DEPARTMENT OF INSURANCE
Legal Division, Office of the Commissioner
45 Fremont Street, 23rd Floor
San Francisco, CA 94105

Adam M. Cole
General Counsel
TEL: 415-538-4010
FAX: 415-904-5889
E-Mail: colea@insurance.ca.gov
www.insurance.ca.gov

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Councilman Brian Maienschein
202 C Street
San Diego, CA 92101

Re: Request for Legal Opinion of the General Counsel of the California Department of Insurance Regarding Application of California Insurance Code Section 2015.5(c)

Dear Councilmember Maienschein:

Thank you for your letter of February 25, 2008 requesting that I provide a legal opinion on the following three questions regarding the application of California Insurance Code Section 2051.5(c):

1. Does replacement cost insurance provide coverage if a homeowner decides to purchase an already built home at a new location?

2. If a homeowner has an extended or guaranteed replacement cost policy and rebuilds in a new location, is the homeowner entitled to the "extended" or "guaranteed" portion of the coverage?

3. If a homeowner purchases a home at a new location for less than the cost to rebuild at the original location, is the homeowner entitled to recover the full amount it would cost to rebuild at the original location?

Below are my responses pursuant to Insurance Code Section 12921.9.[1] This letter does not establish an agency guideline, criterion, bulletin, manual, instruction, order, standard of general

[1] Insurance Code § 12921.9 provides:

(a) A letter or legal opinion signed by the Commissioner or the Chief Counsel of the Department of Insurance that was prepared in response to an inquiry from an insured or other person or entity and that discusses either generally or in connection with a specific fact situation the application of the Insurance Code or regulations promulgated by the commissioner shall be made public. The department may redact the name, address, policy number, and other identifying information regarding a particular insured or other person or entity from the letter or legal opinion when it is made public.

(b) A letter or legal opinion made public pursuant to this section shall not be construed as establishing an agency guideline, criterion, bulletin, manual, instruction, order, standard of general application, rule, or regulation, as those terms are described in Sections 11340.5 and 11342.600 of the Government Code.

application, rule, or regulation, as those terms are described in Sections 11340.5 and 11342.600 of the Government Code.

I. Statutory Interpretation

The starting point of the analysis is the language of the statute. A statute must be read as a whole, its parts in the context of the entire statute. If, based on these principles of statutory construction, the language is clear, there is no need to look beyond the statute to its legislative history.[2]

Insurance Code Section 2051.5 addresses the measure of indemnity under a fire insurance policy. Subsection (a) defines replacement cost and spells out the process by which a homeowner recovers replacement cost:

> Under an open policy that requires payment of the replacement cost for a loss, the measure of indemnity is the amount that it would cost the insured to repair, rebuild, or replace the thing lost or injured, without deduction for physical depreciation, or the policy limit, whichever is less. If the policy requires the insured to repair, rebuild, or replace the damaged property in order to collect the full replacement cost, the insurer shall pay the actual cash value of the damaged property, as defined in Section 2051, until the damaged property is repaired, rebuilt, or replaced. Once the property is repaired, rebuilt, or replaced, the insurer shall pay the difference between the actual cash value payment made and the full replacement cost reasonably paid to replace the damaged property, up to the limits stated in the policy.

Subsection (c), to which your letters refer, addresses replacement cost where a homeowner chooses to replace at a new location:

> In the event of a total loss of the insured structure, no policy issued or delivered in this state may contain a provision that limits or denies payment of the replacement cost in the event the insured decides to rebuild or replace the property at a location other than the insured premises. However, the measure of indemnity shall be based upon the replacement cost of the insured property and shall not be based upon the cost to repair, rebuild, or replace at a location other than the insured premises.

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[2] *See, e.g., Bonnell v. Medical Board* (2003) 31 Cal.4th 1255, 1261 ("[w]e begin our discussion with the oft-repeated rule that when interpreting a statute we must discover the intent of the Legislature to give effect to its purpose, being careful to give the statute's words their plain, commonsense meaning"); *Kavanaugh v. West Sonoma County Union High School Dist.* (2003) 29 Cal.4th 911, 919 ("[i]f the language of the statute is not ambiguous, the plain meaning controls and resort to extrinsic sources to determine the Legislature's intent is unnecessary"); *Diamond Multimedia Sys., Inc. v. Superior Court* (1999) 19 Cal.4th 1036, 1047 (when the statutory language is unambiguous, "'we presume the Legislature meant what it said and the plain meaning of the statute governs'"); *Carrisales v. Dep't of Corrections* (1999) 21 Cal.4th 1132, 1135 (statutory language is not considered in isolation; we "instead interpret the statute as a whole, so as to make sense of the entire statutory scheme").

Subsections (a) and (c) both deal with replacement cost, subsection (a) in the context of replacing or rebuilding at an original location and subsection (c) in the context of replacing or rebuilding at a new location. The second sentence of subsection (c) expressly links the measure of indemnity to replacement cost as defined in subsection (a). Subsections (a) and (c) must be read together. So read, the plain language of the statute furnishes answers to each of your four questions.[3]

II. Discussion

Question 1: Does replacement cost insurance provide coverage if a homeowner decides to purchase an already built home at a new location?

Answer: Yes.

Section 2051.5 requires that replacement cost coverage allow a homeowner to "rebuild or replace" at a new location. The word "replace" means, among other things, "to take the place of: serve as a substitute for or successor of."[4] Nothing in the definition of "replace" requires a homeowner to build a home from scratch at a new location. Purchasing an already built home at a new location "takes the place of" and "substitutes for" the destroyed home as much as constructing a home afresh.

The use of the separate words "rebuild" and "replace" establishes that a homeowner *either* can build a new home (rebuild) *or* purchase an already built home (replace) at the new location. Any other reading would impermissibly read out of the statute the word "replace" in the phrase "rebuild or replace."[5]

In *Conway v. Farmers Home Mutual Insurance Co.* (1994) 26 Cal.App.4th 1185, 1187, the court held that under a replacement cost policy "an insured homeowner may recover the replacement cost of fire damage to an insured home by purchasing another home at another location." The

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[3] Because the plain language of Section 2051 answers the four questions in your letters, it is not necessary to look further to interpret the statute. We note, however, that the legislative history supports our conclusion that subsections (a) and (c) must be read together. For example, referring to comments by a supporter of the bill, the Summary of Bill Analysis from the Senate Floor regarding the July 7, 2004 version (same language as final) explains:

> "Additionally, the author points out that some insurance companies do not permit homeowners to rebuild or replace their property in a location other than where the original loss occurred. Consumers Union supports the bill for all of the reasons noted above. Consumers Union notes that contractors and building materials are often in short supply after a major disaster. Consumers Union also notes that it is unfair to deny full recovery just because someone wants to move from a fire-prone area. *The bill limits the payment to the insured to the amount that would have been due if the insured had rebuilt in the original location.*" [Emphasis added.]

[4] Webster's Third New International Dict. Unabridged (1993) at 1925.

[5] *See Clements v. T. R. Bechtel Co.* (1954) 43 Cal.2d 227, 233 ("[t]he presumption obtains that every word, phrase and provision employed in a statute is intended to have meaning . . ."); *Steketee v. Lintz* (1985) 38 Cal.3d 46, 51-52 ("a construction making some words surplusage is to be avoided") (inner quotation marks and citation omitted).

homeowner there purchased an already built home at a new location rather than rebuild the destroyed home at the original location. (*Id.* at p. 1188.) Relying in part on the same definitions of "replace" quoted above, the court explained:

> The dictionary definition does not draw any distinction between what can be repaired and what cannot be repaired. More importantly, 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. (*Id.* at pp. 1191-1192.)

Although *Conway* focused on the language of the policy and predated the enactment of Insurance Code Section 2051.5(c), the analysis in that case applies even more strongly following the enactment of Section 2051.5(c). That section makes explicit that replacement cost coverage applies when a homeowner replaces at a new location, a protection that was not codified when *Conway* was decided.

Question 2: If a homeowner has an extended or guaranteed replacement cost policy and rebuilds in a new location, is the homeowner entitled to the "extended" or "guaranteed" portion of the coverage?

Answer: Yes.

We understand that some insurers contend that the phrase "replacement cost" as used in Section 2051.5(c) is limited to the specific term "replacement cost" used in certain policies. In the nomenclature of some policies, "replacement cost" is distinguished from "extended replacement cost," which covers replacement up to the dollar limit of the policy plus an additional percentage (e.g., 25%), and "guaranteed replacement cost," which covers replacement regardless of total cost.

The Insurance Code recognizes that there are several types of replacement cost insurance: "Guaranteed replacement cost coverage with full building code upgrade," "guaranteed replacement cost coverage with limited or no building code upgrade," "limited replacement cost coverage with an additional percentage," and "limited replacement cost coverage with no additional percentage." (Ins. Code § 10102(a) (table).)

"Replacement cost" as used in Section 2051.5(c) is not limited to "replacement cost" in distinction from "extended" or "guaranteed" replacement cost. Such an interpretation would limit "replacement cost" as used in Section 2051.5(c) to "limited replacement cost coverage with no additional percentage."

Section 2051.5(c) does not support such a limitation. The purpose of that section is to ensure that a homeowner is not penalized for rebuilding or replacing a destroyed home at a new location. Thus, if a policy provides for extended or guaranteed replacement cost, the full scope

of extended or guaranteed replacement cost coverage is available whether the homeowner rebuilds at an original or a new location.

Any other reading of Section 2051.5(c) would deprive the homeowner of the benefit of his or her bargain with the insurer. A homeowner with an extended or guaranteed replacement cost policy paid premiums for the extended or guaranteed portion of coverage. Eliminating the extended or guaranteed portion of coverage if a homeowner chose to rebuild or replace at a new location effectively would work a forfeiture on the homeowner and penalize him or her for exercising that right in violation of Section 2051.5(c).

To illustrate our analysis, assume an insurer sold an extended replacement cost policy to a homeowner under which the insurer agreed to pay the amount necessary to replace the destroyed home up to 175% of the limit specified in the policy (often referred to as Coverage A). The Coverage A limit (i.e., the amount necessary to replace the original home) is $500,000. Assume that the home is destroyed by fire and the cost to rebuild it at the original location is $600,000. Rather than rebuild at the original location, the homeowner decides to build a home at a new location for $875,000. How much coverage is the homeowner entitled to? Answer: $600,000. The maximum amount to which the homeowner is entitled is 175% x $500,000 = $875,000, up to the amount it would cost to rebuild at the original location. Because the amount to rebuild at the original location is $600,000, that is the maximum amount the homeowner may recover. The homeowner is not entitled to the additional $275,000 it cost to build at the new location.

Question 3: If a homeowner purchases a home at a new location for less than the cost to rebuild at the original location, is the homeowner entitled to recover the full amount it would cost to rebuild at the original location?

Answer: No.

This question is best answered by a hypothetical. Assume that the homeowner has a replacement cost policy (not an extended replacement cost or guaranteed replacement cost policy) with a $500,000 Coverage A limit. The home is destroyed by fire. Assume the cost to replace the property at the original location is $500,000. Rather than doing so, the homeowner decides to build a home at a new location. The cost of building at the new location is $400,000. May the homeowner recover $500,000: $400,000 to build the new home + $100,000 in cash, representing the additional amount the homeowner would have received if he or she rebuilt at the original location? Answer: No.

As explained above, subsections (c) and (a) of Section 2051.5 must be read together. Subsection (a) sets forth the mechanism by which an insurer makes payment to a homeowner when his or her home is destroyed. First, the insurer pays the homeowner the "actual cash value" of the destroyed property. For a home that it is totally destroyed, the actual cash value is the fair market value of the home. (Ins. Code § 2051(b)(1).) Second, "[o]nce the property is repaired, rebuilt, or replaced, the insurer shall pay the difference between the actual cash value payment made and the full replacement cost *reasonably paid to replace the damaged property*, up to the

limits stated in the policy." (*Id.* § 2051.5(a) (emphasis added).) The italicized language establishes that amounts paid by the insurer to the homeowner above actual cash value must cover amounts actually paid by the homeowner (and those amounts must be reasonable).

Assume in the hypothetical that the fair market value of the destroyed home is $300,000. Insurance recovery for the homeowner replacing at a new location would be as follows: First, the insurer pays the homeowner $300,000, the fair market value of the destroyed property. Next, the homeowner builds a home at the new property. The cost of doing so is $400,000. Once the house is built, the insurer pays the homeowner $100,000. The $300,000 actual cash value payment + the $100,000 additional payment (= $400,000) represents the total amount "reasonably paid to replace the damaged property." (Ins. Code § 2051.5(a).)

Section 2051.5 does not authorize the homeowner rebuilding at the new location to recover yet another $100,000, representing the additional amount the homeowner would have recovered if he or she replaced at the original location. Allowing the homeowner building at a new location to recover cash unrelated to the actual cost of building effectively would read the phrase "replacement cost *reasonably paid to replace the damaged property*" out of Section 2051.5(a). Such a reading is impermissible. Whether replacing at an original or a new location, the homeowner may not recover amounts above actual cash value not actually and reasonably spent to rebuild.

In some cases, a homeowner who builds at a new location for less than the replacement cost at the original location has made a decision to "downsize." The proper comparison, therefore, is a homeowner who chooses to downsize at the original location. For example, if the homeowner in the hypothetical decided to rebuild at the original location for $400,000, the insurer would be obligated to pay only $400,000. Section 2051.5 cannot be read to confer a windfall (i.e., an additional $100,000) on a homeowner who decides to downsize at a new location.

Your letter refers to the fact that real estate values fluctuate and contends, as we understand it, that a homeowner should not be penalized in his or her insurance recovery because of a down market. However, we do not read Section 2051.5 as protecting against market fluctuations. For example, the "actual cash value" of a destroyed home is its fair market value (Ins. Code § 2051.5(a)), which by definition reflects fluctuations in the market. The measure of replacement cost coverage above actual cash value is based on what is "reasonably paid to replace the damaged property" (*ibid.*); fluctuations in property values do not affect that calculation. In sum, changes in real estate property values do not appear to bear on the analysis under Section 2051.5.

Very truly yours,

Adam M. Cole
General Counsel