 664 (challenging trial court's decision to allow jury to resolve contract dispute).

ten depends upon the conduct of the insurer in denying replacement cost proceeds and whether that conduct gives rise to causes of action other than for breach of contract.²⁰

I. REPLACEMENT COST COVERAGE

A. *The Loss Settlement Provision*

The most logical starting point at which to begin a discussion of replacement cost coverage would be the loss settlement provisions themselves. Loss settlement provisions typically provide the following replacement cost coverage:

b. Buildings under Coverage A [residence] or B [other structures on the premises] at replacement cost without deduction for depreciation, subject to the following:

19. See, e.g., *University Mechanical Contractors*, 723 P.2d at 650 (noting that insurance contract interpretation is a question of law to be determined “independent of the findings of the trial court”); *Miller*, 47 Cal. App. 4th at 848 (finding that an “appellate court exercises independent review”); *Bulaong*, 588 A.2d at 142 (explaining that construction of insurance contract is reviewed de novo); *E.I. du Pont de Nemours & Co.*, 686 A.2d at 155 (“[T]he interpretation and construction of insurance contracts presents a clear question of law subject to de novo review.”); *Jordan*, 634 A.2d at 1282 (“We review the Superior Court decision for errors of law.”); *Hemenway*, 575 N.W.2d at 147 (“An appellate court has an obligation to reach its conclusions independent of the determinations made by the court below.”); *Hanneman*, 575 N.W.2d at 449 (“Interpretation of an insurance contract is a question of law, fully reviewable on appeal.”); *Zochert*, 576 N.W.2d at 532 (noting that insurance contract interpretation is a “question of law to be reviewed de novo”); *Rainey*, 836 S.W.2d at 118 (“[O]ur scope of review is de novo . . . with no presumption of correctness of the trial court’s conclusions of law.”); *AOK Lands, Inc. v. Shand, Morahan & Co.*, 860 P.2d 924, 925 (Utah 1993), cited in *Coleman*, 927 P.2d at 663 (stating that appellate court must give “the trial court’s legal conclusions regarding the contract no deference but review them for correctness.”); *School Dist. of Shorewood*, 488 N.W.2d at 87 (reiterating that interpretation of an insurance contract “is a question of law which this court decides independently of the decisions of the lower courts”).

20. The traditional exceptions to the actual repair or replacement requirement, such as impossibility, frustration, and estoppel, are ordinarily applied by the court as a matter of law. See *Zaitchick v. American Motorist Ins. Co.*, 554 F. Supp. 209, 215-18 (S.D.N.Y. 1982) (deciding estoppel and impossibility as a matter of law), *affd mem.*, 742 F.2d 1441 (2d Cir. 1983); *National Tea Co.*, 456 N.E.2d at 210; *Bailey v. Farmers Union Coop. Ins. Co.*, 498 N.W.2d 591, 597-99 (Neb. Ct. App. 1992) (discussing frustration as a matter of law).

However, a legal action against an insurance company for breach of contract—refusing to pay replacement cost proceeds—may also include tort claims such as fraudulent misrepresentation, emotional distress, or bad faith. These causes of actions uniformly involve jury trials. See, e.g., *Allstate Ins. Co. v. Hillely*, 595 So. 2d 873, 875-77 (Ala. 1992) (affirming submission of fraud claim to jury); *McCahill v. Commercial Union Ins. Co.*, 446 N.W.2d 579, 582-84 (Mich. Ct. App. 1989) (affirming denial of directed verdict).

(1) If, at the time of loss, the amount of insurance in this policy on the damaged building is 80% or more of the full replacement cost of the building immediately before the loss, we will pay the cost to repair or replace, after application of deductible and without deduction for depreciation, but not more than the least of the following amounts:

- (a) the limit of liability under this policy that applies to the building;
- (b) the replacement cost of that part of the building damaged for like construction and use on the same premises; or
- (c) the necessary amount actually spent to repair or replace the damaged building.

(2) If, at the time of loss, the amount of insurance in this policy on the damaged building is less than 80% of the full replacement cost of the building immediately before the loss, we will pay the greater of the following amounts, but not more than the limit of liability under this policy that applies to the building:

- (a) the actual cash value of that part of the building damaged; or
- (b) that proportion of the cost to repair or replace, after application of deductible and without deduction for depreciation, that part of the building damaged, which the total amount of insurance in this policy on the damaged building bears to 80% of the replacement cost of the building.

....

(4) We will pay no more than the actual cash value of the damage unless:

- (a) actual repair or replacement is complete; or
- (b) the cost to repair or replace the damage is both:
 - (i) less than 5% of the amount of insurance in this policy on the building; and
 - (ii) less than \$1,000.

(5) You may disregard the replacement cost loss settlement provisions and make claim under this policy for loss or damage to buildings on an actual cash value basis. You

may then make claim within 180 days after loss for any additional liability on a replacement cost basis.²¹

Loss settlement provisions provide for two alternative kinds of settlements. The first alternative, replacement cost coverage, is initially conditioned upon the insured satisfying the 80% or more of the actual replacement requirement expressed in section (b)(1). Sections (b)(1) and (2) of the loss settlement provision described above are coinsurance provisions.²² If the amount of insurance purchased does not at least equal the percentage specified in the coinsurance provision, the insured is viewed to be underinsured and retains a portion of the risk of loss. Coinsurance provisions, in the absence of a statute to the contrary, are generally treated as enforceable.²³ If insurance in the amount of 80% or more of the full replacement cost of the building is purchased, the insured, upon completion of repair or replacement, is entitled to recover from the insurer the lesser of: (1) the limits of liability under the policy; (2) the replacement cost of that part of the building damaged for like

21. PRAHL, *supra* note 5, at 53-54 [hereinafter, this provision shall be referred to as "Model Settlement Provision"]. It should be noted that the language used in loss settlement provisions is in no way uniform and varies from company to company. Despite this fact, loss settlement provisions regarding real property, for the most part, provide for the same basic rights, liabilities, and obligations. The variations in expressions are merely attempts on the part of insurance companies to clearly and unambiguously set forth the rights, liabilities, and obligations of the parties to the insurance contract.

22. It is well established that most real property losses are partial and do not result in the total destruction of the structure. Therefore, some insureds play the odds and do not insure their property for its full value. This allows them to save on the cost of insurance because they are paying for less coverage. In an effort to avoid this inequity and to encourage the insured to carry a reasonable amount of insurance in relation to either the actual cash value or replacement cost value of their property, a coinsurance requirement is incorporated into many policies. The insured continues to receive the benefit of a reduced rate when the policy contains a coinsurance provision. If the insured purchases insurance at least equal to the coinsurance percentage specified in the policy, the insurer will pay the amount agreed upon in the policy (the amount specified in subsections (1)(a), (b), and (c) of the model provision) as if the insured had purchased insurance up to the full replacement value of the property.

If the insured purchases insurance in an amount less than the coinsurance percentage, the coinsurance provision limits the amount the insurer will pay to the larger of the actual cash value of that part of the building damaged or that proportion of the loss that the amount of insurance purchased bears to the specific percentage (80% in the model provision) of the replacement cost of the part of the property damaged at the time of loss (subsections 2(a) and (b) of the model provision). See KENNETH ABRAHAM, *INSURANCE LAW AND REGULATION* 264-65 (2d ed. 1995); PRAHL, *supra* note 5, at 89-90; 44 AM. JUR. 2D *Insurance* § 1510 (1982).

23. See, e.g., *Surratt v. Grain Dealers Mut. Ins. Co.*, 74 N.C. App. 288, 292, 328 S.E.2d 16, 19 (1985); 44 AM. JUR. 2D *Insurance* § 1510 (1982).

construction and use on the same premises; or (3) the necessary amount actually spent to repair or replace the damaged building.²⁴

The insurer's obligation to pay replacement cost is clearly and unambiguously subject to two conditions: (1) the purchase of insurance in the amount of 80% or more of the replacement cost of the building; and (2) actual repair or replacement.²⁵ Consequently, the intent to repair or replace the damaged property, in the absence of some countervailing conduct on the part of the insurer, does not trigger the insurer's obligation to pay replacement cost.²⁶ If the insured purchases insurance in an amount less than the specified percentage of full replacement cost value, she is entitled to recover the larger of the actual cash value of that part of the building damaged or the amount that the total amount of insurance carried bears to 80% of the replacement cost of the building.²⁷ The latter amount is determined by applying a simple coinsurance formula. Suppose that the full replacement cost of a house is \$100,000 and the insured purchases \$60,000 of coverage. The policy requires that the house be insured for 80% or more of its full replacement cost. The insured experiences wind damage to the roof of the house. The full cost to replace the damaged roof without deduction for depreciation is \$3000. The actual cash value of the roof is \$2000, replacement cost new less depreciation.²⁸

The actual cash value of the roof is easily ascertained to be \$2000. The typical insurer, however, agrees under replacement cost coverage to pay the larger of the actual cash value or the fraction of insurance carried to insurance required;²⁹ therefore, the latter amount must be determined. The formula for determining the proportion of the loss that the amount of insurance carried bears to the amount of insurance required is:

24. See Model Settlement Provision, *supra* note 21, § (b)(1).

25. See *id.* §§ (b)(1), (b)(4)(a).

26. See *Hilley v. Allstate Ins. Co.*, 562 So. 2d 184, 190 (Ala. 1990); *National Tea Co. v. Commerce & Indus. Ins. Co.*, 456 N.E.2d 206, 211 (Ill. App. Ct. 1983). An intent to repair or replace without more is clearly not enough to justify the recovery of replacement cost proceeds. However, where the insured has begun repair or replacement and the insurer has agreed to make progress payments, the insurer is estopped from requiring complete repair or replacement as a condition for its continued progress payments. See, e.g., *Garnett v. Transamerica Ins. Servs.*, 800 P.2d 656, 665-66 (Idaho 1990) (holding that, once begun, insurer had a duty to continue making proportional payments). Likewise, where the insurer refuses to pay at least actual cash value, its conduct may estop it from asserting the actual repair or replacement requirement or may constitute impossibility, frustration, or fraud, which are also defenses to the actual repair or replacement requirement. See discussion *infra* Part II.B.

27. See Model Settlement Provision, *supra* note 21, § b(2).

28. This illustration was taken from Robert J. Prah. PRAHL, *supra* note 5, at 94-95. For a similar illustration, see KENNETH S. ABRAHAM, *INSURANCE LAW AND REGULATION* 264-65 (2d ed. 1995).

29. See Model Settlement Provision, *supra* note 21, §§ b(2)(a)-(b); PRAHL, *supra* note 5, at 94.

((Amount of insurance carried) / (80% of replacement cost of building)) X (cost to repair or replace without deduction for depreciation) = Proportion³⁰

Using the figures from the example above produces the following result:

$(\$60,000 / \$80,000) \times \$3000$; or $3/4 \times \$3000 = \2250 .³¹

Since \$2,250 exceeds the actual cash value of the loss (\$2000), the insurer is liable for the former amount. Had the insured satisfied the 80% full replacement cost requirement and insured for \$80,000, she would have been entitled to receive the full replacement cost (\$3000) less the applicable deduction.³² If either the actual cash value or the applicable proportion of replacement cost exceeds the amount of insurance carried, the loss payment is limited to the maximum amount of liability under the policy.³³

Modified coinsurance provisions like these guarantee that the insured will never receive less than the actual cash value, even if underinsured.³⁴ If the coinsurance formula here produces an amount in excess of the actual cash value of the damaged property, the insured will receive the greater amount, up to the policy limit. If the formula produces an amount less than actual cash value, the insured is entitled to receive the actual cash value. The insured's right to the proceeds under section (b)(2)(a)-(b) is, however, subject to the actual repair or replacement condition.³⁵

The question whether the percentage specified in the coinsurance formula applicable to underinsurance should be calculated against actual "cost of repair or replacement" or against "replacement cost" has far reaching implications in the context of replacement cost coverage. For example, in *Boudreau v. Manufacturers & Merchants Mutual Insurance Co.*,³⁶ the plaintiffs purchased a house for \$33,500. Plaintiffs insured the property with defendant,

30. PRAHL, *supra* note 5, at 95.

31. *See id.*

32. *See id.*

33. *See id.*

34. Only if the insured is so underinsured that actual cash value exceeds the policy limit will the insured not recover this amount. Note that § b(2) of the Model Settlement Provision, *supra* note 21, may appear to be a coinsurance provision,

"but it is not . . . In a true coinsurance policy, the insured, if underinsured, may recover less than the actual cash value of the property; that is, a penalty will be applied if the insured does not carry insurance which meets a specified percentage of the actual cash value, or in some cases the replacement cost, of the building."

PRAHL, *supra* note 5, at 95.

35. *See* Model Settlement Provision, *supra* note 21, § b(4) ("We will pay no more than the actual cash value of the damage unless . . . actual repair or replacement is complete . . .").

36. 588 A.2d 286 (Me. 1991).

with a coverage limit of \$95,000.³⁷ Several months later the property was destroyed by fire. Defendant initially paid plaintiffs \$24,000 representing the actual cash value of the destroyed portion of the house.³⁸ The parties agreed that the cost to fully replace the farm house with like kind and quality of materials would be \$203,658.58.³⁹ The parties also agreed that the coinsurance clause of the loss settlement provision pertaining to underinsurance governed the dispute because the face amount of the policy (\$95,000) was less than 80% of \$203,658.58.⁴⁰

The plaintiffs never rebuilt the farm house, but instead constructed another structure on a different site for which they sought to hold the defendant liable.⁴¹ Plaintiffs spent \$58,054 to build the new house.⁴² Consequently, the trial court had to interpret the coinsurance provision of the policy, which provided "that portion of the cost to repair or replace . . . which the total amount of insurance in this policy on the damaged building bears to [eighty percent] of the replacement cost of the building."⁴³ The court concluded that \$95,000, the total amount of the policy, was 58% of \$162,927, or 80% of the "replacement cost" of the building. The court, therefore, concluded that the insureds were entitled to recover \$33,671, or 58% of their actual "cost to repair or replace."⁴⁴ The plaintiffs disagreed with the trial court's determination and appealed.⁴⁵

On appeal, the Supreme Court of Maine agreed that the "cost to repair and replace" language in the policy was "distinct from and used in a different context than 'replacement cost.'"⁴⁶ Therefore, the relevant language did not contemplate that actual replacement cost would be used in calculating the amount to which the insured was entitled.⁴⁷ Thus, the trial court "correctly interpreted the 'cost to repair or replace' provision . . . to mean the amount actually spent by the Boudreaus to construct their property in Massachusetts."⁴⁸ As a result, the plaintiffs, because they were underinsured, were entitled to 58% of the amount they actually spent to rebuild the new home, or \$33,671.12.⁴⁹ In contrast, had the plaintiffs' coverage been limited instead to 58% of the "replacement cost," the insurance company would have had to pay the full \$58,054.

37. *See id.* at 288.

38. *See id.* at 287.

39. *See id.*

40. *See id.*

41. *See id.*

42. *See id.*

43. *Id.* at 288 (emphasis added).

44. *See id.*

45. *See id.* at 286.

46. *Id.* at 289.

47. *See id.* at 288-89.

48. *Id.*

49. *See id.* at 288.

Subsections (1)(a)-(c) of the model loss settlement provision are measures of liability and not conditions of coverage.⁵⁰ Thus, as explained in an often-cited authority on replacement cost coverage:

[L]oss settlement provisions are best viewed as separate and apart from the requirement in these policies that liability of the company beyond actual cash value loss does not occur until actual repair or replacement is completed. It is best to apply a two-part analysis. Viewed in this manner, first, the company's liability for additional funds is established if the insured completes the repair or replacement. The amount of its liability, as the second question however, is to be determined from a review of the loss settlement provisions.⁵¹

Jordan further explains:

The first [limit of liability], of course, limits the amount available for replacement to policy limits, while the second relates to a theoretical or hypothetical measure of loss: that is, the replacement cost of rebuilding the identical structure as one limit of the company's liability. This particular limitation does not require repair or replacement of an identical building on the same premises, but places that rebuilding amount as one of the measures of damage to apply in calculating liability under the replacement cost coverage. The effect of this limitation comes into play when the insured desires to rebuild either a different structure or on different premises. In those instances, the company's liability is not to exceed what it would have cost to replace an identical structure to the one lost on the same premises. Although liability is limited to rebuilding costs on the same site, the insured may then take that amount and build a structure on another site, or use the proceeds to buy an existing structure as the replacement, but paying any additional amount from his or her own funds.

Finally, the third limitation of liability strengthens the requirement that liability of the company does not exist until repair or replacement is made. The purpose of this limitation is to limit recovery to the amount the insured spent on repair or replacement as yet another measure of the loss liability of the insurer. This third valuation method is intended to disallow an insured from recovering, in replacement cost proceeds, any amount other than that actually expended.⁵²

50. See *S & S Tobacco & Candy Co. v. Greater N.Y. Mut. Ins. Co.*, 617 A.2d 1388, 1391 (Conn. 1992) (finding that this section "addresses the amount of the defendant's liability rather than" imposing conditions).

51. Jordan, *supra* note 2, at 39.

52. *Id.* at 19-21. Several courts have allowed the insured to recover replacement cost following rebuilding at a different site. See, e.g., *Huggins v. Hanover Ins. Co.*, 423 So. 2d 147, 150 (Ala. 1982); *Blanchette v. York Mut. Ins.*

The second loss settlement alternative in a typical policy permits the insured to recover the actual cash value of the property subject to a depreciation allowance.⁵³ This alternative is not optional on the part of the insurer.⁵⁴ The insured's right to receive the actual cash value of her insured property is absolute and not subject to any conditions precedent other than the existence of coverage.⁵⁵ The legal reasoning that supports this rule was explained by the Alabama Supreme Court in *State Farm Fire & Casualty Co. v. Ponder*.⁵⁶ In *Ponder*, State Farm issued a homeowner's policy for \$70,000 on a dwelling owned by Joe and Seretha Ponder.⁵⁷ During the thirteen months between issuance of the policy and the date of loss "the policy coverage increased to \$74,430 on the dwelling and \$40,810 on the contents. On September 19, 1981 the house and its contents were totally destroyed by a fire."⁵⁸ The policy at issue in *Ponder* contained a loss settlement provision very similar to that illustrated above.⁵⁹

Co., 455 A.2d 426, 427-28 (Me. 1983); *Johnson v. Colonial Penn Ins. Co.*, 487 N.Y.S.2d 285, 286-87 (Sup. Ct. 1985); see also *Smith v. Michigan Basic Property Ins. Ass'n*, 490 N.W.2d 864, 868 (Mich. 1992) (recognizing that actual repair or replacement is allowed, under the second measure of damages, other than at the site of the loss.)

53. See Model Settlement Provision, *supra* note 21, §§ b(2)(a), (4), (5).

54. See, e.g., *State Farm Fire & Cas. Co. v. Ponder*, 469 So. 2d 1262, 1266 (Ala. 1985) ("There is absolutely nothing in the policy language . . . that requires the insured to forfeit the actual cash value coverage if he elects to forgo the optional replacement cost."); *Higgins v. Insurance Co. of N. Am.*, 469 P.2d 766, 773 (Or. 1970) (stating that "[i]n the usual course, liability under the policy accrues on an actual cash value basis until repair or replacement has actually been effected. This means that if the property is not repaired or replaced, the only liability of the company will be on an actual cash value basis"); *Jordan*, *supra* note 2, at 19 (stating that the "requirement for actual repair or replacement by the insured does not affect the company's liability to pay for actual cash value loss, but only for the difference between that figure and the higher replacement cost").

55. See, e.g., *Huggins*, 423 So. 2d at 150 (finding the insureds entitled to cash value without regard to the conditions precedent relevant to replacement cost coverage); *Pierce v. Farm Bureau Mut. Ins. Co.*, 548 N.W.2d 551, 594 (Iowa 1996) (explaining that replacement cost provisions contemplate payment of cash value before insured complies with replacement conditions); *Smith*, 490 N.W.2d at 867-68 (noting that insured is at least entitled to cash value, regardless of conduct, in case involving arson allegations); *Harrington v. Amica Mutual Ins. Co.*, 645 N.Y.S.2d 221, 223 (App. Div. 1996); *Bratcher v. State Farm Fire & Cas. Co.*, 961 P.2d 828, 829 (Okla. 1998) (holding provision for payment of actual cash value in absence of repair or replacement not unconscionable); *Higgins*, 469 P.2d at 774 (holding that insured's failure to meet conditions for replacement coverage results in insurer owing only cash value); *Hess v. North Pac. Ins. Co.*, 859 P.2d 586, 586-87 (Wash. 1993) (holding that insured who fails to meet replacement condition is entitled only to cash value).

56. 469 So. 2d 1262 (Ala. 1985).

57. *Id.* at 1262.

58. *Id.*

59. *Id.* at 1262-63.

Following the loss, State Farm made numerous payments to the Ponders for additional living expenses.⁶⁰ State Farm also "obtained an estimate of the cost of replacement from a contractor, one Frank Shaddix."⁶¹ Shaddix estimated cost of replacement at \$58,444.84.⁶² Thereafter, the Ponders "were paid \$61,680.77 for the dwelling loss. This figure included the Shaddix bid, debris removal, and damage and destruction to trees and shrubbery."⁶³

Joe Ponder rejected the bid by Shaddix to rebuild the house.⁶⁴ He also obtained bids from two other contractors, but both were higher than Shaddix's bid.⁶⁵ Mr. Ponder ultimately decided to rebuild the house himself.⁶⁶ At the time of trial, the Ponders were living in the house and had already spent approximately \$30,000 in replacement cost.⁶⁷ Mr. Ponder testified that he could finish construction of the house for about \$15,000.⁶⁸

State Farm contended that because the Ponders had already been paid the sum of \$61,680.77 on the house loss, which "was \$15,000 more than Ponder himself testified he had spent and would spend in replacing the house," it had no further liability under the policy.⁶⁹ State Farm argued that the applicable and controlling policy provision was 3c.(1)(c), which stated:

c. Buildings under Coverage A at replacement cost without deduction for depreciation, subject to the following:

(1) We will pay the cost of . . . replacement, without deduction for depreciation, but not exceeding the smallest of the following amounts:

....

(c) The amount actually and necessarily spent to repair or replace the damaged building.⁷⁰

Thus, State Farm contended "that the only reasonable and logical interpretation to be placed on these policy provisions is that replacement is anticipated."⁷¹ In fact, according to State Farm, the Ponders did replace the house. Consequently, they were entitled to be paid only the replacement cost, "which by [Joe Ponder's] own tes-

60. *See id.* at 1263.

61. *Id.*

62. *See id.*

63. *Id.*

64. *See id.*

65. *See id.*

66. *See id.*

67. *See id.*

68. *See id.*

69. *Id.* at 1263-64.

70. *Id.* at 1264.

71. *Id.*

timony was approximately \$45,000–\$30,000 of which he had already spent and \$15,000 more than he needed to complete the building. According to State Farm, he was actually paid \$61,680.77, or \$16,680.77 more than the amount at which [Ponder] established the replacement cost.⁷²

The Ponders asserted that they were entitled to the difference between what they had already been paid and the actual cash value of the house. “In other words, plaintiffs [argued] that they had the option of disregarding replacement costs in making their claim for a loss under Coverage A, the house.”⁷³ Plaintiffs argued that, despite the conditions set out in paragraph 3c.(1) of the policy, the controlling loss settlement provision was 3c.(3), which provided: “You may disregard the replacement cost loss settlement provisions and make claim under this policy for loss or damage to buildings on an actual cash value basis and then make claim within 180 days after loss for any additional liability on a replacement cost basis.”⁷⁴ Thus, plaintiffs argued that this paragraph allowed them to disregard the section of the policy relied upon by defendant “and to make their claim on an actual cash value basis. In other words, the plaintiffs say that this provision applies where an insured wishes to convert his loss to cash and spend substantially less money in the construction of another dwelling.”⁷⁵ The court disagreed with the plaintiffs.

According to the court, replacement cost coverage is “optional coverage” and does not control the insured’s right to actual cash value.⁷⁶ Furthermore, no provision in the policy required “the insured to forfeit the actual cash value coverage if he elect[ed] to forgo the optional replacement cost.”⁷⁷ The *Ponder* analysis is appropriate because replacement cost coverage contemplates “that, ordinarily, actual cash value will be less than replacement cost;” consequently, “[t]he insurer will first pay the lesser amount—actual cash value.”⁷⁸ However, a failure to pay actual cash value as soon as reasonably possible, after coverage has been determined, can deprive the insured of the funds necessary to begin repair or replacement. Depriving the insured of actual cash value proceeds can, therefore, constitute estoppel, which precludes the insurer from insisting upon actual repair or replacement as a condition precedent to payment of replacement cost proceeds.⁷⁹

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.* at 1266.

77. *Id.*

78. *Pierce v. Farm Bureau Mut. Ins. Co.*, 548 N.W.2d 551, 554 (Iowa 1996); see also *American Reliance Ins. Co. v. Perez*, 689 So. 2d 290, 291 (Fla. Dist. Ct. App. 1997) (“Payment on a replacement cost basis is thus expected to be more than payment on an actual cash value basis.”).

79. See *infra* Part II.B.

1. *The meaning of "make claim within 180 days after loss"*

A loss settlement provision, such as that illustrated above, unambiguously recognizes the unconditional right of the insured to make a claim for loss on an actual cash value basis.⁸⁰ It is not uncommon to find, within the same provision, language establishing the insured's right to subsequently "make claim within 180 days after loss for any additional liability on a replacement cost basis."⁸¹ On occasion, insurers have attempted to deny replacement cost coverage on the theory that the "make claim within 180 days" language conditions payments of the proceeds not only upon actual repair and replacement, but also on the repair and replacement being substantially completed within the 180 day time limit.⁸² The meaning of this phrase was addressed by the Supreme Court of Maine in the seminal opinion of *Blanchette v. York Mutual Insurance Co.*⁸³ Therein, plaintiff, Timothy Blanchette, purchased homeowner's insurance in the amount of \$15,000 from Defendant York Mutual Insurance Company.⁸⁴ Several months later the house was destroyed by fire.⁸⁵ Mr. Blanchette elected to take the actual cash value of the destroyed property immediately and informed York Mutual that he also intended to claim replacement cost by replacing the home.⁸⁶ He then informed York Mutual that the onset of winter might delay his ability to replace the structure immediately.⁸⁷ In response, the adjuster granted Mr. Blanchette a 90-day extension to the 180-day period in which claims for reimbursement for replacement cost could be filed.⁸⁸

The relevant section of the loss settlement provision of the policy provided: "You may disregard the replacement cost loss settlement provisions and make claim under this policy for loss or damage to buildings on an actual cash value basis and then make claim within 180 days after loss for any additional liability on a replacement cost basis."⁸⁹

Plaintiff subsequently learned that the house could not be rebuilt on the same lot because of sewage disposal ordinances.⁹⁰ He informed the defendant of the situation and expressed his intention

80. See Model Settlement Provision, *supra* note 21, § b(5) ("You may disregard the replacement cost loss settlement provisions and make claim . . . on an actual cash value basis.").

81. *Id.*

82. See, e.g., *Blanchette v. York Mutual Ins. Co.*, 455 A.2d 426, 428 (Me. 1983) (deciding that such provisions do not require substantial completion).

83. *Id.*

84. See *id.* at 426.

85. See *id.*

86. See *id.* at 427.

87. See *id.*

88. See *id.*

89. *Id.* at 427 n.2.

90. See *id.* at 427.

to replace the destroyed house by rebuilding on another lot.⁹¹ At that time, representatives of defendant told plaintiff "that he would not qualify for replacement cost reimbursement unless he built on the original lot and unless the replacement structure was 'substantially completed' within the 270-day period (180 days plus the 90-day extension)."⁹²

The court in *Blanchette* was presented with two issues: (1) "whether the replacement cost feature of the insurance policy applies only if the damaged structure is repaired or replaced on the same premises;" and (2) whether the property must be "substantially completed within the time allowed for making a claim."⁹³ The court derived its answer to both issues from a literal reading of the contract. Accordingly, the language of the policy clearly did not preclude plaintiff from rebuilding on a different site.⁹⁴ In response to the second issue, the court observed that "[t]here is simply no support for the company's argument that the obligation to make a claim imposes the requirement that the replacement building must be 'substantially complete' at the time the claim is made."⁹⁵ Therefore, plaintiff was entitled to recover replacement cost proceeds up to the policy limits for the house he constructed at a different location.⁹⁶

In *Bourrie v. United States Fidelity & Guaranty Insurance Co.*,⁹⁷ the Oregon Court of Appeals also addressed the issue of the meaning of the language "make claim."⁹⁸ In *Bourrie*, the plaintiff's home was destroyed by fire.⁹⁹ The plaintiff had purchased a homeowner's policy from the defendant that provided for replacement cost coverage on the structure.¹⁰⁰ Defendant paid plaintiff \$33,929.50 for the actual cash value of the loss.¹⁰¹ Plaintiff also provided the defendant

91. *See id.*

92. *Id.*

93. *Id.*

94. *See id.* at 427-28. For a detailed discussion of the replacement requirement, see *supra* notes 3-52 and accompanying text. Courts generally interpret provisions that provide, in pertinent part, for payment of "the replacement cost of that part of the building damaged for equivalent construction and use on the same premises" as a hypothetical measure of liability and not as a condition to the recovery of replacement cost proceeds. *Johnson v. Colonial Penn. Ins.*, 487 N.Y.S.2d 285, 286-87 (Sup. Ct. 1985) (emphasis added); *see also S & S Tobacco & Candy Co. v. Greater N.Y. Mut. Ins. Co.*, 617 A.2d 1388, 1390-91 (Conn. 1992) (construing any ambiguity in the application of "on the same premises" against the insurance company).

95. *Blanchette*, 455 A.2d at 428.

96. *See id.* at 427.

97. 707 P.2d 60 (Or. Ct. App. 1985).

98. *See id.* at 63.

99. *See id.* at 61.

100. *See id.*

101. *See id.*

with a statement of the full replacement cost of the insured building.¹⁰²

Plaintiff replaced the destroyed structure on an adjacent site.¹⁰³ Operating under the belief that the policy required completion within 180 days, plaintiff still could not complete replacement in time and the defendant denied replacement cost proceeds.¹⁰⁴ The *Bourrie* court, unlike the court in *Blanchette* that relied upon the literal language of the contract, concluded that the policy language "make claim within 180 days" was ambiguous and unclear.¹⁰⁵ Consequently, the court noted that "[i]f defendant had intended to require repair or replacement within a specific period of time, it would have been a simple matter to so require in clear language."¹⁰⁶ Though the court in *Bourrie* used a different analysis, it nonetheless cited *Blanchette* for its legal reasoning.¹⁰⁷ Both courts agreed that the current state of the law is that: (1) the "make claim within 180 days" language merely prescribed the time period in which the insured must apprise the insurance company of his intentions to repair or rebuild; and (2) in the absence of a clear expression of the time within which replacement must be complete, the law would imply a requirement that repair or replacement be completed within a reasonable time.¹⁰⁸

2. Does intent to rebuild satisfy the actual repair or replacement requirement?

The best response to this question was put forth nearly a decade ago by Leo Jordan in his often-cited article, *What Price Rebuilding?*¹⁰⁹ Therein, Mr. Jordan observed:

102. *See id.*

103. *See id.*

104. *See id.*

105. *Id.* at 63.

106. *Id.*

107. *Id.* at 63 n.3.

108. *See Blanchette v. York Mut. Ins.*, 455 A.2d 426 (Me. 1983); *Bourrie*, 707 P.2d at 63; *see also Maine Mut. Fire Ins. Co. v. Watson*, 532 A.2d 686, 689 (Me. 1987) (holding that 180-day period "merely provides a procedural mechanism" and insured has a reasonable time to rebuild); *Smith v. Michigan Basic Property Ins. Ass'n*, 490 N.W.2d 864, 868 & nn.14-15 (Mich. 1992) (citing *Blanchette* and *Watson*).

109. Jordan, *supra* note 2. Some policies contain replacement cost provisions which require that repair or replacement must be completed with "due diligence." Courts construing such provisions have also accorded the insured, in light of the circumstances of the case, a reasonable time to complete the repair or replacement. *See, e.g., Central Nat'l Ins. Co. v. Devonshire Coverage Corp.*, 565 F.2d 490, 496 (8th Cir. 1977) (applying Nebraska law and requiring reimbursement when insured began repairs five months after fire and completed them five months later); *Ruter v. Northwestern Fire & Marine Ins. Co.*, 178 A.2d 640, 643 (N.J. Super. Ct. App. Div. 1962) (requiring repair or replacement within a reasonable time).

On occasion, insureds have attempted to recover replacement cost proceeds without complying with the requirement to actually complete the repair or replacement. Whether a court will allow an insured to do so, based upon intent to rebuild alone, depends upon the actions of the insurer in the treatment of the insured's basic loss. For the most part, if the insured is unable to rebuild because of actions taken by the insurer, then courts are likely to find a waiver of the requirement. Otherwise, courts have firmly enforced the rebuilding obligation.¹¹⁰

This passage accurately reflects the current state of the law.

However, courts also recognize an exception to the actual repair or replacement requirement where the policy is ambiguous. For example, in *Sayes v. Safeco Insurance Co. of America*,¹¹¹ the court addressed the actual repair or replacement requirement in the context of a homeowner's policy that provided in pertinent part: "We will settle covered losses to the dwelling under Coverage A without regard to the limit of liability shown in the Declarations. You agree to . . . repair or replace the damaged dwelling."¹¹² Defendant contended that, under the policy, its obligation to pay replacement cost proceeds was reciprocal to the insured's obligation to repair.¹¹³ The court agreed that the plaintiffs were obligated to repair the property.¹¹⁴ However, the issue was whether, if plaintiff agreed to make the repairs, the repair would actually have to be made prior to payment of the proceeds or whether the repairs could be made subsequent to payment.¹¹⁵ Finding that the policy language was ambiguous, the court interpreted the policy in favor of the insured and ordered the payment of the replacement cost proceeds prior to actual repair or replacement.¹¹⁶

Intent to repair may also be sufficient if the insurer agrees to cooperate with or assist the insured by guaranteeing or making proportional payments toward the repair or reconstruction of the damaged property.¹¹⁷ This result does not depend upon the existence of a policy provision obligating the insurer to so act. Rather, it

110. *Jordan*, *supra* note 2, at 21; *see also* *Hilley v. Allstate Ins. Co.*, 562 So. 2d 184, 190 (Ala. 1990) ("A mere intention to replace does not trigger the insurer's replacement cost payment obligations."); *Higginbotham v. American Family Ins. Co.*, 493 N.E.2d 373, 375 (Ill. App. Ct. 1986) (holding that lower court correctly found intent to repair insufficient).

111. 567 So. 2d 687 (La. Ct. App. 1990).

112. *Id.* at 689.

113. *See id.* at 689-90.

114. *See id.* at 690.

115. *See id.* at 689.

116. *See id.* at 690.

117. *See Garnett v. Transamerica Ins. Servs.*, 800 P.2d 656, 665-66 (Idaho 1990) (noting that policy could be read literally to require repair before payment but that, where insurer began to make progress payments, intent to repair was sufficient to require continuation of payments).

is based on purely equitable considerations—something in the nature of estoppel.¹¹⁸

3. *What constitutes replacement?*

The requirement of actual repair or replacement, as previously expressed, is a condition precedent to the recovery of replacement cost proceeds. This condition is further subject to the policy language requirement that the repair or replacement be complete.¹¹⁹ In other words, payment of replacement cost proceeds is due when the repair or replacement is completed. Few insurance policies define the terms “replacement” or “complete.” Therefore, these terms are accorded their ordinary meaning.¹²⁰ Thus, “replace” is commonly understood to mean “to put something new in the place of.”¹²¹ The term “complete” is generally understood to mean “brought to an end; concluded.”¹²²

118. See *infra* Part II.B.

119. See Model Settlement Provision, *supra* note 21, § b(4) (“We will pay no more than the actual cash value of the damage unless; (a) actual repair or replacement is complete . . .”).

120. Two generally accepted rules of contract interpretation provide that: (1) when contested terms within a contract are undefined, courts generally give the undefined terms their ordinary meaning; and (2) when searching for the ordinary meaning of a term, it is acceptable to refer to dictionaries. See, e.g., *Arizona Property & Cas. Ins. Guar. Fund v. Dailey*, 751 P.2d 573, 575 (Ariz. Ct. App. 1987) (interpreting “employee” according to ordinary meaning); *Eott Energy Corp. v. Storebrand Int’l Ins. Co.*, 52 Cal. Rptr. 2d 894, 899 (Ct. App. 1996) (citing ordinary meaning rule and consulting dictionaries); *Budris v. Allstate Ins. Co.*, 686 A.2d 533, 535 (Conn. App. Ct. 1996) (stating that “words are to be given their ordinary meaning” and consulting dictionaries to interpret “owner”); *Muller v. Firemen’s Fund Ins. Co.*, 682 N.E.2d 331, 335 (Ill. App. Ct. 1997) (“In ascertaining the plain and ordinary meaning of words, courts often consult dictionaries.”); *Mikel v. American Ambassador Cas. Co.*, 644 N.E.2d 168, 170 (Ind. Ct. App. 1994) (applying ordinary meaning rule); *Lemars Mut. Ins. Co. v. Joffer*, 574 N.W.2d 303, 307 (Iowa 1998) (“In determining the ordinary meaning of undefined terms in a policy, we commonly refer to dictionaries.”); *Ledbetter v. Concord Gen. Corp.*, 665 So. 2d 1166, 1169 (La.) (applying “general, ordinary, plain and popular meaning of the words used in the policy”), *amended by* 671 So. 2d 915 (La. 1996); *Minnesota Mining & Mfg. Co. v. Travelers Indem. Co.*, 457 N.W.2d 175, 179, 182 (Minn. 1990) (applying “ordinary meaning” rule); *Hanneman v. Continental W. Ins. Co.*, 575 N.W.2d 445, 452 (N.D. 1998) (“The dictionary is a good source to determine the plain, ordinary definition of an undefined term.”); *Nationwide Mut. Fire Ins. Co. v. Guman Bros. Farm*, 652 N.E.2d 684, 686 (Ohio 1995) (holding that undefined terms in an insurance contract must be given “their plain and ordinary meaning”); *Twilleager v. North Am. Accident Ins. Co.*, 397 P.2d 193, 194-95 (Or. 1964) (“[Words] are to be given effect in accordance with their plain and ordinary meaning.”); *Ramsay v. Maryland Am. Gen. Ins. Co.*, 533 S.W.2d 344, 346 (Tex. 1976) (noting that courts often refer to dictionaries to find ordinary meaning); *State Farm Mut. Auto. Ins. Co. v. Ruiz*, 952 P.2d 157, 159 (Wash. 1998) (en banc) (consulting dictionaries in search of ordinary meaning).

121. MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY 992 (10th ed. 1996).

122. *Id.* at 235.

Complete replacement does not necessarily require the insured to conclude all aspects of the transfer of property process. Rather, the insured may satisfy this requirement by entering into a legally enforceable binding contractual arrangement, such as an executory real estate contract. For example, in *Pierce v. Farm Bureau Mutual Insurance Co.*,¹²³ the plaintiffs purchased a homeowner's policy providing replacement cost coverage from defendant.¹²⁴ Thereafter, their home was damaged by fire.¹²⁵ Defendant, Farm Bureau Mutual, immediately paid the Pierces the actual cash value of the dwelling.¹²⁶ Under the replacement cost provision of the policy, the Pierces had to repair or replace the house by September 17, 1992.¹²⁷ Farm Bureau Mutual extended this deadline to January 19, 1993.¹²⁸

The Pierces found another house owned by the Martins.¹²⁹ The Martins were the parents of Jeri Pierce, one of the insureds.¹³⁰ "On December 18, 1992, the Pierces and the Martins executed a short form Iowa State Bar Association real estate contract on this property."¹³¹ The contract terms called for \$40,000 to be paid at closing on January 3, 1993, monthly payments of \$500 for eight years, and a final balloon payment.¹³² The Pierces failed to make the down payment and the monthly installments required under the contract prior to Farm Bureau Mutual's January 19, 1993 deadline.¹³³

Despite this failure of payment, the Pierces still sought replacement cost proceeds from Farm Bureau Mutual.¹³⁴ Farm Bureau Mutual denied the claim because the Pierces "failed to spend any amounts to repair or replace the damaged dwelling before the January 19, 1993 extended deadline."¹³⁵ The Pierces subsequently filed suit against Farm Bureau. Several months thereafter "[t]he Martins served the Pierces with a notice of forfeiture on the real estate contract. . . . In the notice the Martins alleged the Pierces failed to make the \$40,000 down payment due January 3, 1993, and any of the \$500 monthly payments."¹³⁶

The court in *Pierce* formulated the dispositive issues as whether the insured: "(1) made a bona fide replacement, and (2) actually spent money to replace the damaged dwelling, thereby triggering

123. 548 N.W.2d 551 (Iowa 1996).

124. *See id.* at 552.

125. *See id.*

126. *See id.*

127. *See id.*

128. *See id.*

129. *See id.*

130. *See id.*

131. *Id.*

132. *See id.* at 553.

133. *See id.*

134. *See id.*

135. *Id.*

136. *Id.*

the replacement cost provision.¹³⁷ Rather than treating the terms "replacement" and "complete" as terms of art, the court accorded them their generally understood meanings.¹³⁸ Therefore, the court focused its analysis upon the nature of the executory real estate contract. Concluding that the specific contract at issue was binding upon the Pierces and Martins, the court noted that execution of such an instrument conveyed at least equitable title to the purchaser.¹³⁹ Consequently, the court concluded: (1) "such contracts satisfy the 'actual and complete' replacement requirement of the replacement cost provision;" and (2) "the obligation the insureds incur by virtue of such contracts satisfies the 'money actually spent' requirement of the provision."¹⁴⁰

The legal effect of the executory real estate contract was the most influential factor in *Pierce*. An enforceable executory real estate contract conveys equitable title to the vendee and treats him as the owner of the property.¹⁴¹ Executory contracts, which are premised on the doctrine of equitable conversion, allow the vendor to retain legal title while holding the title in trust for the vendee.¹⁴² Most compelling, however, is the fact that vendors under an executory real estate contract have various remedies against a defaulting vendee.¹⁴³

4. *Who must repair or replace?*

The principle of indemnity, from both a theoretical and a practical perspective, is the most distinguishing feature between actual cash value and replacement cost coverage. As expressed earlier, an actual cash value policy is a pure indemnity contract, while replacement cost coverage is not.¹⁴⁴ Despite this distinction, in resolving the issue of who must repair or replace, courts have chosen to apply this most fundamental principle of property insurance to replacement cost coverage litigation.

137. *Id.* at 552.

138. *See id.* at 555.

139. *See id.*

140. *Id.* at 556.

141. *See id.* at 555.

142. *See id.*

143. *See id.* at 556. Vendors may elect:

(1) [t]o keep good their tender of performance, demand the balance of the purchase price and sue for specific performance; (2) to terminate the contract because of the vendee's breach, keep their land and sue for damages for the breach; (3) to rescind the contract in toto; or (4) to enforce a forfeiture under the statute.

Id.

144. *See supra* notes 3-14 and accompanying text.

The issue of who must repair or replace has shown itself particularly susceptible to the indemnity analysis.¹⁴⁵ The primary objective of indemnity is to compensate an insured for loss suffered.¹⁴⁶ The doctrine's application in the property insurance context, however, is limited to pecuniary losses.¹⁴⁷ This aspect of indemnification has been juxtaposed onto the law of replacement cost coverage. Consequently, replacement cost requires not only a replacement but also pecuniary loss of money spent by the insured to replace the property.¹⁴⁸ Otherwise, the replacement cost coverage would encourage moral hazard and constitute a contract of wager.¹⁴⁹

In *Paluszek v. Safeco Insurance Co. of America*,¹⁵⁰ the court articulated the contours of the indemnity analysis. The plaintiff, Mary Paluszek, purchased a homeowner's policy from defendant.¹⁵¹ The insured property sustained extensive fire damage approximately ten months later.¹⁵² Although there was evidence that the fire was started by arson, Safeco decided to provide coverage.¹⁵³ Shortly thereafter, the parties disagreed over contractor bids for the repair of the house. After three months passed without any repair work or agreement on a contractor, Safeco sent the plaintiff two checks, one for \$36,371.30 and one for \$2750.94, together representing the actual cash value of the property.¹⁵⁴ This payment complied with the policy's terms, which provided that Safeco would not be liable for losses exceeding the property's actual cash value until repair or replacement was complete.¹⁵⁵

Following receipt of the actual cash value proceeds, the parties reached an agreement on a contractor's bid to repair the house for \$41,286.56.¹⁵⁶ Shortly thereafter, the plaintiff sold the damaged house in an "as is" condition without making any repairs or notifying Safeco of the sale.¹⁵⁷ After the sale of the damaged structure, the plaintiff sued Safeco for [\$2164.32], the difference between the ac-

145. See, e.g., *Harrington v. Amica Mut. Ins. Co.*, 645 N.Y.S.2d 221 (App. Div. 1996) (denying replacement cost proceeds when insured sold house to a third party who paid for repairs).

146. See *id.* at 223.

147. See *id.* at 224 (rejecting plaintiff's claims because he had no "costs—he spent nothing to replace the dwelling").

148. See *id.* at 228.

149. See *id.* ("[W]ithout [these requirements], the replacement cost provision becomes a mere wager.").

150. 517 N.E.2d 565 (Ill. App. Ct. 1987).

151. See *id.* at 565. The policy insured against losses due to fire. See *id.*

152. See *id.*

153. See *id.* at 566.

154. See *id.* The additional check for \$2,750.94 represented the correction of an error in the original calculation of the dwelling's actual cash value. See *id.*

155. See *id.* at 565-67.

156. See *id.* at 567.

157. See *id.*

tual cash value (\$39,122.24) and the agreed cost of repairing the structure (\$41,286.56).¹⁵⁸

Safeco argued that plaintiff was not entitled to replacement cost proceeds because she sold the premises prior to repairs.¹⁵⁹ Because the plaintiff expended nothing in the repair of the premises, which was performed by the purchaser, providing her any additional proceeds would result in a windfall.¹⁶⁰ The plaintiff contended that, since the pertinent policy language limited Safeco's liability to "actual cash value of the damaged property unless and until actual repair or replacement is completed" did not specify who was to make the repairs, she was entitled to the full repair amount.¹⁶¹

The court, relying upon indemnity, the most fundamental principle of property insurance, concluded that the provision required that the repair be made by the insured.¹⁶² Specifically, the court observed that the right to be indemnified is personal to the individual insured and does not attach to the property and, thus, inure to the benefit of subsequent owners.¹⁶³ Property insurance contracts, therefore, are agreements to compensate for loss actually sustained by the insured and not those suffered by subsequent owners. Because plaintiff expended no money for the repair of the premises, she had not sustained the type of pecuniary loss replacement cost provisions were designed to compensate.¹⁶⁴

Paluszek certainly illustrates the majority view with regard to the issue of who must repair or replace.¹⁶⁵ However, case law does reflect some judicial leniency with regards to what constitutes a pecuniary loss. For example, in *Machson v. Wausau Underwriters Insurance Co.*,¹⁶⁶ the plaintiff had purchased fire insurance for a restaurant from defendant.¹⁶⁷ Plaintiff owned the premises and leased them to a lessor who subsequently sublet the premises to another operator.¹⁶⁸ The premises were destroyed by fire on October 26, 1982, and plaintiff received proceeds representing the actual cash value of the loss.¹⁶⁹

Following the fire, plaintiff leased the land to Wendy's International, Inc.¹⁷⁰ In the lease, Wendy's agreed to build a new building at its expense to replace the one that had burned. Plaintiff spent no

158. *See id.*

159. *See id.*

160. *See id.*

161. *Id.* at 567-68.

162. *See id.* 568.

163. *See id.*

164. *See id.*

165. *See also* *Harrington v. Amica Mut. Ins. Co.*, 645 N.Y.S.2d 221 (App. Div. 1996) (discussed *supra* notes 144-49 and accompanying text).

166. No. C.A.85C-FE-103, 1986 WL 8179 (Del. Super. Ct. July 24, 1986).

167. *See id.* at *1.

168. *See id.*

169. *See id.*

170. *See id.*

money on this new building.¹⁷¹ However, she subsequently sought to recover replacement cost proceeds from defendant.¹⁷²

Defendant argued that the applicable policy provision clearly required that the plaintiff actually incur replacement expenses in order to recover.¹⁷³ The provision provided: "The Company shall not be liable under this endorsement for any loss unless and until the damaged or destroyed property is actually repaired or replaced by the insured with due diligence and dispatch."¹⁷⁴ The court agreed that this position was literally correct.¹⁷⁵ Despite this literal language, the court examined the facts for evidence of payment by the insured in a form other than actual cash. Thus, the court formulated the relevant question as: "Did plaintiff, in effect, pay for the replacement, not in actual cash, but by giving up other substantial rights in its agreement with Wendy's which she would otherwise have had without the requirement that Wendy's do the reconstruction?"¹⁷⁶ The court, without the benefit of a detailed record, concluded that "in all probability" the replacement by Wendy's was not a "gratuity" and that, in all likelihood, plaintiff paid for the reconstruction by giving up a valuable right.¹⁷⁷ However, rather than resolve the case on the basis of its own assumptions, the court denied both parties' motions for summary judgment.¹⁷⁸ Despite the ultimate ruling in *Machson*, the court clearly expressed the sentiment that where the insured retains full title, both legal and equitable, and the premises are repaired by a third party, something other than the actual payment of money could constitute a pecuniary loss.¹⁷⁹

II. EXCEPTIONS TO THE ACTUAL REPAIR OR REPLACEMENT REQUIREMENT

Much of the allure of the rule that actual repair or replacement is a condition precedent to the recovery of replacement cost stems from the rule's effective balancing of the insured's interest in obtaining protection against depreciation with the insurance industry's interest in reducing the risk of moral hazard, unjust enrichment, and fraud.¹⁸⁰ Equally appealing is that loss settlement provisions achieve this balance without undue inconvenience to insureds. Though the nearly universal appeal of the rule requiring actual replacement is beyond doubt, decisional law recognizes that,

171. *See id.*

172. *See id.*

173. *See id.* at *2.

174. *Id.* at *1.

175. *See id.* at *2.

176. *Id.*

177. *Id.*

178. *See id.* at *3.

179. *See id.*

180. *See supra* Part I.A.3.

when conduct attributable to the insurance company unduly disturbs the balance between the interests of the parties to the contract, performance by the insured may be excused. Accordingly, the replacement cost proceeds are awarded to the insured as a remedy for breach of contract.

A. *Impossibility or Frustration*

As has been the case throughout the development of the law of replacement cost coverage, courts have relied upon principles of contract interpretation to explain those situations in which the insured's performance of the actual repair or replacement requirement is excused.¹⁸¹ The requirement is usually excused where the insurer's conduct frustrates or makes performance impossible. For example, in *Bailey v. Farmers Union Co-Operative Insurance Co.*,¹⁸² the plaintiff, a single, disabled, mother of two children, acquired a homeowner's policy from defendant.¹⁸³ The policy provided replacement cost coverage up to \$52,000.¹⁸⁴ Following a collapse of the house due to negligent renovations, defendant's agent sought to deny plaintiff the insurance proceeds.¹⁸⁵ The policy clearly provided coverage for loss resulting from collapse of plaintiff's house. However, upon determining that the loss was covered under the policy, defendant's agent contemplated using a number of defenses to avoid paying plaintiff the policy proceeds.¹⁸⁶ Several months after the loss, defendant wrote a letter to plaintiff containing a final offer of settlement.¹⁸⁷ The amount offered to settle the entire claim was \$11,900, the actual cash value of the home less the deductible.¹⁸⁸ Defendant at all times maintained that plaintiff's claim was doubtful and disputable.¹⁸⁹

Plaintiff subsequently rejected the offer of settlement and informed defendant that she wished to exercise her option to make an immediate claim for actual cash value and then make a claim within 180 days for any additional replacement costs.¹⁹⁰ Defendant later informed plaintiff "that the actual cash value figure was the total value of the claim and that Farmers Union would not cover repair and replacement costs."¹⁹¹ Later still, after much correspon-

181. See, e.g., *Bailey v. Farmers Union Coop. Ins. Co.*, 498 N.W.2d 591, 598-99 (Neb. Ct. App. 1992) (applying "general principle of contract law" to excuse actual replacement).

182. *Id.*

183. See *id.* at 594.

184. See *id.*

185. See *id.* at 594-96.

186. See *id.* at 595.

187. See *id.*

188. See *id.*

189. See *id.* at 596.

190. See *id.*

191. *Id.*

dence between the parties, defendant offered to purchase plaintiff "another dwelling of like kind and quality . . . as this involve[s] the least amount of cost of [our] three settlement options."¹⁹² Plaintiff rejected this offer because she wanted to rebuild her home on the original site.¹⁹³

As a consequence of defendant's refusal to pay plaintiff the actual cash value proceeds of the policy and additional living expenses, plaintiff was forced to send her children to stay with friends and secure temporary lodging for herself with her estranged sister.¹⁹⁴ Plaintiff eventually rented an apartment, and, against her physician's advice, was forced to get a job to pay the rent and maintain the mortgage on the destroyed premises.¹⁹⁵

Finally, negotiations reached an impasse and plaintiff filed suit against the defendant alleging breach of contract and bad faith.¹⁹⁶ During the trial, defendant asserted that plaintiff was not entitled to replacement cost coverage because of her failure to comply with the policy requirement that she rebuild or repair the insured premises within 180 days and make claim for the cost of such replacement.¹⁹⁷ Plaintiff contended that she at all times desired to replace the structure but was prevented from doing so by the conduct of the defendant.¹⁹⁸ Plaintiff's desire to immediately replace her home was sufficiently supported by the evidence.¹⁹⁹ Similarly, defendant's persistent efforts to deprive plaintiff of the proceeds of the policy and her right to immediately claim actual cash value were clearly evidenced in the claims file.²⁰⁰ Concluding that defendant's conduct prevented plaintiff from rebuilding the house, the court applied the rule that "[a] condition is excused if the occurrence of the condition is prevented by the party whose performance is dependent upon the condition."²⁰¹

192. *Id.*

193. *See id.*

194. *See id.* at 594.

195. *See id.* at 596.

196. *See id.* at 596-97.

197. *See id.* at 598.

198. *See id.*

199. *See id.*

200. *See id.* at 597.

201. *Id.* at 598. This is a universal principle of contract law. *See, e.g., Zobel & Dahl Constr. v. Crotty*, 356 N.W.2d 42, 45 (Minn. 1984) ("[E]very contract contains an implied condition that each party will not unjustifiably hinder the other from performing."). The RESTATEMENT (SECOND) OF CONTRACTS § 245 cmt. a (1979) provides:

Excuse of non-occurrence of condition. Where a duty of one party is subject to the occurrence of a condition, the additional duty of good faith and fair dealing imposed on him under [section] 205 may require some cooperation on his part, either by refraining from conduct that will prevent or hinder the occurrence of that condition or by taking affirmative steps to cause its occurrence . . . Under this Section it has the further effect of excusing the non-occurrence of the condition it-

Instances in which courts have excused performance of the condition precedent of repair and replacement are factually similar.²⁰² Courts typically excuse performance if the insurer wrongfully withholds payment of the actual cash value proceeds and engages in conduct that: (1) manifests a callous disregard of the insured's rights under the policy;²⁰³ (2) is extreme or outrageous and designed to deprive the insured of its rights under the policy;²⁰⁴ or (3) manifests an absence of good faith.²⁰⁵ Ultimately, whether performance of the condition precedent is excused depends upon whether the insurer acted in good faith during the claims process.²⁰⁶ Good faith on the part of the insurer operates as an adhesive.²⁰⁷ This adhesive binds the parties to the terms of the agreement even though it may later be determined that the insurer was wrong by initially determining that the insured's loss was not covered by the policy.²⁰⁸

B. Estoppel

Estoppel is an equitable doctrine intended to prevent the party against whom it is asserted from taking an unconscionable, unjust, or inequitable advantage of his own wrong by asserting an otherwise valid legal right.²⁰⁹ The existence of estoppel depends upon the facts of the individual case and is ordinarily treated as a question of fact for the jury to determine.²¹⁰ The party asserting equitable estoppel must prove that the party to be estopped had:

self, so that performance of the duty that was originally subject to its occurrence can become due in spite of its non-occurrence. The rule stated in this Section only applies, however, where the lack of cooperation constitutes a breach, either of a duty imposed by the terms of the agreement itself or of a duty imposed by a term supplied by the court.

Id. (citation omitted).

202. See, e.g., *Zaitchick v. American Motorists Ins. Co.*, 554 F. Supp. 209, 217 (S.D.N.Y. 1982), *aff'd*, 742 F.2d 1441 (2d Cir. 1983); *State Farm Fire & Cas. Ins. Co. v. Miceli*, 518 N.E.2d 357, 362 (Ill. App. Ct. 1987); *McCahill v. Commercial Union Ins. Co.*, 446 N.W.2d 579, 585 (Mich. Ct. App. 1989); *Pollock v. Fire Ins. Exch.*, 423 N.W.2d 234, 237 (Mich. Ct. App. 1988).

203. See, e.g., *Zaitchick*, 554 F. Supp. at 217; *Miceli*, 518 N.E.2d at 362.

204. See, e.g., *McCahill*, 446 N.W.2d at 582-83.

205. See, e.g., *Pollock*, 423 N.W.2d at 237.

206. See, e.g., *Smith v. Michigan Basic Property Ins. Ass'n*, 490 N.W.2d 864, 867-68 (Mich. 1992). The *Smith* holding has been superseded by statute. See *Salesin v. State Farm Fire & Casualty Co.*, 581 N.W.2d 781, 787 (Mich. Ct. App. 1998).

207. See *Smith*, 581 N.W.2d at 787.

208. See *id.*

209. See 28 AM. JUR. 2D *Estoppel and Waiver* § 35 (1966).

210. As a general rule, the question of estoppel is for the jury, and it is only when the facts are undisputed and the inferences therefrom are plain and incapable of reasonable doubt or difference of opinion that it may be a question of law for the court. See, e.g., *Taylor v. Waters*, 477 So. 2d 441, 443 (Ala. Civ. App. 1985); *Morgan v. Hays*, 426 P.2d 647, 655 (Ariz. 1967) (en banc) (stating waiver is a question of fact for the jury); *Aetna Cas. & Sur. Co. v. Aceves*, 233 Cal. App.

(1) [acted in a manner] which amounts to a false representation or concealment of material facts, or, at least, which is calculated to convey the impression that the facts are otherwise than, and inconsistent with, those which the party subsequently attempts to assert; (2) the intention, or at least the expectation, that such conduct shall be acted upon by, or influence, the other party or other persons; and (3) knowledge, actual or constructive, of the real facts.²¹¹

The party claiming estoppel must also show proof that he himself had:

(1) [a] lack of knowledge and of the means of knowledge of the truth as to the facts in question; (2) reli[ed], in good faith, upon the conduct or statements of the party to be estopped; and (3) action or inaction based thereon of such a character as to change the position or status of the party claiming the estoppel, to his injury, detriment, or prejudice.²¹²

The decisional law regarding replacement cost coverage reflects that the same facts supporting the impossibility or frustration exception to the actual repair or replacement requirement would also support the existence of an estoppel claim. This may explain the absence of decisional law in which courts have relied upon estoppel as the basis for their decision. In the single case where estoppel was expressly asserted by the plaintiff, *Zaitchick v. American Mo-*

3d 544, 556 (Ct. App. 1991); *Duren, Inc. v. City of Lakewood*, 709 P.2d 74, 76 (Colo. Ct. App. 1985); *Hanover Ins. Co. v. Fireman's Fund Ins. Co.*, 586 A.2d 567, 572 (Conn. 1991); *United Sec. Corp. v. Verene*, 193 A.2d 429, 431 (D.C. Ct. App. 1963); *Six L's Packing Co. v. Florida Farm Bureau Mut. Ins. Co.*, 268 So. 2d 560, 564 (Fla. Dist. Ct. App. 1972); *Pantle v. Industrial Comm'n*, 335 N.E.2d 491, 494 (Ill. 1975); *Lee v. Ohio Cas. Ins. Co.*, 373 N.E.2d 1027, 1031 (Ill. App. Ct. 1978); *Sprowl v. Eddy*, 547 N.E.2d 865, 868 (Ind. Ct. App. 1989); *Bowen v. Westerhaus*, 578 P.2d 1102, 1107 (Kan. 1978); *McKenzie v. Oliver*, 571 S.W.2d 102, 106 (Ky. Ct. App. 1978); *Campione v. Wilson*, 661 N.E.2d 658, 665 (Mass. 1996); *L & H Transp., Inc. v. Drew Agency, Inc.*, 403 N.W.2d 223, 227 (Minn. 1987); *Olszak v. Peerless Ins. Co.*, 406 A.2d 711, 714 (N.H. 1979); *Jersey Discount Co. v. Aetna Ins. Co.*, 25 A.2d 506, 507 (N.J. 1942); *Western Cas. & Sur. Co. v. City of Santa Fe*, 504 P.2d 17, 20 (N.M. 1972); *Reeve v. General Accident Ins. Co.*, 658 N.Y.S.2d 143, 145 (1997); *Brendle v. Shenandoah Life Ins. Co.*, 76 N.C. App. 271, 277, 332 S.E.2d 515, 519 (1985); *Hanson v. Cincinnati Life Ins. Co.*, 571 N.W.2d 363, 367 (N.D. 1997); *Northern Assurance Co. of Am. v. Stan-Ann Oil Co.*, 603 S.W.2d 218, 223 (Tex. Civ. App. 1979).

211. 28 AM. JUR. 2D *Estoppel and Waiver* § 35.

212. *Id.*; see also *Blue Cross & Blue Shield, Inc. v. Taylor*, 370 So. 2d 1040, 1042 (Ala. Civ. App. 1979) (stating the party claiming estoppel must also show proof that he had: (1) a lack of knowledge and of the means of knowledge of the truth as to the facts in question; (2) relied, in good faith, upon the conduct or statements of the party to be estopped; and (3) action or inaction based thereon of such a character as to change the position or status of the party claiming the estoppel, to his injury, detriment, or prejudice); *Horne v. Exum*, 419 S.E.2d 147, 148-49 (Ga. Ct. App. 1992) (same).

torists Insurance Co.,²¹³ the court based its determination that the actual repair or replacement requirement was excused on the theory of impossibility, and not on estoppel.²¹⁴ Furthermore, of the cases cited in one of the leading replacement cost coverage commentaries supporting estoppel, all but one were actually based on frustration or impossibility.²¹⁵ In the single exception, *Maine Mutual Fire Insurance Co. v. Watson*,²¹⁶ the court failed to articulate any doctrinal basis for its decision to excuse the insured's performance of the condition precedent of actual repair.²¹⁷

In *Maine Mutual*, the insurer engaged in conduct designed to prevent the insured from asserting his right to replacement cost coverage.²¹⁸ The insurer's conduct included "the blatant misrepresentation of the policy language."²¹⁹ This conduct led the insured to believe that he had to rebuild completely or replace the home within 180 days of the fire or otherwise forfeit his replacement cost claim.²²⁰ Likewise, the insurer attempted initially to deny the insured his right to actual cash value proceeds.²²¹ In the words of the court, "[t]o agree with the [insurer] would be to allow a party to take advantage of his own wrong, which we will not countenance."²²² This observation bespeaks of equitable considerations that support the conclusion that the court implicitly based its ultimate decision on the principle of estoppel. However, neither estoppel nor impossibility was expressly articulated as the rationale for the case.

Though the same facts can serve as the basis for application of both the estoppel and impossibility exceptions, neither doctrine renders the other superfluous. Each principle is distinct. Estoppel requires a much higher threshold of proof than impossibility. However, estoppel is attractive because it is ordinarily treated as a question of fact for the jury to determine.²²³ Consequently, the assertion of estoppel might entitle the insured to a jury trial.²²⁴

213. 554 F. Supp. 209 (S.D.N.Y. 1982).

214. *See id.* at 217.

215. *See* Randy R. Koenders, Annotation, *Construction and Effect of Property Insurance Provision Permitting Recovery of Replacement Cost of Property*, 1 A.L.R.5th 817, § 13a (1992).

216. 532 A.2d 686 (Me. 1987).

217. *See id.* at 688.

218. *Id.* at 689.

219. *Id.*

220. *See id.* at 687.

221. *See id.*

222. *Id.* at 689.

223. *See* *Messick v. Star Enter.*, 655 A.2d 1209, 1211 (Del. 1995), *aff'd*, No. 130,1998, 1998 WL 986035 (Del. Nov. 30, 1998).

224. *See supra* note 20 (comparing questions of law and questions of fact).

C. Unconscionability

Courts are ordinarily only concerned with the legality of contracts.²²⁵ Consequently, a contract containing clear and unambiguous language, which is not the result of fraud, duress, undue influence, or mistake, is usually enforced according to its terms. Nevertheless, courts are not powerless and, if the circumstances of the case require, may ignore this rule and examine the wisdom and fairness of a contract. A court may refuse to enforce a contract or any clause contained therein if it determines that the contract or clause was unconscionable at the time it was made.²²⁶

An unconscionable contract is one that no person "in his senses and not under delusion would make . . . and [that] no honest and fair man would accept."²²⁷ The doctrine of unconscionability allows the court to rule directly on the validity of the contract, or clause therein, without having "to avoid unconscionable results by interpretation."²²⁸ A contract is unconscionable if two conditions exist: (1) one of the parties to the contract lacked a meaningful choice about whether to accept the provision in question; and (2) the challenged provision unreasonably favors the other party.²²⁹ The applicability of unconscionability to replacement cost coverage was first examined by the court in *Ferguson v. Lakeland Mutual Insurance Co.*²³⁰ In *Ferguson*, the plaintiffs' organ was destroyed when struck by lightning.²³¹ Plaintiffs subsequently filed a claim with defendant for destruction of the organ under their homeowner's policy.²³² Defendant disputed the claim and the plaintiffs were forced to file suit.²³³

The trial court instructed the jury to disregard the policy provision requiring the plaintiffs to actually repair or replace the organ before receiving the replacement value of the organ.²³⁴ The court further observed that this "provision [was] oppressive and unfair since it required [plaintiffs] to expend a large sum of money prior to a liability determination."²³⁵ The jury ultimately returned a verdict in favor of plaintiffs and against defendant in the amount of

225. See *Joseph v. Donover Co.*, 261 F.2d 812, 824 (9th Cir. 1958).

226. See RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981).

227. *Hume v. United States*, 132 U.S. 406, 411 (1889). Similarly, see *Lloyd v. Service Corp.*, 453 So. 2d 735, 739 (Ala. 1984) and *Barnes v. Helfenbein*, 548 P.2d 1014, 1020 (Okla. 1976).

228. RESTATEMENT (SECOND) OF CONTRACTS § 208 cmt. a.

229. See *id.* § 208 cmt. d.; see also *Wilson v. World Omni Leasing, Inc.*, 540 So. 2d 713, 716 (Ala. 1989); *Rodgers v. Tecumseh Bank*, 756 P.2d 1223, 1226 (Okla. 1988); *Koval v. Liberty Mut. Ins. Co.*, 531 A.2d 487, 491 (Pa. Super. Ct. 1987).

230. 596 A.2d 883 (Pa. Super. Ct. 1991).

231. *Id.* at 884.

232. See *id.*

233. See *id.*

234. See *id.*

235. *Id.*

\$23,317.40.²³⁶ The parties agreed that the actual cash value of the organ was \$5700.²³⁷

On appeal, the defendant argued that a court could not refuse to enforce a clear and unambiguous replacement coverage provision.²³⁸ The appellate court agreed with this contention as the basic proposition. However, it observed that "a court may on occasion be justified in deviating from the plain language of a contract of insurance."²³⁹ According to the court of appeals, a finding that a contract, or one of its provisions, is unconscionable would support a decision to deviate from otherwise clear and unambiguous language.²⁴⁰

Whether a contract is unconscionable is a question of law to be determined by the court.²⁴¹ The *Ferguson* court was guided in its decision by the two-pronged test previously expressed, a lack of meaningful choice and a provision unreasonably favoring a party.²⁴² To find a lack of a meaningful choice about whether to accept the contract, the court observed that insurance policies are essentially adhesion contracts.²⁴³ The court expressed that the definitive characteristic of such contracts is the weaker party's lack of a realistic choice as to its terms.²⁴⁴ The court also found that the challenged provision unreasonably favors the other party since the insurer denied liability and the insureds were faced with the dilemma of either accepting the lower actual cash value of the organ or expending a large sum of money in replacement costs without a guarantee of reimbursement.²⁴⁵ Accordingly, the replacement cost provision in question was unconscionable and, thus, void as a matter of public policy.²⁴⁶

Unconscionability, unlike impossibility and estoppel, has never been sanctioned as a reason for excusing the actual repair or replacement requirement by the court of last resort in any jurisdiction. Furthermore, only one other appellate court has used unconscionability to avoid the condition precedent of actual repair or replacement.²⁴⁷ That decision was subsequently overruled by the court of last resort.²⁴⁸ Consequently, the validity of unconscionabil-

236. *See id.*

237. *See id.*

238. *See id.*

239. *Id.* at 885.

240. *See id.*

241. *See id.*; RESTATEMENT (SECOND) OF CONTRACTS § 208 cmt. f (1981).

242. *See supra* note 229 and accompanying text.

243. *See Ferguson*, 596 A.2d at 885.

244. *See id.*

245. *See id.*

246. *See id.*

247. *See Coblentz v. Oklahoma Farm Bureau Mut. Ins. Co.*, 915 P.2d 938, 940 (Okla. Ct. App. 1995), *overruled by Bratcher v. State Farm Fire & Cas. Co.*, 961 P.2d 828 (Okla. 1998).

248. *See Bratcher*, 961 P.2d at 831.

ity as a grounds for excusing performance of the condition precedent of actual repair or replacement is uncertain.

D. Ambiguity

Ambiguity is one of the oldest and most implemented variance principles.²⁴⁹ The rule of ambiguity is simply that an ambiguity in an insurance policy will be construed against its drafter and in favor of the non-drafting party.²⁵⁰ A contract is ambiguous when a word, phrase, or provision in the contract has, or is susceptible to, more than one reasonable interpretation when the policy is read as a whole.²⁵¹ Ambiguity in an insurance contract can arise from three sources: (1) inconsistent policy provisions;²⁵² (2) policy organization;²⁵³ and (3) ambiguous language.²⁵⁴ Whether an ambiguity exists

249. See ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES* §6.3, at 628 (2d ed. 1988).

250. See *id.*

251. See, e.g., *United States Fire Ins. Co. v. General Reinsurance Corp.*, 949 F.2d 569, 572 (2d Cir. 1991) (applying New York substantive law); *Federated Guar. Life Ins. Co. v. Dunn*, 439 So. 2d 1283, 1285 (Ala. Civ. App. 1983); *Delgado v. Heritage Life Ins. Co.*, 157 Cal. App. 3d 262, 271 (Ct. App. 1984); *National Cas. Co. v. Great Southwest Fire Ins. Co.*, 833 P.2d 741, 746 (Colo. 1992); *Murr v. Selag Corp.*, 747 P.2d 1302, 1310 (Idaho Ct. App. 1987); *United States Fire Ins. Co. v. Coleman*, 754 S.W.2d 941, 944 (Mo. Ct. App. 1988); *Union Ins. Co. v. Land & Sky, Inc.*, 529 N.W.2d 773, 776 (Neb. 1995); *Graber v. Engstrom*, 384 N.W.2d 307, 309 (N.D. 1986); *Weisman v. Green Tree Ins. Co.*, 670 A.2d 160, 161 (Pa. Super. Ct. 1996); *Gredig v. Tennessee Farmers Mut. Ins. Co.*, 891 S.W.2d 909, 912 (Tenn. Ct. App. 1994); *Universal C.I.T. Credit Corp. v. Daniel*, 243 S.W.2d 154, 157 (Tex. 1951); *Baehmer v. Viking Ins. Co.*, 827 P.2d 1113, 1115 (Wash. Ct. App. 1992); *Pilling v. Nationwide Mut. Fire Ins. Co.*, 500 S.E.2d 870, 872 (W. Va. 1997).

252. See, e.g., *Barnes v. Atlantic & Pac. Life Ins. Co.*, 325 So. 2d 143, 151 (Ala. 1975); *Home Indem. Co. v. City of Marianna*, 761 S.W.2d 171, 173 (Ark. 1988); *Coit v. Jefferson Standard Life Ins. Co.*, 168 P.2d 163, 169 (Cal. 1946); *Imperial Cas. & Indem. Co. v. State*, 714 A.2d 1230, 1237 (Conn. 1998); *Reliance Life Ins. Co. v. Lynch*, 197 So. 723, 727-28 (Fla. 1940) (Brown, J., dissenting); *Davis v. United Am. Life Ins. Co.*, 111 S.E.2d 488, 492 (Ga. 1959); *National Discount Shoes, Inc. v. Royal Globe Ins. Co.*, 424 N.E.2d 1166, 1171 (Ill. App. Ct. 1981); *Brumley v. Lee*, 963 P.2d 1224, 1226 (Kan. 1998); *Auto Club Ins. Ass'n v. DeLaGarza*, 444 N.W.2d 803, 805 (Mich. 1989); *Rusthoven v. Commercial Standard Ins. Co.*, 387 N.W.2d 642, 644-45 (Minn. 1986); *Oleson v. Farmers Ins. Group*, 605 P.2d 166, 169 (Mont. 1980); *American Shops, Inc. v. Reliance Ins. Co.*, 97 A.2d 513, 517 (N.J. Super. Ct. Law Div. 1953); *American Mfr. Mut. Ins. Co. v. Ingram*, 301 N.C. 138, 150, 271 S.E.2d 46, 53 (1980); *C.P.A. Co. v. Jones*, 263 P.2d 731, 734 (Okla. 1953); *Elliot Leases Cars, Inc. v. Quigley*, 373 A.2d 810, 813 (R.I. 1977); *Marson Coal Co. v. Insurance Co.*, 210 S.E.2d 747, 750 (W. Va. 1974).

253. See, e.g., *McRaven v. F-Stop Photo Labs, Inc.*, 660 S.W.2d 459, 462 (Mo. Ct. App. 1983); *Atwood v. Hartford Accident & Indem. Co.*, 365 A.2d 744, 746 (N.H. 1976).

254. See, e.g., *Vargas v. Ins. Co. of N. Am.*, 651 F.2d 838, 839-40 (2d Cir. 1981); *Columbia Heights Motors, Inc. v. Allstate Ins. Co.*, 275 N.W.2d 32, 34 (Minn. 1979); see also KEETON & WIDISS, *supra* note 249.

is a question of law.²⁵⁵ The determination that an ambiguity exists as a result of inconsistent policy provisions or poor policy organization requires little more than an examination of the entire policy and application of the controlling rule.²⁵⁶ However, determining whether policy language is ambiguous requires the application of a detailed legal analysis.

As expressed earlier, the interpretation of an insurance contract is primarily the responsibility of the court. In performance of this responsibility, courts are guided by the most fundamental principle of contract interpretation, that "[a]n insurance contract should be construed to carry out the intention of the parties, and that intention should be ascertained, if possible, from the language in the policy alone."²⁵⁷ This is the supreme rule and all other rules of construction are subservient to it.²⁵⁸

Consequently, ambiguity, no matter the source, "should first be resolved by giving effect to the intention of the parties."²⁵⁹ If the intention of the parties can be ascertained, the court should not con-

255. See *Columbia Heights*, 275 N.W.2d at 34.

256. See, e.g., *Davis*, 111 S.E.2d at 492; *Rusthoven*, 387 N.W.2d at 644-45; *Atwood*, 365 A.2d at 746-47.

257. *Wheeler v. Allstate Ins. Co.*, 814 P.2d 9, 10 (Colo. Ct. App. 1991). For expressions of similar views, see *Hall v. American Indemnity Group*, 648 So. 2d 556, 559 (Ala. 1994), *Home Indemnity Co. v. Wilson*, 489 P.2d 244, 247 (Ariz. 1971), *Floyd v. Otter Creek Homeowners Association*, 742 S.W.2d 120, 123 (Ark. Ct. App. 1988), *Bay Cities Paving & Grading, Inc. v. Lawyer's Mutual Insurance Co.*, 355 P.2d 1263, 1271 (Cal. 1993), *Hitz v. Allied American Mutual Life Insurance Co.*, 195 A.2d 446, 448 (Conn. Cir. Ct. 1963), *E.I. du Pont de Nemours & Co. v. Allstate Insurance Co.*, 686 A.2d 152, 155-56 (Del. 1996), *State Farm Fire & Casualty Insurance Co. v. Deni Associates, Inc.*, 678 So. 2d 397, 400 (Fla. Dist. Ct. App. 1996), *Luzar v. Western Surety Co.*, 692 P.2d 337, 341 (Idaho 1984), *Willison v. Economy Fire & Casualty Co.*, 690 N.E.2d 1073, 1075 (Ill. App. Ct. 1998), *Aetna Insurance Co. v. Rodriguez*, 504 N.E.2d 1030, 1032 (Ind. Ct. App. 1987), *rev'd*, 517 N.E.2d 386 (Ind. 1988), *Loyd v. Federal Kemper Life Assurance Co.*, 518 N.W.2d 374, 375 (Iowa 1994), *Farm Bureau Mutual Insurance Co. v. Old Hickory Casualty Insurance Co.*, 810 P.2d 283, 286 (Kan. 1991), *Benton v. Long Manufacturing N.C., Inc.*, 550 So. 2d 859, 860 (La. Ct. App. 1989), *Maine Drilling & Blasting, Inc. v. Insurance Co. of North America*, 665 A.2d 671, 675 (Me. 1995), *JMP Associates, Inc. v. St. Paul Fire & Marine Insurance Co.*, 693 A.2d 832, 834 (Md. 1997), *Western National Mutual Insurance Co. v. United States Fire Insurance Co.*, 269 N.W.2d 34, 36 (Minn. 1978), *Dairyland Insurance Co. v. Implement Dealers Insurance Co.*, 199 N.W.2d 806, 811 (Minn. 1972), *Peterson v. Continental Boiler Works, Inc.*, 783 S.W.2d 896, 901 (Mo. 1990), *Farm Bureau Insurance Co. v. Bierschenk*, 548 N.W.2d 322, 324 (Neb. 1996), *Caruso v. John Hancock Mutual Life Insurance Co.*, 57 A.2d 359, 360 (N.J. 1948), *Loya v. State Farm Mutual Insurance Co.*, 888 P.2d 447, 451 (N.M. 1994), *Hickman v. Saunders*, 645 N.Y.S.2d 49, 50 (1996), and *Employers Reinsurance Corp. v. Landmark*, 547 N.W.2d 527, 532 (N.D. 1996).

258. See 13 APPLEMAN & APPLEMAN, *supra* note 4, § 7385 (1976 & Supp. 1998).

259. *Board of County Comm'rs v. Colorado Counties Cas. & Property Pool*, 888 P.2d 352, 355 (Colo. Ct. App. 1994).

strue the policy in favor of either of the parties, but should give effect to the parties' mutual intentions.²⁶⁰

If an ambiguity exists as a result of a reading of the policy language, the court may resolve the ambiguity by resorting to extrinsic evidence.²⁶¹ The insurer must prove not only that the words and expressions used in the insurance contract are susceptible to the construction sought, but that it is the only reasonable construction that may fairly be placed on them.²⁶² Courts, in assessing whether the insurer's interpretation of the policy is the only reasonable one, are free to look beyond the language of the policy. Relevant considerations may include: (1) the ordinary meaning of the words in question; (2) how reasonable persons would construe the words in question; (3) availability of clearer language; and (4) the nature, type, and purpose of the insurance in question.²⁶³ If the court determines that the words and expressions are susceptible to more than one

260. See *id.*; see also *supra* note 257 and accompanying text.

261. Both patent and latent ambiguities may arise from the language used in insurance policies. See *C. & A. Constr. Co. v. Benning Constr. Co.*, 509 S.W.2d 302, 303 (Ark. 1974); *North Am. Philips Corp. v. Aetna Cas. & Sur. Co.*, No. 88C-JA-155, 1995 Del. Super. LEXIS 356, at *6 (Del. Super. Ct. Mar. 10, 1995); *Hall v. Equitable Life Assurance Soc'y*, 295 N.W. 204, 206 (Mich. 1940); *Koplin v. Franklin Fire Ins. Co.*, 44 A.2d 877, 878 (Pa. Super. Ct. 1945); *National Union Fire Ins. Co. v. CBI Indus., Inc.*, 907 S.W.2d 517, 520 (Tex. 1995).

A patent ambiguity exists when the language on its face is capable of more than a single interpretation and arises from the use of defective, obscure, or insensible language. See *Crown Management Corp. v. Goodman*, 452 So. 2d 49, 52 (Fla. Dist. Ct. App. 1984). "Extrinsic evidence is inadmissible if the ambiguity is patent, because such evidence would, in effect, allow the court to rewrite the contract for the parties by supplying information the parties themselves did not choose to include." *Id.* A latent ambiguity exists when patently unambiguous language becomes ambiguous when applied. "A latent ambiguity . . . is said to exist where a contract fails to specify the rights or duties of the parties in certain situations and extrinsic evidence is necessary for interpretation or a choice between two possible meanings." *Id.*

Although there appears to be some divergence of opinion as to when parol evidence is properly admitted because of the latent ambiguity—patent ambiguity dichotomy, the distinction between the type of ambiguity involved is one of form over substance. The growing and better reasoned trend of authority indicates that the introduction of parol evidence to probe the true intent of the parties is proper, irrespective of any technical classification of the type of ambiguity present.

Id.

262. See *Vargas v. Insurance Co. of N. Am.*, 651 F.2d 838, 840 (2d Cir. 1981). "The insurer is 'obliged to show (1) that it would be unreasonable for the average man reading the policy to (construe it as the insured does) and (2) that its own construction was the only one that fairly could be placed on the policy.'" *Id.* (quoting *Sincoff v. Liberty Mut. Fire Ins. Co.*, 183 N.E.2d 899, 901 (N.Y. 1962)).

263. See, e.g., *Vargas*, 651 F.2d at 840-42 (using a number of interpretive techniques to analyze the contract in question); *Jacobs v. Central Sec. Mut. Ins. Co.*, 551 N.E.2d 1059, 1061 (Ill. App. Ct. 1990) (explaining various considerations for the court if faced with an ambiguity).

meaning and that the insured's construction of same was reasonable, the rule of ambiguity is applied.²⁶⁴

Conflicting interpretations or opposite conclusions from different jurisdictions regarding the legal effect or meaning of policy language or provisions can also give rise to ambiguity.²⁶⁵ Thus, the doctrine of ambiguity has had a significant impact on the development of insurance contracts and has been the catalyst for the development of insurance policies containing clear and concise words and expressions. Courts almost universally agree that the words and expressions of replacement cost provisions are clear and unambiguous.²⁶⁶ As a result, ambiguity has rarely been applied in replacement cost coverage litigation.²⁶⁷

III. THE HUMAN FACTOR

The insurance industry has a valid interest in preventing moral hazard, unjust enrichment, and fraud. This interest must be balanced against the insured's interest in protecting her property against possible loss, including depreciation, and the public's interest in maintaining a proper balance between the two. Replacement cost provisions, for the most part, achieve an acceptable balance between these often competing interests.

The law of replacement cost coverage is a model of uniformity, certainty, and predictability. This achievement is to be heralded because the insurance industry has, for the most part, succeeded in fashioning a policy provision that, on its face, is virtually immune to

264. See *Vargas*, 651 F.2d at 839-40; *Jacobs*, 551 N.E.2d at 1061.

265. See *State Farm Mut. Auto. Ins. Co. v. Wilson*, 782 P.2d 727, 732 (Ariz. 1989); *Employers Mut. Liab. Ins. Co. v. Farm Bur. Mut. Ins. Co.*, 549 S.W.2d 267, 268 (Ark. 1977); *Upjohn Co. v. New Hampshire Ins. Co.*, 476 N.W.2d 392, 397 (Mich. 1991); *Maddox v. Colonial Life & Accident Ins. Co.*, 303 N.C. 648, 654, 280 S.E.2d 907, 910 (1981); *Cimarron Ins. Co. v. Travelers Ins. Co.*, 355 P.2d 742, 746-47 (Or. 1960). *But see* *FDIC v. American Cas. Co.*, 528 N.W.2d 605, 608 (Iowa 1995) (refusing to follow the view that an ambiguity arises merely because there is conflicting case authority); *Motorist Mut. Ins. Co. v. RSJ, Inc.*, 926 S.W.2d 679, 681 (Ky. Ct. App. 1996) (holding that conflicting judicial interpretation is a factor that warrants consideration in assessing the existence of ambiguity, but is in no way dispositive); *Sullins v. Allstate Ins. Co.*, 667 A.2d 617, 624 (Md. 1995) (stating that conflicting judicial interpretation is a factor that warrants consideration in assessing the existence of ambiguity, but is in no way dispositive); *Standard Life Ins. Co. v. Hughes*, 315 S.W.2d 239, 242 (Tenn. 1958) (recognizing that insurance policies will not be automatically construed against the insurer where judicial construction of the terms is clear); *Grain Dealers Mut. Ins. Co. v. McKee*, 943 S.W.2d 455, 459 (Tex. 1997) (declining to follow view that an ambiguity arises merely because there is conflicting case authority).

266. See *supra* note 15 and accompanying text.

267. *But see* *Sayes v. Safeco Ins. Co.*, 567 So. 2d 687, 689-90 (La. Ct. App. 1990); *Bourrie v. United States Fidelity & Guar. Ins. Co.*, 707 P.2d 60, 63 (Or. Ct. App. 1985).

legal challenge. Nevertheless, it is possible for a fly to enter the ointment. That fly is the human factor.

The human factor involves the individual representatives of insurance companies and how they conduct themselves during the sales and distribution of insurance policies and handling of insurance claims. Decisional law imposes upon insurers a contractual and tort obligation of good faith and fair dealing.²⁶⁸ Breach of the contractual obligation supports an award of replacement cost proceeds despite the fact that the condition of actual repair or replacement has not been performed.²⁶⁹ Good faith and fair dealing, in the context of the latter obligation, require that insurers exercise reasonable care in dealing with, or otherwise disposing of, insurance claims. A failure to exercise reasonable care or other opprobrious conduct on the part of the insurer operates as a catalyst that transforms the breach of contract claim into one sounding in tort.²⁷⁰

268. *See State Farm Fire & Cas. Co. v. Nicholson*, 777 P.2d 1152, 1156-57 (Alaska 1989).

269. *See id.* at 1153 & n.1.

270. Several commentators provide a detailed discussion of bad faith and other possible tort claims that might arise as a result of unreasonable conduct by the insurer. *See, e.g.*, WILLIAM M. SHERNOFF ET AL., *INSURANCE BAD FAITH LITIGATION* §§ 1.01-1.08 (1994) (discussing the evolution and development of the tort of bad faith); PAUL J. SKOK, *ATTORNEY'S GUIDE TO INSURANCE COVERAGE AND BAD FAITH* (1994 & Supp. 1998); DENNIS J. WALL, *LITIGATION AND PREVENTION OF INSURER BAD FAITH* (2d ed. 1994).