
THE SANTA ANA WIND-DRIVEN **2007 SOUTHERN CALIFORNIA** **WILDFIRES**



A Preliminary First-Party Factual and Legal Analysis of the Santa Ana Wind-Driven Wildfires



Thomas M. Jones, Esquire
800-423-1950
TJones@cozen.com

Joann Selleck, Esquire
800-782-3366
JSelleck@cozen.com

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San Diego Office: 501 West Broadway, Suite 1610, San Diego, CA 92101 • 619-234-1700 • 800-782-3366

www.cozen.com

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These materials are intended to generally educate the participants on current legal issues. Accordingly, these materials should not be relied upon without seeking specific legal advice on matters discussed herein.

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Michael Hamilton

Richard Mackowsky

Richard Mason

Abby Sacunas

Marvin Velastegui

John L. Williams

* * * * *

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COVERAGE ISSUES PERTAINING TO
THE 2007 SOUTHERN CALIFORNIA WILDFIRES

I. INTRODUCTION

In the early morning hours of October 21, 2007, the Santa Ana winds, which blow from the desert to the Pacific Ocean, produced estimated gusts of 110 miles per hour. The winds led to one of the worst fire disasters in California's history. By mid-week, 23 wildfires were burning in seven counties from Santa Barbara to the United States border south of San Diego. The fires damaged more than 600 square miles of public, residential, commercial and agricultural land, an area more than twice the size of New York City. Remarkably, there were only 10 fire-related fatalities.

The cost to insurers for this Santa Ana driven conflagration is estimated to exceed \$1.6 billion. The fires destroyed in excess of 2,000 homes and damaged hundreds of businesses. More than one million people evacuated their homes and businesses as more than 10,000 fire fighters battled the fires. Power and water was cut off in numerous communities. Two major north/south freeways and a primary east/west freeway were closed. Numerous surface streets were also closed to regular traffic to allow for evacuations and use by emergency vehicles. The mayor in at least one city ordered all but essential personnel to avoid travel to work. The state and federal governments declared states of emergency. City and county offices, businesses and key tourist attractions closed.

CAT teams arrived and adjusters began the process of responding to an onslaught of claims. Cozen O'Connor has prepared this overview of first-party property insurance issues. It addresses many of the situations that may arise from the Santa Ana wind-driven fires. The overview provides information regarding *general* developments in the context of pertinent

coverages and offers practical observations. In that regard, readers should consult with counsel in order to obtain specific advice with respect to specific claims, issues and policy language.

II. FIRE FACTS

A. Sequence of Events

Saturday, October 20, 2007

The Santa Ana winds, forecasted to last for the better part of a week, blew into southern California on October 20, 2007. The National Weather Service clocked wind gusts of 108 miles per hour at Whittaker peak.

Gusts of 85 miles an hour were common below mountain passes and canyons. The hot, dry winds led to several fires. The first fire quickly whipped into a 500 acre blaze shortly before 10:00 p.m. on Saturday, October 20th in the Angeles National Forest, northeast of Los Angeles County near the town of Piru.

Sunday, October 21, 2007

Residents were abruptly awoken on Sunday morning, October 21st, at approximately 5:00 a.m. when a canyon fire ignited in Malibu. Approximately 1,500 people evacuated their houses. By the end of the day, the fire tore through 1,200 acres of dry brush in the posh neighborhoods of Malibu.

As the Santa Ana winds continued to roar, the “Harris Fire” in eastern San Diego County erupted at 9:30 a.m. The Harris Fire left several dead, injured several fire fighters and burned throughout most of the week. At approximately 12:30 p.m., the “Witch Fire” ignited in northern San Diego County. The Witch Fire also burned for the majority of the week and forced the evacuation of numerous communities as it rapidly spread into the City of San Diego and the eastern communities of the County.

Within hours of the Witch Fire, the “Santiago Fire” started in the Silverado Canyon in Orange County. Before the day was over, several other fires blazed in southern California.

Monday, October 22, 2007

The Santa Ana winds continued to blow through southern California on Monday, October 22nd. Before sunrise, the “Rice Fire” erupted in eastern San Diego County, and forced tens of thousands of people to evacuate. Less than an hour later, the “Grass Valley Fire” near the Lake Arrowhead area in San Bernardino County destroyed 113 homes.

Within a few hours, the “Slide Fire” was reported in the San Bernardino mountains, also near Lake Arrowhead. It consumed more than 1,500 acres and 20 structures by the end of the day. The day finished with two additional fires, the “Cajon Fire” and a fire near Magic Mountain theme park in the Santa Clarita Valley. Before Monday was over, Governor Arnold Schwarzenegger declared a state of emergency in seven counties. San Diego had opened up Qualcomm Stadium, the home of the San Diego Chargers, to more than 10,000 evacuees.

Tuesday, October 23, 2007

Tuesday, October 23rd, brought little relief. The ferocious Santa Ana winds continued to impede airborne water tankers used to fight the massive fires. Before sunrise, the “Poomacha Fire” broke out in the Pauma Valley area of San Diego County. By mid-morning, Camp Pendleton was ablaze with the “Horno/Ammo” fire. Power lines from the San Onofre Nuclear Power Plant that crossed Camp Pendleton caused concern for the security of the power grid as the blaze moved across the open land separating San Diego and Orange County. The day ended with President Bush declaring a federal state of emergency for the seven-county region.

Wednesday, October 24, 2007

Although the fires would continue to burn for several more days, by Wednesday, October 24th, the Santa Ana winds began subsiding, thus allowing airborne water tankers and helicopters

to assist in the fire fighting activities on a much greater scale. Evacuation orders began to be lifted as the damage assessment got underway.

The fires damaged or destroyed 2,608 homes, 1,016 outbuildings, and nine commercial structures, burned 518,021 acres and caused 10 fire-related deaths. As of October 28th, 2007, a week after the fires started, six fires were still burning, only two of which were 50% contained. As of November 1st, two of the fires -- the Poomacha Fire and Santiago Fire-- continued to burn as a new Santa Ana wind was forecast.

All together, fire occurred in 23 areas from what has been designated as catastrophes 21 and 22 for the year 2007:

San Diego County

Poomacha Fire – 49,410 acres

Witch Fire – 197,990 acres

Harris Fire – 90,440 acres

Rice Fire – 9,472 acres

Horno/Ammo Fire – 21,004 acres

Wilcox Fire – 100 acres

Cajon Fire – 250 acres

McCoy Fire – 300 acres

Coronado Hills Fire – 300 acres

San Bernardino County

Slide Fire – 12,759 acres

Grass Valley Fire - 1,247 acres

Martin Fire – 123 acres

Walker Fire – 160 acres

Orange County

Santiago Fire – 28,400 acres

Los Angeles County

Ranch Fire – 58,401 acres

Canyon Fire – 4,565 acres

Magic Fire – 2,824 acres

Buckweed Fire – 38,356 acres

Meadowridge Fire – 40 acres

Santa Barbara County
Sedgewick Fire – 710 acres

Riverside County
Rosa Fire – 411 acres
Roca Fire – 270 acres

Ventura County
Nightsky Fire – 35 acres

See www.fire.ca.gov for dates and details of specific fires.

B. Weather/winds

Weather is the primary force that drives wildfires. Southern California's weather has a powerful ingredient; unusually strong, seasonal winds called Santa Anas that erratically gust through mountains and valleys packed with homes. Santa Ana winds are a meteorological phenomenon that occurs primarily in the fall in southern California. High pressure air moves into the Nevada, Utah and Arizona deserts and pushes up against the San Gabriel mountains. Dry desert air is pushed westward through the canyons into California and the air compressed by the winds heats up. Santa Ana winds can be strong enough to uproot trees and lift roofs from houses. Given their devastating impact, the Santa Ana winds have been called "Devil's Breath" and "Satan Winds"

The Santa Ana winds not only led to many wildfires, they also caused the spread of many wildfires. At one point, the winds measured 111 mph, the speed of a Category 3 hurricane. The erratic and shifting winds which led to the fire storm began to abate on Wednesday, October 24, 2007, dropping to a sustained 15 – 35 mph wind and continued to diminish after having caused extensive damage. ISO's Property Claim Service Catastrophe Bulletin dated October 26, 2007 concluded that the devastation from CAT Serial No. 22 resulted from the Santa Ana winds. Similarly, Governor Schwarzenegger's October 21, and November 2, 2007 State of Emergency

Proclamations acknowledged the extensive damage caused by the extreme winds in all seven counties of Southern California.

C. Evacuation Orders

As of Monday, October 22nd, authorities in San Diego County had made reverse 911 calls to some 346,000 homes, warning people to evacuate. During the week of the fires more than one million people throughout southern California were ordered to evacuate their homes. By midday, Friday October 26th, about 45,000 San Diego County residents were still under mandatory evacuation orders. By October 30th, most evacuation orders had been lifted across the seven counties affected by the fires. Mandatory evacuations, however, remained in force in some areas, such as Silverado Canyon in Orange County, where 200 homes and 3,000 people remained threatened by the Santiago Fire. On October 30th, ten days after the catastrophe began, the 13,000 acre Slide Fire in San Bernardino County still threatened 2,500 homes.

Qualcomm Stadium in San Diego served as one of several evacuation centers. An estimated 13,000 people were sheltered at Qualcomm alone during the week of the fires. At the peak of evacuation efforts, San Diego's shelters housed 27,086 people at 50 public and private shelters.

In San Diego County, more than 360,000 acres burned during the first week of the fire. The following areas in San Diego County were under either partial or full mandatory evacuation orders: Chula Vista; Del Mar; Scripps Ranch; Escondido; Fallbrook; Valley Center; Poway; Rancho Santa Fe; Lakeside, Carveacre; Lawson Valley Region; Jamul; Potrero; Tecate; Dulzura; Barrett Junction; Engineer Spings; Deehon; Valley Indian Springs; Julian; Pine Hills; Cuymaca; Santa Ysable; Alpine; Mesa Grande; Harbison Canyon; San Diego; Ramona and Rancho Bernardo.

The Canyon Fire in Los Angeles County led to mandatory evacuation orders for all or portions of the following areas: Topanga Canyon, Puerto Canyon, Sweetwater Canyon, Carbon Canyon, Malibu Road, Malibu Colony, Malibu Crest, Serra Retreat, Big Rock, Carbon Mesa, Rambla Pacifica, Las Flores Canyon, Powder Horn Ranch and Monte Vista Road.

The Ranch Fire also burned over 58,000 acres in Los Angeles and Ventura Counties, causing mandatory evacuations of Hasley Canyon, Oak Springs, Val Verde and the Piru Area.

D. Road Closures

Numerous roads throughout southern California were either partially or fully closed during portions of the week of the wildfires, including sections of three major freeways in San Diego, I-5, I-15, and I-8.

The following roads in areas of Los Angeles and Ventura Counties were either partially or fully closed during the week of the fires: Pacific Coast Highway, Halsey Canyon Road; Hillcrest Parkway; Schueren Road; Glendora Mountain Road; Bouquet Canyon Road; Vasquez Canyon Road; Aqua Dulce and Sierra Highway; White Canyon; Steinway, San Franciscuito Canyon Road; Carbon Canyon Road; Del Valle; Las Flores Canyon Road; and Tuna Canyon.

As a result of the Santiago Fire, road closures in Orange County included: Portola Parkway; Alton Parkway; 133 freeway; Santiago Canyon; Portola Parkway; Irvine Blvd; Jamboree; Live Oak Canyon Road; Silverado Canyon Road; Jackson Ranch Road; and Trabuco Canyon Road.

In San Diego, highways 56, 94, 67, 76 and 188 were also either partially or fully closed during the week of the fires. Additionally, surface streets too numerous to name in both the City and County of San Diego were closed for periods of time.

E. Government directives/closures

On Monday, October 22nd, San Diego Mayor Sanders urged residents to stay home and to avoid using cell phones unnecessarily so that the freeways and airwaves would be clear for emergency workers and evacuees. As discussed above, state and federal states of emergency were declared on several dates beginning on October 21, 2007.

Many businesses in San Diego County closed during the entire week of the fires. The San Diego Union Tribune reported on October 30th that, according to the San Diego Institute for Policy Research, the cost of San Diego County's wildfires would probably exceed \$2 billion. The figure included \$893 million in lost productivity.

Courts in San Diego County were closed from October 22nd through October 26th. The Los Angeles County courthouse in Malibu was also closed because of the nearby fires. The U.S. District Court, Southern District, closed from October 24th through October 29th. All San Diego County public schools and several colleges and universities were closed from October 22nd to October 29th.

F. Loss of water and power

Numerous communities lost water and power service for long periods as a result of the Santa Ana winds and fires. San Diego Gas & Electric reported 41 active outages commencing at 10:00 a.m. October 22, 2007. In areas of Los Angeles County and other counties serviced by Southern California Edison, approximately 600,000 customers lost power beginning October 21, 2007 due to fires and wind conditions. Power to all of Southern California Edison's customers was restored by October 28, 2007.

One of the San Diego communities hard hit by the fires, Ramona, had its water system drained Tuesday, October 23rd, after a pumping station stopped sending water to the community. The situation grew ugly on Thursday, October 25th, when water problems kept thousands of

Ramona residents from returning home. A handful of frustrated residents drove through a roadblock on state Route 67. It was reported on October 27th that residents of Ramona had to wait approximately four days to safely drink, shower or wash dishes with Ramona municipal water.

G. Smoke plumes – Ash

The Santa Ana winds distributed ash, soot and debris widely. Properties located miles from the fires were affected. The sky in many areas was black for days because of smoke and ash from the firestorm. The Santa Ana winds create very hot, dry, dusty air. When ash, smoke, soot and other debris are added, the air in the vicinity of the fires becomes dirty and unhealthy to breathe. Warnings of the resulting health hazards continued for days.

Government authorities also advised that smoke and ash debris needed to be handled properly and issued several warnings to citizens. Because of ecological concerns, citizens have also been instructed to avoid washing smoke and ash in a manner that allows it to enter storm systems.

In addition to smoke and ash, burned fire debris covers hundreds of acres, including residential and commercial properties. Some municipalities have indicated that they will waive various permit fees for dumping debris and rebuilding. Nevertheless, debris removal will be an issue in the adjustment of most claims.

H. Damages – Types of claims

The overall damage caused by the wildfires is estimated to exceed \$1.6 billion and may well exceed \$2 billion after all of the claims are in. As of this date, more than 3,618 structures have been damaged or destroyed, including 2,608 homes. In addition to the burned homes and buildings, thousands of claims for fire-related damage to properties that did not burn are likely.

The impact on tourist destinations has been varied. Given the large numbers of evacuations, hotels in some areas may have had a temporary increase in occupancy. Nevertheless, the numbers of persons prevented from accessing tourist and entertainment destinations because of the fires, smoke, ash, evacuation and overall fear of the fires has, undoubtedly, been significant.

The principal claims under personal lines policies likely will be for (1) physical damage to or destruction of structures, (2) damage to personal property, and (3) additional living expense. Additional living expense claims may be made by a substantial portion of the more than one million persons who evacuated their homes, even though the majority of them did not sustain actual fire damage.

Damage to landscaping and trees caused by ash and smoke in the air even miles away from the fire is already resulting in claims. Questions exist as to whether or not vegetation will be permanently destroyed by the smoke and ash or is only temporarily damaged until the next growing season. Debris removal claims will likely be made as a result of smoke and ash, even where no other direct physical loss or damage to the property has occurred.

Commercial claims will likely include some businesses that were physically damaged by direct fire loss to structures. Also, there will likely be business interruption claims where direct physical loss or damage to property has not occurred. These may include businesses that closed because of power and/or water service interruption. There may also have been building closures due to smoke and ash which would disable HVAC and ventilation systems, if they were turned to "on". Business closures due to ingress/egress problems in the vicinity of the fires may have also occurred. Business interruption claims are also likely to arise where a civil authority ordered evacuation and/or advised citizens to refrain from traveling to work on the local roads.

Claims may also arise due to losses at agricultural facilities. Some of these may have been damaged by direct flame impingement and resulted in crop loss. For example, one of the largest crops in San Diego County is avocados. In addition to fire damage, a large percentage of the avocado crop was lost when the fruit was blown off of the trees during the Santa Ana winds.

III. POLICIES

The coverage available for the anticipated claims will depend upon the language of the policies. Most policies contain the requirement for coverage that there be direct physical loss or damage to insured property. Specific policy language should also be evaluated to determine what threshold requirements exist for losses where there is no physical loss/damage to insured property, such as claims for evacuation costs, business interruption, and the like.

California Insurance Code section 2071 sets forth California's standard form fire insurance (residential) policy. Pursuant to section 2070 of the Insurance Code, all fire insurance policies must provide coverage "substantially equivalent to or more favorable to the insured" than the statutory standard form policy. Compliance with section 2071 is often accomplished through the use of standard ISO forms, accompanied by California supplements, or through forms specifically written to conform with California's insurance requirements.

Basic personal lines property policies include coverage for damage to: 1) dwelling; 2) other structures; 3) personal property; and 4) loss of use. California Insurance Code § 10102 also requires residential policies to state whether and what replacement cost and building code upgrade coverage is provided.

Commercial claims will need to be reviewed under a wide variety of insurance forms, ranging from standard ISO commercial policies, to company-specific forms, to broker or manuscript forms. Businesses whose properties were damaged or destroyed by fire, ash or

smoke will likely submit claims for loss to buildings and contents, for debris removal, and for business interruption. Businesses not directly damaged by the fire may nevertheless submit claims for business interruption resulting from ingress/egress issues stemming from mandatory evacuation orders. Businesses with contingent business interruption coverage will likely submit claims as well.

In addition, insurers should expect to see claims under agricultural policies, condominium policies, renter's policies and even builder's risk policies. With claims under condominium policies, care will need to be taken to examine what constitutes property owned by a condominium association versus property consisting of an individual "unit."

This paper attempts to address, in a preliminary fashion, many of the issues that insurers are likely to face under a variety of policies. The vast majority of property policies are written on an "all risk" basis, subject to exclusions and limitations. As such, all risk policies are the primary focus of this paper. Nevertheless, "named peril" policies also remain in use.

IV. EFFICIENT PROXIMATE CAUSE

Under California law, an insurer owes policy benefits to an insured if the "efficient proximate cause" of the insured's loss is a covered peril, even when other excluded perils contribute to the loss. Cal. Ins. Code §530; Sabella v. Wisler (1963) 59 Cal.2d 21, 27 (insurer required to pay when efficient proximate cause of the loss was a covered peril even though an excluded peril was a contributory cause.) Efficient proximate cause is only an issue where two or more causes contribute to cause a loss. The efficient proximate cause of a loss is the "predominating cause" of a loss. Garvey v. State Farm Fire & Casualty Co. (1989) 48 Cal.3d 395, 403. If more than one peril contributes to a loss, which peril is the efficient proximate cause generally is a factual matter for the jury to resolve. Garvey at p. 413. Expert testimony may be required to assist in making such determinations.

The case of Howell v. State Farm (1990) 218 Cal.App.3d 1446, is illustrative of the “efficient proximate cause” analysis (and also addresses what may occur when, after the wildfires, southern California experiences its rainy season). In Howell, a fire stripped a riverbank of vegetation. A landslide subsequently occurred after heavy rains, resulting in damage to the insured’s property when large pieces of the property were lost because there was no vegetation to hold the river bank. The Court of Appeal held that the efficient proximate cause of the loss was fire, which the policy covered, as opposed to landslide, which the policy excluded.

Insurers have made a variety of attempts to address the concurrent causation issues. Some policies included “anti-concurrent causation” language. In Howell, however, the court held:

Stated simply, the important question presented by this case is whether a property insurer may contractually exclude coverage when a covered peril is the efficient proximate cause of the loss, but an excluded peril has contributed or was necessary to the loss. We conclude that a property insurer may not limit its liability in this manner, since the statutory and judicial law of this state make the insurer liable whenever a covered peril is the ‘efficient proximate cause’ of the loss, regardless of other contributing causes.

The court relied, in part, on California Insurance Code section 530 which states:

An insurer is liable for a loss of which a peril insured against was the proximate cause, although the peril not contemplated by the contract may have been a remote cause of the loss; but he is not liable for a loss of which the peril insured against was only a remote cause.

The California Supreme Court confirmed Howell’s reasoning in Julian v. Hartford Underwriters Ins. Co., (2005) 35 Cal. 4th 747. The court analyzed section 530 and the efficient proximate cause doctrine to assess whether an insurer could deny coverage for a rain induced landslide by invoking, among other exclusions, a provision that excludes coverage for losses

caused by weather conditions that “contribute in any way with” an excluded cause or event such as a landslide. The court conducted a thorough analysis of the Garvey and Howell decisions and upheld the efficient proximate cause analysis by each court.

V. NUMBER OF OCCURRENCES

The number of occurrences may effect the number of policy limits exposed and the number of deductibles or self-insured retentions the insured is required to pay. The issue of whether certain losses constitute a single or multiple occurrences has been addressed by several California courts, however, such analysis primarily has been done in the liability, not first-party, context.

The first consideration in addressing this issue should be the policy language. Policy language may define what constitutes an occurrence. As was demonstrated in the World Trade Center litigation arising from the 9/11 losses, how the policy language may be applied to determine the number of occurrences involves an in-depth analysis of both the facts and the policy language. See, SR Intern. Business Ins. Co. Ltd. v. World Trade Center (S.D.N.Y., 2002), 222 F.Supp.2d 385; World Trade Center Properties, L.L.C. v. Hartford Fire Ins. (2d Cir. 2003), 345 F.3d 154, overruled on other grounds, Wachovia Bank v. Schmidt, (2006) 546 U.S. 303, 309.

Our review of first-party insurance case law revealed few reported California cases which addressed number of occurrences issues on facts analogous to the wildfires.

In Eott Energy Corp. v. Storebrand International Ins. Co. (1996) 45 Cal.App.4th 565, a petroleum products dealer sued its all-risk property insurer for losses due to 653 thefts of diesel fuel from a pumping facility over an 11-month period. In analyzing whether the thefts constituted a single occurrence or numerous occurrences, the court noted that:

an occurrence is determined by the cause or causes of the resulting injury [and thus a court must determine] ‘ “if [t]here was but one

proximate, uninterrupted, and continuing cause which resulted in all of the injuries and damage.” ‘ (Appalachian Ins. Co. v. Liberty Mut. Ins. Co. (3rd Cir.1982) 676 F.2d 56, 61.)

Eott, 45 Cal.App.4th at 575-78. The court then held that because the thefts resulted from a continuous, ongoing scheme, there was only a single occurrence.

How the question of the number of occurrences will be evaluated will depend on the policy language at issue and the facts from which the issue arises.

VI. MANIFESTATION OF THE LOSS/TRIGGER

Manifestation of loss determines which of several successive insurers is solely responsible for indemnification of a first-party progressive property loss.

Manifestation issues may arise in the unusual situation where a policy renewal occurs while a fire is still burning. It also may arise where there is an initial fire during one policy, and a mudslide during a second policy, although the mudslide is caused by fire damage.

In California, manifestation of loss is defined as that point in time when appreciable damage occurs and is or should be known to the insured, such that a reasonable insured would be aware that its notification duty under the policy has been triggered. Prudential LMI Insurance v. Superior Court (1990) 51 Cal.3d 674, 699.

Under the manifestation rule, liability for a progressive loss falls on the insurer on the risk at the time the loss manifests itself. Id. at 674. Under this rule, the reasonable expectations of the insureds are met because they have looked to their present carrier for coverage. At the same time, the underwriting practices of the insurer can be made predictable because the insurer is not liable for a loss once its contract with the insured ends unless the manifestation of loss occurred during its contract term. Home Ins. Co. v. Landmark Ins. Co. (1988) 205 Cal.App.3d 1388, 1393.

VII. VALUATION

A. Replacement Cost

After the 1991 Oakland wildfires, a substantial problem arose when many insureds discovered that “replacement cost” coverage was insufficient to rebuild their properties. Both the California legislature and the Department of Insurance took action to remedy the so-called “underinsurance” problem. The Legislature enacted Insurance Code Section 10102 to provide insureds an explanation, in plain language, of the type of coverage they had purchased and the difference between actual cash value and the different types of “replacement coverages” available in the market. No doubt this type of consumer education has been of some benefit. Nevertheless, even though the statute took effect in 1993, there were still numerous lawsuits filed against brokers, agents and insurers for “under-insurance” problems in connection with the 2003 wildfires in southern California. The statute in its current form requires that companies provide the insured with the following form:

CALIFORNIA RESIDENTIAL PROPERTY INSURANCE DISCLOSURE

This disclosure is required by California law (Section 10102 of the Insurance Code). It describes the principle forms of insurance coverage in California for residential dwellings. It also identifies the form of dwelling coverage you have purchased or selected.

This disclosure form contains only a general description of the coverages and is **not part of your residential property insurance policy**. Only the specific provisions of your policy will determine whether a particular loss is covered and, if so, the amount payable. Regardless of which type of coverage you purchase, your policy may exclude or limit certain risks.

READ YOUR POLICY CAREFULLY. If you do not understand any part of it or have questions about what it covers, contract your insurance agent or company. You may also call the California Department of Insurance consumer information line at (1-800-927-4357)

INSURANCE CODE SECTION 10102

FORMS OF COVERAGE FOR DWELLINGS	Dwelling coverage selected or purchased
<p><u>GUARANTEED REPLACEMENT COST COVERAGE WITH FULL BUILDING CODE UPGRADE</u> PAYS REPLACEMENT COSTS WITHOUT REGARD TO POLICY LIMITS, AND INCLUDES COSTS RESULTING FROM CODE CHANGES.</p> <p>In the event of any covered loss to your home, the insurance company will pay the full amount needed to repair or replace the damaged or destroyed dwelling with like or equivalent construction <u>regardless of policy limits. Your policy will specify whether you must actually repair or replace the damaged or destroyed dwelling in order to recover guaranteed replacement cost.</u> The amount of recovery will be reduced by any deductible you have agreed to pay.</p> <p>This coverage includes all additional costs of repairing or replacing your damaged or destroyed dwelling to comply with any new building standards (such as building codes or zoning laws) required by government agencies and in effect at the time of rebuilding.</p> <p>To be eligible to recover full guaranteed replacement costs with building code upgrade, you must insure the dwelling to its full replacement cost at the time the policy is issued, with possible periodic increases in the amount of coverage to adjust for inflation and increases in building costs; you must permit inspections of the dwelling by the insurance company; and you must notify the insurance company about any alterations that increase the value of the insured dwelling by a certain amount (see your policy for that amount).</p>	
<p><u>GUARANTEED REPLACEMENT COST COVERAGE WITH LIMITED OR NO BUILDING CODE UPGRADE</u> PAYS REPLACEMENT COSTS WITHOUT REGARD TO POLICY LIMITS BUT LIMITS OR EXCLUDES COSTS RESULTING FROM CODE CHANGES.</p> <p>In the event of any covered loss to your home, the insurance company will pay the full amount needed to repair or replace the damaged or destroyed dwelling with like or equivalent construction <u>regardless of policy limits. Your policy will specify whether you must actually repair or replace the damaged or destroyed dwelling in order to recover guaranteed replacement cost.</u> The amount of recovery will be reduced by any deductible you have agreed to pay.</p> <p>This coverage does <u>not</u> include all additional costs of repairing or replacing your damaged or destroyed dwelling to comply with any new building standards (such as building codes or zoning laws) required by government agencies and in effect at the time of rebuilding. Consult your policy for the applicable exclusions or limits</p>	

FORMS OF COVERAGE FOR DWELLINGS	Dwelling coverage selected or purchased
<p>with respect to these costs.</p> <p>To be eligible to recover full guaranteed replacement cost with limited or no building code upgrade, you must insure the dwelling to its full replacement cost at the time the policy is issued, with possible periodic increases in the amount of coverage to adjust for inflation and increases in building costs; you must permit an inspection of the dwelling by the insurance company; and you must notify the insurance company about any alterations that increase the value of the insured dwelling by a certain amount (see your policy for that amount).</p>	
<p><u>LIMITED REPLACEMENT COST COVERAGE WITH AN ADDITIONAL PERCENTAGE PAYS REPLACEMENT COSTS UP TO A SPECIFIED AMOUNT ABOVE THE POLICY LIMIT.</u></p> <p>In the event of any covered loss to your home, the insurance company will pay to repair or replace the damaged or destroyed dwelling with like or equivalent construction <u>up to a specified percentage over the policy's limits</u>. See the declarations page of your policy for the limit that applies to your dwelling. <u>Your policy will specify whether you must actually repair or replace the damaged or destroyed dwelling in order to recover this benefit.</u> The amount of recovery will be reduced by any deductible you have agreed to pay.</p> <p>To be eligible for this coverage, you must insure the dwelling to its full replacement cost at the time the policy is issued, with possible periodic increases in the amount of coverage to adjust for inflation; you must permit an inspection of the dwelling by the insurance company; and you must notify the insurance company about any alterations that increase the value of the insured dwelling by a certain amount (see your policy for that amount). Read your declaration page to determine whether your policy includes coverage for building code upgrades.</p>	

<p><u>LIMITED REPLACEMENT COST COVERAGE WITH NO ADDITIONAL PERCENTAGE</u> PAYS REPLACEMENT COSTS UP TO POLICY LIMITS ONLY.</p> <p>In the event of any covered loss to your home, the insurance company will pay to repair or replace the damaged or destroyed dwelling with like or equivalent construction only <u>up to the policy's limits</u>. See the declarations page of your policy for the limit that applies to your dwelling. <u>Your policy will specify whether you must actually repair or replace the damaged or destroyed dwelling in order to recover this benefit</u>. The amount of recovery will be reduced by any deductible you have agreed to pay. To be eligible to recover this benefit, you must insure the dwelling to [company will denote percentage] percent of its replacement cost at the time of loss. Read your declaration page to determine whether your policy includes coverage for building code upgrades.</p>	
<p><u>ACTUAL CASH VALUE COVERAGE</u> PAYS THE FAIR MARKET VALUE OF THE DWELLING AT THE TIME OF THE LOSS, OR THE COST TO REPAIR, REBUILD OR REPLACE THE DAMAGED OR DESTROYED DWELLING WITH LIKE KIND AND QUALITY CONSTRUCTION UP TO POLICY LIMIT.</p> <p>In the event of any covered loss to your home, the insurance company will pay either the fair market value of the damaged or destroyed dwelling (excluding the value of land) at the time of the loss or the cost to repair, rebuild or replace the damaged or destroyed dwelling with like and quality construction <u>up to the policy limit, with possible consideration of physical depreciation</u>. The amount of recovery will be reduced by any deductible you have agreed to pay. Read your declaration page to determine whether your policy includes coverage for building code upgrades.</p>	
<p><u>BUILDING CODE UPGRADE—ORDINANCE AND LAW COVERAGE</u> PAYS, UP TO LIMITS SPECIFIED IN YOUR POLICY, ADDITIONAL COSTS REQUIRED TO BRING THE DWELLING “UP TO CODE.”</p> <p>In the event of any covered loss, the insurance company will pay any additional costs, up to the stated limits, of repairing or replacing a damaged or destroyed dwelling to conform with any building standards such as building codes or zoning laws required by government agencies and in effect at the time of the loss or rebuilding (see your policy).</p>	

B. Actual Cash Value

- 1. Under California law, the term “actual cash value” means fair market value, not replacement cost less depreciation.**

Even with replacement cost coverage, property policies typically entitle insureds to recover actual cash value when a covered loss has occurred, until replacement is accomplished. California uses a different method to calculate actual cash value than do most jurisdictions. In California, actual cash value means fair market value, at least with respect to a total loss.

In Cheeks v. California Fair Plan Association (1998) 61 Cal. App. 4th 423, an insured sued his homeowners’ insurer for breach of contract, bad faith, fraud, and infliction of emotional distress after the insurer used the replacement cost less depreciation method to establish actual cash value after an earthquake loss. In 1994, Cheeks purchased a policy from California Fair Plan (CalFair) covering damage to his home, including damage caused by an earthquake. *Id.* at 425. The loss settlement provision of the policy stated, “Covered property losses are settled at actual cash value at the time of loss but not more than the amount required to repair or replace the damaged property.” *Id.* The Cheeks home suffered damage due to the 1994 Northridge earthquake. A dispute arose between Cheeks and CalFair about how to measure the loss. The trial court ordered an appraisal and confirmed the appraisal award based on cost of repair or replacement minus depreciation.

The Court of Appeal reversed and held that “actual cash value” meant fair market value, not replacement cost less depreciation. *Id.* at 426. The Court of Appeal stated: “Based on our Supreme Court’s opinion in Jefferson Ins. Co. v. Superior Court (1970) 3 Cal. 3d 398, we conclude ‘actual cash value’ as used in Cheeks’ policy means ‘fair market value’ not replacement cost less depreciation.” *Id.* Nevertheless, the court left open the option that the insurance contract could provide for a different definition of actual cash value. Indeed, many policies now have an endorsement defining actual cash value as replacement cost less

depreciation. Cheeks 61 Cal.App.4th at 429. See also Jefferson Ins. Co. v. Superior Court (1970) 3 Cal. 3d 398, 402 (“the term ‘actual cash value’ as used in Ins. Code § 2071, is synonymous with ‘fair market value.’”)

2. **Partial Loss/Contents Loss Calculation Allows Consideration of Depreciation**

In 2004, after the Cheeks decision, the Legislature enacted Insurance Code section 2051.

Subdivision (b), provides in pertinent part:

Under an open policy that requires payment of actual cash value, the measure of the actual cash value recovery, in whole or partial settlement of the claim, shall be determined as follows: ... (2) In case of a partial loss to the structure, or loss to its contents, amount it would cost the insured to repair, rebuild, or replace the thing lost or injured less a fair and reasonable deduction for physical depreciation based upon its condition at the time of the injury or the policy limit, whichever is less. In case of a partial loss to the structure, a deduction for physical depreciation shall apply only to components of a structure that are normally subject to repair and replacement during the useful life of that structure.

According to the legislative history, one of the goals of this statute was to prevent insurers from depreciating those claims which by their nature do not typically depreciate, such as labor and some structural components of a building.

3. **The insured may recover the actual cash value immediately after the loss and can subsequently recover additional payments for replacement cost if and when actual repair or replacement occurs.**

An insured may recover the actual cash value immediately after the loss and can later submit a request to recover any additional replacement cost if repair or replacement actually occurs.

In Myers v. Allstate Insurance Co. (C.D. Cal. 1997) 989 F. Supp. 1250, the court found that the replacement cost provision in a homeowner’s insurance policy, providing for prompt payment of actual cash value of loss to the insured and giving the insured the option to make a claim for additional payment on replacement cost basis, did not violate Insurance Code section

2070. The court held that the insurer satisfied the statute by paying the cash value of the loss within 30 days. The court further held that the prompt payment provisions with respect to replacement cost were not triggered until the insured actually repaired or replaced damaged property. See also Maryland Casualty Co. v. Knight (9th Cir. 1996) 96 F.3d 1284. (Replacement cost policies, providing for reimbursement of repair cost only after such expenditures are made, do not violate section 2071.)

Similarly, Conway v. Farmers Home Mutual Ins. Co. (1994) 26 Cal. App. 4th 1185, determined the meaning of the terms “replace” and “replacement” in an insurance policy. The court held that the insurance company’s obligation to pay replacement cost does not exist until repair or replacement is made. Id. It explained: “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, an amount other than that actually expended.” Id. at 1190 quoting Hess v. North Pacific Ins. Co. (Wash. 1993) 859 P.2d 586.

In Lincoln Fountain Villas Homeowners Ass’n v. State Farm Fire & Casualty Ins. Co. (2006) 136 Cal. App. 4th 999, 1007, the court stated that if the insured elects to have its loss settled on an actual cash value basis and then makes repairs, the insured may apply for and receive additional payments for replacement costs basis if the cost of necessary repairs is greater than the actual cash value. Conversely, “if the actual cost to repair is less than the actual cash value payment previously received, the insured is not entitled to any additional payment.” Id.

4. The insured can recover replacement cost even if it decides to repair or replace the insured property at a different location.

In Conway, supra, the court also addressed the question of whether an insured can recover replacement costs if he purchases a replacement building. In that case, the homeowner sought a declaratory judgment that the insurer was liable for replacement cost, even though he

did not rebuild, but instead purchased a replacement home at a different location. The court held that the insured could recover replacement cost in this circumstance. The court noted:

... although the term replace certainly includes rebuilding on the same premises, the term also includes the notion of substituting for an original item another item which serves the same function as the original but is different in nature from the original. This broader and widely accepted meaning would certainly encompass the purchase of another house at a different location. *Id.* at 1192.

In short, because the policy at issue did not restrict payment of replacement cost to replacement on the same premises the insured was allowed to recover.

5. To recover replacement cost, the insured must repair or replace the insured property within the time outlined in the insurance policy.

Many policies impose a time limit for repairs as a prerequisite to recovery of replacement costs. In *Fraley v. Allstate Insurance Co.* (2000) 81 Cal. App. 4th 1282, the court held that such a provision is enforceable. The term at issue in *Fraley* stated: “You may make a claim for any additional payment on a replacement cost basis if you repair or replace the damaged building structure within 180 days of the actual cash value payment.” *Id.* at 1287. The court found that the term required the insureds to comply with the 180-day requirement as a pre-condition to recovery of replacement costs. The court explained: “payment provisions such as the one here preclude recovery of replacement cost without proof of the insureds’ actual repair or replacement of the damaged or lost property. To ameliorate the hardship to the insureds, however, the insured’s may initially obtain the actual cash value of the property and use it ‘to begin the process or replacement, at which point [they] could submit claims for expenditures that went above the actual cash value of the loss.” *Id.* at 1290 quoting *Myers v. Allstate Ins. Co.*, *supra* at 1254.

As discussed immediately below, however, policy time limits on rebuilding have been extended by statute.

6. **A declared state of emergency extends the replacement period.**

Pursuant to Insurance Code section 2051.5(b):

In the event of a loss relating to a 'state of emergency' as defined in Section 8558 of the Government Code, no time limit of less than 24 months from the date that the first payment toward the actual cash value is made shall be placed upon the insured in order to collect the full replacement cost of the loss, subject to the policy limit.

The statute does not prohibit the insurer from providing an even more generous allotment of time for the insured to complete repairs.

Both state and federal states of emergency were declared for the seven counties affected by wildfire. The statutory twenty-four month replacement period will therefore apply. Per the terms of the statute, the replacement period commences running upon the first actual cash value payment.

C. **Co-insurance**

Many policies contain co-insurance clauses that require insureds to maintain policy limits sufficient to fully cover any loss. A co-insurance clause penalizes an insured for underinsuring the property at a percentage of the total loss. Policy provisions will differ as to what percentage of the full value of the risk is required to be insured. If, for example, a building is required to be insured to 95% of its value and after a loss it is determined that the insurance carried was only 85% of the value of the structure, a 10% "co-insurance" deduction or "penalty" may be applied.

Numerous issues may arise from "underinsurance" problems including questions about how policy limits were selected, the underwriting of a risk and the insured's knowledge of a potential co-insurance penalty.

VIII. DEBRIS REMOVAL

Debris removal provisions typically occur in both homeowners and commercial policies. A standard ISO homeowner's policy form¹ provides "additional coverage" for debris removal arising from a covered loss as follows:

1. Debris Removal. We will pay your reasonable expense for the removal of:

a. Debris of covered property if a Peril Insured Against that applies to the damaged property causes the loss; or

b. Ash, dust or particles from a volcanic eruption that has caused direct loss to a building or property contained in a building. This expense is included in the limit of liability that applies to the damaged property. If the amount to be paid for the actual damage to the property plus the debris removal expense is more than the limit of liability for the damaged property, an additional 5% of that limit of liability is available for debris removal expense.²

A. Debris Removal Coverage Applies Separately To Each Class Of Covered Property

"Debris removal" coverage applies separately to each of the three categories of covered property: (1) "residence premises;" (2) "other structures;" and (3) "personal property."

Payments for debris removal are included in the stated limits of liability for each of the three categories of covered property. In the event the loss, including debris removal, exceeds the stated limit, an additional five percent of the applicable limit is payable under the debris removal coverage. For example, under a policy with Dwelling Limits of \$500,000; Other Structures Limits of \$50,000 and Personal Property Limits of \$250,000, the policy would pay an additional

¹ HO 00 03 04 91

² The debris removal coverage also provides up to another \$500 for removal of felled trees provided the fallen tree damaged a covered structure.

\$25,000 for dwelling debris removal, \$2,500 for other structures debris removal and \$12,500 for personal property debris removal if the covered loss exceeded each of the applicable limits.

Allocating the costs of debris removal among the three categories of covered property may not be practical. In the vast majority of circumstances, it is unlikely that a demolition/removal contractor will bid or bill separately for the costs of removing the structural debris of a house and the debris of personal property contained in the house. Moreover, the amount payable under the standard policy for debris removal is only an issue when the insured's actual loss exceeds the applicable policy limit because it is only in that circumstance that the 5% "additional coverage" is triggered for purposes of additional payments under the policy. If prior experience holds true with the 2007 wildfires, a significant number of homeowners who suffered total losses may claim to be "underinsured" because they have not adjusted their policy limits enough to reflect the increase in construction costs over the last several years.³ Although each claim will need to be evaluated and adjusted on its merits, insurers should expect a substantial number of claims in which the 5% additional coverage for debris removal will come into play.

B. Debris Removal Coverage Only Applies To Removal Of Insured Property

By its terms, the "debris removal" coverage of the ISO homeowner's policy applies only to the cost of removing "debris of *covered* property," *i.e.*, the remains of damaged/destroyed property that is insured by the policy.⁴ See, W.H. Breshears, Inc. v. Federated Mut. Ins. Co., (E.D. Ca. 1993) 832 F. Supp. 288 *aff'd in part, rev'd in part*, (9th Cir. 1994) 38 F.3d 1219 (noting debris removal coverage applies only to debris of "covered property"). The costs of removing *the insured's* burned-down house, "other structures" (such as an unattached garage) or

³ See CNNMoney.com (October 25, 2007) noting underinsurance "controversy" following 2003 wildfires.

⁴ The one exception to this limitation stated in the policy is for removal of "volcanic" ash, dust or particles. The exception obviously does not apply because the fires did not arise from the eruption of a volcano.

fire-damaged personal property would thus be covered by the “debris removal coverage” of a standard homeowner’s policy.

The standard ISO “debris removal” term does not explicitly limit *where* the debris must be located for the coverage to apply. Other policy forms, however, have such a limitation. There may be circumstances in which the “debris of covered property” is on a third-party’s property. For example, some of the remains of an insured’s house may have fallen onto the adjoining neighbor’s lot. If an insured pays to have his debris removed from his neighbor’s property, that cost may fall within the scope of debris removal coverage if the particular policy at issue does not expressly state the debris must be on the insured’s property.

Conversely, the cost of removing debris that settles on an insured’s covered property as a consequence of the burning of some other non-covered property, such as a neighbor’s house, may not fall within the “debris removal” coverage.⁵ Insurers should expect homeowner claims for the cost of removing ash, soot and smoke residue off houses that themselves did not catch fire. Such claims also may not fall within the scope of the debris removal coverage because the ash, soot and smoke are not “debris of covered property.” However, to the extent the presence of ash, soot or smoke residue constitutes a “physical loss to property,” the clean up costs may fall within the basic property damage coverage. (See § III, *supra*.)

For most claims, what constitutes “debris” should not be an issue. Some courts, however, have had occasion to construe debris removal coverage quite broadly, albeit in contexts materially different from the fire losses at issue. For example, in Lexington Ins. Co. v. Ryder Sys., Inc. (Ga. App. 1977) 234 S.E.2d 839, the court held that the debris removal coverage of an all-risk policy covered the costs of cleaning up oil contamination from a leaking underground storage tank. The stored oil was “covered property” under the terms of the policy at issue. The

⁵ Whether that circumstance would raise a liability coverage issue is beyond the scope of this paper.

court held that, because the escaped oil was no longer fit for its intended purpose it was “debris.” See, also, Compass Ins. Co. v. Cravens, Dargen & Co. (Wyo. 1988) 748 P.2d 724 (clean up of leaking oil on insured’s property is covered debris removal).

IX. CODE UPGRADE COVERAGE/EXCLUSIONS

Homeowners who elect to rebuild/repair their houses will be required to comply with building code regulations that did not exist at the time of the original construction. Depending upon the age of the damaged/destroyed house, this could present a significant exposure. Many of the areas affected by the wildfires are subject to stringent building code regulations largely directed at the fire risk, including the type of material that can be used in residential construction. In addition, new California state fire codes for construction in areas rated “very high risk” for fire will take effect in 2008. Whether increased construction costs incurred to satisfy new building code requirements is covered or excluded depends on the specific policy language and on whether California’s notice requirements have been met regarding building code coverage. Mardirossian v. Superior Court (1997) 55 Cal. App. 4th 1464.⁶

A. Policy Terms

In general, three terms are pertinent to the evaluation of building code upgrade coverage.

The standard ISO Loss Settlement term for dwelling coverage states, in relevant part, that the policy will pay *the least* of the following amounts: (1) “replacement cost of that part of the building damaged with material of like kind and quality...;” (2) the amount “actually spent” to repair/replace the damaged building; or (3) the policy limit, including any extended limit.

One sample policy provides additional “Ordinance Or Law” coverage as follows:

⁶ The California Supreme Court ordered the Mardirossian decision “depublished.” The Court of Appeal’s decision therefore cannot be cited as precedent. Depublication, however, is not considered a comment on the merits of the lower court’s decision.

2. Ordinance Or Law

a. You may use up to 10% of the limit of liability that applies to Coverage A ... for the increased costs you incur due to enforcement of any ordinance or law which requires or regulates:

(1) The construction, demolition, remodeling, renovation or repair of that part of a covered building or other structure damaged by a Peril Insured Against;

(2) The demolition and reconstruction of the undamaged part of a covered building or other structure, when that building or other structure must be totally demolished because of damage by a Peril Insured Against to another part of that covered building or other structure; or

(3) The remodeling, removal or replacement of the portion of the undamaged part of a covered building or other structure necessary to complete the remodeling, repair or replacement of that part of the covered building or other structure damaged by a Peril Insured Against.

b. You may use all or part of this Ordinance or Law Coverage to pay for the increased costs you incur to remove debris resulting from the construction, demolition, remodeling, renovation, repair or replacement of property as stated in a. above.

The “Ordinance Or Law” additional coverage, however, does not cover “the loss in value” to a covered building due to the requirements of any law or ordinance, nor does it cover the costs of complying with any law or ordinance requiring the testing, monitoring or removal of pollutants from a covered structure.⁷

If Ordinance Or Law Additional Coverage is *not* purchased, then the standard policy form “Ordinance Or Law” exclusion remains in effect. It states that the policy does not cover loss caused directly or indirectly by any ordinance or law “[r]equiring or regulating the construction, demolition, remodeling, renovation or repair of property, including removal of any resulting debris.” Once again, the facts need to be evaluated to assess how efficient proximate cause may apply with such exclusion.

⁷ Form No.: HO 01 04 02 00

B. Notice Requirements

As discussed above, California legislature enacted statutes requiring insurers to provide certain notices to insureds with residential property policies. Insurance Code section 10102 requires the insurer to provide the insured a written disclosure with regard to whether guaranteed replacement cost coverage includes the costs of complying with changes in building codes. Insurance Code section 10103 further requires that if the policy does *not* provide building code upgrade coverage, the declarations page must state in 10-point type face: “THIS POLICY DOES NOT INCLUDE BUILDING CODE UPGRADE COVERAGE.” Cal. Ins. Code §10103(a)(5).

The consequences of failing to comply with the statutorily mandated notice requirements are unclear. Nevertheless, one California appellate decision, since depublished by the California Supreme Court, suggests that failure to comply with the notice requirements regarding building code upgrade coverage may impact an insurer’s ability to deny coverage for the increased costs of reconstruction necessitated by current building codes. Mardirossian, *supra*.

C. California Law On Building Code Upgrade Coverage Limitations

As a general proposition, a homeowner’s policy need not provide coverage for the cost of building code upgrades. The relevant language of the statutory form policy is: “[Insurer] does insure [insured] ... to the extent of the actual cash value of the property at the time of the loss, but not exceeding the amount which it would cost to repair or replace the property with material of like kind and quality ... *without allowance for any increased cost of repair or reconstruction by reason of any ordinance or law regulating construction or repair.*” Cal. Ins. Code §2071 (emphasis added). As one court explained, this provision is consistent with the purpose of fire insurance – to compensate for the actual loss sustained, not to place the insured in a better

position than he or she was before the fire. Breshears v. Indiana Lumbermans Mut. Ins. Co. (1967) 256 Cal. App.2d 245, 248.

In light of the foregoing provision of the statutory fire policy form, some California courts have held that a policy that covers “equivalent construction” or excludes coverage for building code upgrades does not cover the costs of complying with current building codes. Id. (fire policy covers cost of restoring building to pre-loss condition, but not the additional cost of complying with new building code requirements); McCorkle v. State Farm Ins. Co. (1990) 221 Cal. App. 3d 610 (fire policy’s provision covering “equivalent construction” does not cover increased costs of more expensive material required by new building code); Bischel v. Fire Ins. Exchange (1991) 1 Cal. App. 4th 1168 (“ordinance or law” exclusion foreclosed coverage for costs of complying with current building code).

One California appellate decision, however, muddled the waters at least for some “guaranteed replacement cost” policies. In Fire Ins. Exchange v. Superior Court (2004) 116 Cal. App. 4th 446, the court addressed claims arising from the 1994 Northridge earthquake under a group of homeowners’ policies. None of the policies were subject to the statutory notice requirements regarding building code coverage because they were all issued before the effective date of the statutes. The policies at issue provided “guaranteed replacement cost” coverage “regardless of limits” and a “value protection” clause pursuant to which premiums would increase annually to account for increased construction costs. The loss settlement provisions of the policies provided for payment of the cost of “equivalent construction.” The policies also had an “ordinance or law” exclusion that appeared in the list of excluded perils. The court held the policies covered the costs of building code upgrades on two grounds. First, contrary to the McCorkle and Bischel cases, supra, the court held that the term “equivalent construction” did not comply with Insurance Code section 2071 and therefore did not limit coverage to the cost of

repairing/rebuilding a house to its pre-loss condition. *Id.* at 459. Second, the court held the policies' "ordinance or law" exclusion was ambiguous. In that regard, the court emphasized that the exclusion appeared in the list of excluded "perils" and therefore "its intended function [was] to exclude a peril, not to place a limit on replacement costs." *Id.* at 465. Thus, the court concluded "an insured might reasonably construe the exclusion as referring to such perils as the forced demolition or repair of a dilapidated, encroaching, or nonconforming building or part of a building by civil authorities." *Id.* See, also, *Mardirossian, supra* ("ordinance or law" exclusion conflicts with "guaranteed replacement cost" coverage and therefore is unenforceable).

The *Fire Insurance* decision should not be overlooked but it may not be applicable to the wildfire claims for at least two reasons. First, all residential property policies currently in effect were subject to the statutory notice requirements regarding building code upgrade coverage. If the notice requirements have been satisfied, insureds who did not purchase code upgrade coverage should be foreclosed from arguing they had any expectation of such coverage. Second, the language of many current standard policy forms differs materially from the terms that troubled the court in *Fire Insurance*. In particular, the current standard loss settlement term states the company will pay the "replacement cost of that part of the building damaged *with material of like kind and quality...*" This language mimics that of the Insurance Code section 2071, unlike the "equivalent construction" language at issue in *Fire Insurance*. The *Fire Insurance* court acknowledged, albeit obliquely, that policy language substantially complying with section 2071 would preclude coverage for building code upgrades. *Id.* at 460-461.

X. COMMERCIAL ISSUES

In addition to losses the California wildfires affected many businesses in southern California. Undoubtedly, insurers will be faced with claims under commercial property policies even though a relatively small number of businesses were destroyed by the wildfires. Claims

will be varied in scope and size, and will require a fact-specific and policy-specific analysis of insurance coverage issues, especially questions associated with business interruption losses. Among other key provisions, policy requirements for direct physical loss or damage should be kept in mind. The following addresses the typical issues that commercial insurers may face.

A. Business Interruption and Other Time Element Coverages

“It is well settled that the purpose and nature of ‘business interruption’ ...insurance is...to indemnify the insured for any loss sustained by the insured because of his inability to continue to use specified premises...[that is,] for loss caused by the interruption of a going business consequent upon the destruction of the building, plant, or parts thereof.” Pacific Coast Engineering Co. v. St. Paul Fire & Marine Ins. Co. (1970) 9 Cal. App.3d 270, 275. As one commentator has noted, generally speaking, a covered claim for business interruption losses must meet the following requirements:

- (1) a covered peril;
- (2) that causes direct physical loss or damage to covered property;
- (3) that causes a necessary suspension or interruption in the insured’s business operations;
- (4) that causes a covered loss, such as actual lost income or extra expense; and
- (5) that the covered loss occurred during the appropriate “period of restoration.”

Jon C. Rice, Business Interruption Coverage in the Wake of Katrina: Measuring the Insured’s Loss in a Volatile Economy, (ABA, Spring 2006) 41:3 Tort, Trial & Insurance Practice Law Journal, 857, 858.

1. Direct Physical Loss

Like most coverages under a first-party property policy, covered business interruption losses typically require that the insured suffer “direct physical loss or damage” or “physical loss or damage” to covered property giving rise to the business interruption loss. Whether there has been physical loss or damage to covered property giving rise to business income losses is a threshold issue for insurers to consider when evaluating a business interruption claim. California courts enforce this basic coverage requirement contained in most commercial property policies.

In Simon Marketing v. Gulf Ins. Co. (2007) 149 Cal. App.4th 616, the court rejected a claim by the insured marketing company for lost business following the theft of high-value, winning game tickets from promotional games sponsored by the policyholder’s client, and explained:

. . . [T]he threshold requirement for recovery under a contract of property insurance is that the insured property has sustained physical loss or damage. “The requirement that the loss be ‘physical,’ given the ordinary definition of that term is widely held to exclude alleged losses that are intangible or incorporeal, and, thereby, to preclude any claim against the property insurer where the insured merely suffers a detrimental economic impact unaccompanied by a distinct, demonstrable, physical alteration of the property.”

Id., at 623 (citations omitted). Termination of business as a result of customers’ cancellation of their contracts with the insured is not physical loss or damage to insured property. Likewise, payments to settle litigation, defense costs and costs of winding up business are not physical damage to property. See also Better Imaging Facilitators, Inc. v. St. Paul Fire & Marine Ins. Co. (Cal. App. 2006) 2006 WL 3187150 (policyholder could not recover loss of income resulting from failure of the MRI machine to function properly) (unreported decision).

Not only must the loss be “direct” and/or “physical,” the loss must be to insured property, not property of third parties. For example, in Southeast Mental Health Center, Inc. v. Pacific Ins.

Co., Ltd. (W.D. Tenn. 2006) 439 F.Supp.2d 831, a commercial policyholder sought coverage under an all-risk property policy providing business interruption insurance after the insured clinic and its operations center were damaged by heavy rain and windstorm following a hurricane. Power and utility poles adjacent to the insured property were blown down or destroyed, resulting in the loss of electrical and telephone service at the policyholder's location. The policyholder alleged that loss of electricity damaged and caused loss of data from its pharmacy's computer, its operations were suspended, and it lost significant business income as a result of loss of electricity and telephone service. The court held that the electrical and telephone outages were caused by damage to power and utility lines that were not located on the insured property. Therefore, the power outage did not constitute "direct physical loss of or damage to" the insured property as required by the policy. However, the resulting corruption of the insured pharmacy's computer was direct physical loss of or damage to property under the business interruption policy, and the resulting loss of business income would fall within the scope of the policy's business interruption coverage.

Furthermore, in Source Food Technology, Inc. v. United States Fidelity & Guarantee Co. (8th Cir. 2006) 465 F.3d 834, the court held under Minnesota law there was no "direct physical loss to property" as required under a business interruption insurance policy following an embargo on Canadian beef based on a mad cow disease report. The policyholder, Source Food, could not fill orders and was forced to locate a new beef products supplier. As a result, Source Food's best customer terminated its contract seven months early. Source Food filed a business interruption claim seeking compensation for extraordinary operating expenses, lost profits based on early termination of its contract and the costs of obtaining alternative products from a new supplier. The court held that there was no covered business interruption loss, reasoning that

although Source Food's beef product could not be transported into the United States, there was no physical contamination or damage in any manner to the product.

While many businesses in the areas generally affected by the wildfires may well have suffered a disruption of business operations and lost income, this circumstance does not necessarily give rise to a valid business interruption claim. Insurers must consider the threshold issue of whether the insured suffered direct physical loss to covered property before considering other aspects of the business interruption claim.

2. Period Of Restoration Issues

Time element coverages, such as Business Interruption and Extra Expense coverages, compensate the insured for income lost and costs incurred due to property damage. They are based on the time needed to restore the property. Determining the precise period of restoration can be complicated enough in a routine property loss. Determining the period of restoration is even more complicated when a regional catastrophe occurs, such as the California wildfires. Numerous factors, such as the availability of raw materials, building trades and contractors, cleaning and restoration services, and the operational status of the remaining civil infrastructure all affect the period of restoration.

Policies typically define "period of restoration" as the time necessary to rebuild, repair, or replace the property "with due diligence and dispatch" or with "reasonable speed and similar quality." Most policies state that the period of restoration begins when the physical loss occurs and ends on the earlier of (a) the date when the property at the described premises "should be" or "would be" repaired, rebuilt, or replaced with reasonable speed or similar quality or (b) the date when business is resumed. Jess B. Millikan, Time Element Losses During Catastrophes, 31 The Brief 52, 57 (Spring 2002).

Variables that could affect the period of restoration after a catastrophe, depending on the policy language, include:

- weather conditions;
- acts of third parties such as government authorities and other property owners;
- availability of contractors, engineers, architects, cleaning and restoration services, etc.;
- code and ordinance compliance issues (although some policies expressly provide that time lost on these issues does not extend the restoration period); see, United Nuclear Corp. v. Allendale Mut. Ins. Co. (N.M. 1985) 709 P.2d 649, 656
- work force dislocation;
- destruction of papers and electronic records; and
- delays in payment to the insured of money to rebuild or restore the property.

Millikan, supra at 57.

Courts, almost uniformly, have interpreted the “period of restoration” definition to mean the time *theoretically* necessary to repair or replace the damaged property. See, e.g., SR Int’l Bus. Ins. Co. v. World Trade Ctr. Props. (S.D.N.Y. 2005) 2005 WL 827074 at *3 (noting case law is “consistently” in accord and that the term “actual” did not appear anywhere in the subject policy’s definition of the restoration period). The courts reason that the use of the subjunctive “should” or “would” imply a hypothetical or constructive calculation. Id.; see also, Duane Reade Inc. v. St. Paul Fire & Marine Ins. Co. (2nd Cir. 2005) 411 F.3d 384, 392.

In Zurich American Ins. Co. v. ABM Industries, Inc. (2nd Cir. 2006) 397 F.3d 158, ABM provided janitorial, lighting and engineering services for the common areas of the World Trade Center, and for many of its tenants. Zurich issued a policy to ABM providing both standard contingent and business interruption coverage. In determining whether the period of recovery

should end when the World Trade Center was rebuilt or earlier, when the tenants of the World Trade Center have relocated, the court noted that ABM's business was "fundamentally connected to its use of the common spaces at the World Trade Center." Because restoration of the World Trade Center itself was necessary for ABM to resume its business operations, the court determined that the appropriate period of recovery is the hypothetical length of time required to rebuild the World Trade Center. See also Children's Place Retail Stores, Inc. v. Federal Ins. Co. (N.Y. 2007) 37 A.D. 3d 243, (insured retail store, having elected not to relocate after its World Trade Center location was destroyed, was entitled to business interruption coverage for the period of time it would have reasonably taken to resume operations at a different location); Royal Indemnity Co. v. Retail Brand Alliance, Inc. (N.Y. 2006) 33 A.D. 3d 392, (once store resumed operations, business income coverage terminated regardless of whether insured's income was restored to pre-loss levels).

Some courts have departed from the general rule and permitted recovery for the actual time taken to restore the property. For instance, in a Louisiana case, the court extended the restoration period to the actual length of the business interruption because the insured could not begin rebuilding until it received payments from the insurer. United Land Investors, Inc., v. The Northern Ins. Co. of Am. (L.A. App. 1975) 476 So. 2d 432, 437-38. Courts such as the one in United Land Investors may be willing to extend the restoration period when delays are attributable to actions taken by the insurers, as opposed to the insureds. World Trade Ctr. Props., (S.D.N.Y. 2005) 2005 WL 827074. Other courts will not extend the restoration period, even for delays attributable to the insurer. See, Jonari Mgmt. Corp. v. St. Paul Fire & Marine Ins. Co. (N.Y. 1983) 448 N.E.2d 427.

The importance of determining the restoration period using the theoretical time to rebuild or restore becomes clear in circumstances where the insured is a lessee and the responsibility and

authority to rebuild or restore rests with third parties, such as the landlord. In this instance, neither the insurer or the insured can compel restoration of the damaged property. The United States Court of Appeals for the Second Circuit addressed this very situation. In Duane Reade Inc. v. St. Paul Fire & Marine Ins. Co. (2nd Cir. 2005), 411 F.3d 384, 398, the court held that the restoration period for the business interruption losses of a World Trade Center tenant would not last until the tenant could restore operations in a store in the rebuilt WTC. Rather, the period of restoration, and therefore the period of indemnity, was the hypothetical time it would reasonably take the tenant to repair, rebuild, or replace its WTC store at a suitable location. *Id.* (recognizing that the tenant may not make the same level of profits at a new location but that any difference in the value of the locations would be addressed by the leasehold interest provision of the policy.) The Duane Reade court concluded that courts have consistently construed period of restoration language like that quoted above to mean that the insured was entitled to indemnity for lost profits until it could build a reasonably equivalent place of business in a reasonably equivalent location. 411 F.3d at 393.

In Retail Brand Alliance, Inc. v. Factory Mut. Ins. Co. (S.D.N.Y. 2007) 489 F. Supp. 2d 326, again involving claims for lost business income following the September 11th attack, the court held that the period of liability for purposes of the business interruption coverage is tied and related to the condition of the insured's building and equipment, rather than the condition of its business. The policy provided that the period of liability for business interruption coverage ended when the insured's building and equipment could be replaced and made ready for operations "under the same or equivalent and/or operating conditions." The phrase "under the same or equivalent physical and operating conditions" explicitly modified the phrase "building and equipment" in the policy, and therefore the period of liability must be tied to the condition of



COZEN O'CONNOR

DIRECTORY OF OFFICES

PRINCIPAL OFFICE: PHILADELPHIA

1900 Market Street
Philadelphia, PA 19103-3508
Tel: 215.665.2000 or 800.523.2900
Fax: 215.665.2013

For general information please contact:
Joseph A. Gerber, Esq.

ATLANTA

Suite 2200, SunTrust Plaza
303 Peachtree Street, NE
Atlanta, GA 30308-3264
Tel: 404.572.2000 or 800.890.1393
Fax: 404.572.2199

Contact: Kenan G. Loomis

CHARLOTTE

Suite 2100, 301 South College Street
One Wachovia Center
Charlotte, NC 28202-6037
Tel: 704.376.3400 or 800.762.3575
Fax: 704.334.3351

Contact: T. David Higgins, Jr., Esq.

CHERRY HILL

Suite 300, LibertyView
457 Haddonfield Road, P.O. Box 5459
Cherry Hill, NJ 08002-2220
Tel: 856.910.5000 or 800.989.0499
Fax: 856.910.5075

Contact: Thomas McKay, III, Esq.

CHICAGO

Suite 1500, 222 South Riverside Plaza
Chicago, IL 60606-6000
Tel: 312.382.3100 or 877.992.6036
Fax: 312.382.8910

Contact: James I. Tarman, Esq.

DALLAS

2300 Bank One Center, 1717 Main Street
Dallas, TX 75201-7335
Tel: 214.462.3000 or 800.448.1207
Fax: 214.462.3299

Contact: Lawrence T. Bowman, Esq.

DENVER

707 17th Street, Suite 3100
Denver, CO 80202-3400
Tel: 720.479.3900 or 877.467.0305
Fax: 720.479.3890

Contact: Brad W. Breslau, Esq.

HOUSTON

One Houston Center
1221 McKinney, Suite 2900
Houston, TX 77010-2009
Tel.: 832.214.3900 or 800.448.8502
Fax: 832.214.3905

Contact: Joseph A. Ziemianski, Esq.

LOS ANGELES

Suite 2850
777 South Figueroa Street
Los Angeles, CA 90017-5800
Tel: 213.892.7900 or 800.563.1027
Fax: 213.892.7999

Contact: Mark S. Roth, Esq.

LONDON

9th Floor, Fountain House
130 Fenchurch Street
London, UK
EC3M 5DJ
Tel: 011.44.20.7864.2000
Fax: 011.44.20.7864.2013

Contact: Richard F. Allen, Esq.

MIAMI

Wachovia Financial Center
200 South Biscayne Boulevard,
Suite 4410, Miami, FL 33131
Tel: 305.704.5940 or 800.215.2137

Contact: Richard M. Dunn, Esq.

NEW YORK

45 Broadway Atrium, Suite 1600
New York, NY 10006-3792
Tel: 212.509.9400 or 800.437.7040
Fax: 212.509.9492

Contact: Michael J. Sommi, Esq.

909 Third Avenue
New York, NY 10022
Tel: 212.509.9400 or 800.437.7040
Fax: 212.207.4938

Contact: Michael J. Sommi, Esq.

NEWARK

Suite 1900
One Newark Center
1085 Raymond Boulevard
Newark, NJ 07102-5211
Tel: 973.286.1200 or 888.200.9521
Fax: 973.242.2121

Contact: Kevin M. Haas, Esq.

SAN DIEGO

Suite 1610, 501 West Broadway
San Diego, CA 92101-3536
Tel: 619.234.1700 or 800.782.3366
Fax: 619.234.7831

Contact: Joann Selleck, Esq.

SAN FRANCISCO

Suite 2400, 425 California Street
San Francisco, CA 94104-2215
Tel: 415.617.6100 or 800.818.0165
Fax: 415.617.6101

Contact: Joann Selleck, Esq.

SANTA FE

125 Lincoln Avenue, Suite 400
Santa Fe, NM 87501-2055
Tel: 505.820.3346 or 866.231.0144
Fax: 505.820.3347

Contact: Harvey Fruman, Esq.

SEATTLE

Suite 5200, Washington Mutual Tower
1201 Third Avenue
Seattle, WA 98101-3071
Tel: 206.340.1000 or 800.423.1950
Fax: 206.621.8783

Contact: Jodi McDougall, Esq.

TRENTON

144-B West State Street
Trenton, NJ 08608
Tel: 609.989.8620

Contact: Jeffrey L. Nash, Esq.

TORONTO

One Queen Street East, Suite 1920
Toronto, Ontario M5C 2W5
Tel: 416.361.3200 or 888.727.9948
Fax: 416.361.1405

Contact: Christopher Reain, Esq.

WASHINGTON, DC

The Army and Navy Building
Suite 1100, 1627 I Street, NW
Washington, DC 20006-4007
Tel: 202.912.4800 or 800.540.1355
Fax: 202.912.4830

Contact: Barry Boss, Esq.

WEST CONSHOHOCKEN

Suite 400, 200 Four Falls Corporate Center
P.O. Box 800
West Conshohocken, PA 19428-0800
Tel: 610.941.5400 or 800.379.0695
Fax: 610.941.0711

Contact: Ross Weiss, Esq.

WILMINGTON

Suite 1400, Chase Manhattan Centre
1201 North Market Street
Wilmington, DE 19801-1147
Tel: 302.295.2000 or 888.207.2440
Fax: 302.295.2013

Contact: Mark E. Felger, Esq.