



Legal Beat

By MICHAEL SEAN QUINN

Imbetterment & Enworsement

RC Auto Policies? AG Suit Draws Attention to Betterment

The Attorney General of Texas has now sued a bucket full of auto insurers, seeking an order requiring them, among other things, to pay policyholders all the money insurers have deducted for depreciation in certain first party auto repair claims. (See *IJ/Texas*, Feb. 28, page 4 for details). The AG is also seeking fines of up to \$10,000 per incident under the Texas Insurance Code. This claim could add up to hun-

dreds of millions of dollars.

The seeds of discourse

The suit is based upon *Great Texas County Mutual Insurance Company v. Lewis*, which was decided by the Austin Court of Appeals on November 5, 1998, and which was not taken to the Supreme Court of Texas. This case looked harmless enough when it was decided. It's not harmless anymore.

The controversy was quite simple, and the facts were undisputed. An insured auto with approximately 110,000 miles sustained auto damage. Repairs included the cost of a re-manufactured engine, related replacement parts and labor. The total price was approximately \$3,600. There was a policy deductible of \$500. The insurer, however, wanted to pay only approximately \$1,000, because it said that something over \$2,000 would be deducted for depreciation (a.k.a. betterment). The sole issue before the court was whether the language of the auto policy authorized the deduction of the \$2,000 for betterment.

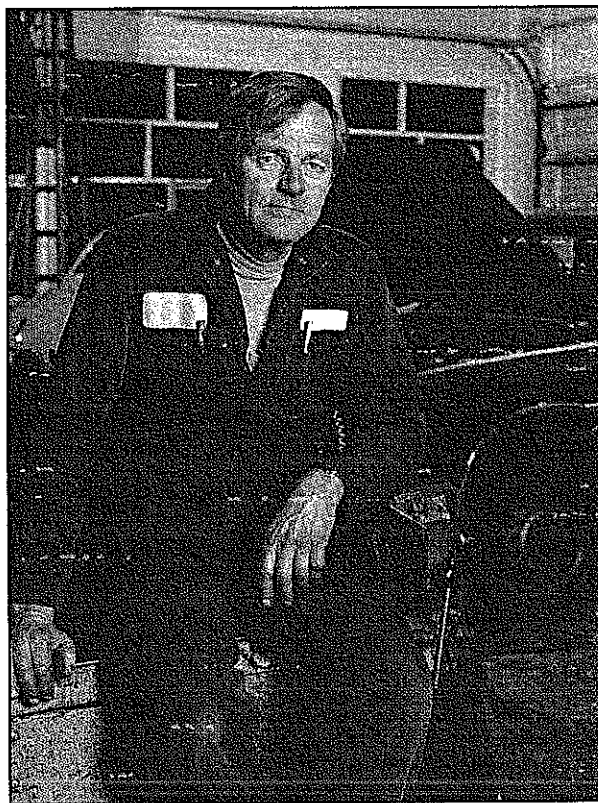
The precise terms of the policy are important. The only applicable portion of the insurance contract said that the insurance company's limit of liability would be the least of the following three: (1) the actual cash value (ACV) of the damaged property, (2) the amount necessary to repair or replace damaged property with other property of like kind and quality, or (3) maximum limit of liability as stated in the declarations sheet.

The crucial thing to know about this case is that the insurance company had elected to pay under Option #2. That's how the insurer, the insured and the court all saw it.

In other words, the court said, the insurance company had elected to pay an amount necessary to repair or replace the property with other property of like kind and quality.

The court then said that since the insurer, after inspecting the engine, had elected Option #2, it did not have the right to deduct any sum for depreciation. The court acknowledged that the insurer would have the right to deduct depreciation if it had elected the ACV option.

The court held that the words "repair" and "replace" imply that the insurer will pay to restore a damaged car to a condition substantially the same as the one which existed just before the damage occurred. Of course, the insurer can replace damaged parts, e.g., an engine, with a thing of similar age, condition and worth. It is not required to do so,



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however. In addition, the insurer in *Lewis* presented no evidence in *Lewis* concerning the availability of such an engine.

If the insurance company does not attempt to repair the car with parts of similar age, condition and value as well as present cash value, it must pay whatever price required to repair the car, so long as that price is less than either Options #1 or #3.

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The insurer in *Lewis* argued that the insured did not have a right to a re-manufactured engine, as opposed to a used engine, because the re-manufactured engine was not of like kind and quality. The principal reason the insurer gave for its position was that re-manufactured engines have warranties and are, in general, better than used engines. As a consequence, the insured who got one would be unjustly enriched, because he finished the insurance transaction better off than when he started.

The *Lewis* court rejected this argument on the grounds that the phrase "like kind and quality" refers to "parts fit for their intended purpose[,] rather than parts similar in age, condition, or a value to the parts damage." Furthermore, the *Lewis* court held that an insurance company that exercises Option #2 has a duty to provide an insured with enough money to make his vehicle as "serviceable as it was before the loss."

Theoretical arguments

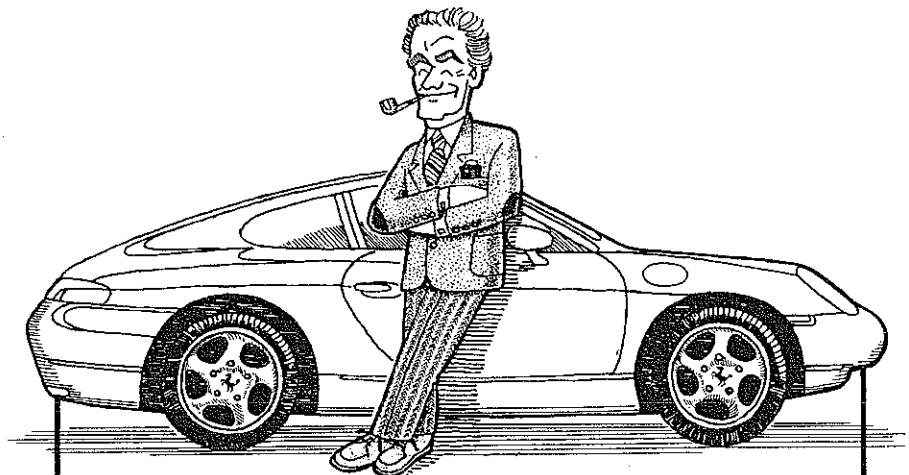
From the point of view of textbook insurance theory, the insurer was right. The legal obligation of insurance companies to make payments is limited by the Principle of Indemnity. The point to insurance is compensatory. It is not to make people better off. It is not to better their circumstances.

Nevertheless, the *Lewis* court was right, if the "Limits of Liability" section of the policy really involves three separate options. Once the insurance company exercised Option #2 it had a duty to make the car serviceable. It had a duty to render the car repaired. What happened here was that the insurer did not appreciate that the "repair or replace" option is automatically an exception to the Principle of Indemnity.

What is troubling here is that homeowners' insurers know this. In those contracts, replacement cost endorsements always trump depreciation, whereas ACV coverage does not. But aren't homeowners insurers often the same as auto insurers? State Farm sells both. Allstate sells both. So do many others.

So why don't auto insurers opt for ACV coverage? The reason is that the automotive aftermarket for used parts is disorganized and therefore slow. One of the most important features of auto insurance is that adjustments must proceed quickly, as must the repairs. Locating satisfactory used parts takes time. Determining that available used parts really are of like kind and quality to the damaged parts takes both time and money. The possibilities for dispute with insureds are endless, and resolving these potentially numerous controversies would be enormously costly.

These facts are inconsistent with the pur-



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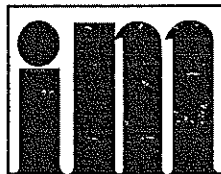
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pose of auto insurance. The purposes of speed and certainty are just as important as the Principle of Fortuity. Insurers should look at the price of the entire transaction, including adjustment costs, before they determine what they should pay the insured.

Application of the law

There has been some grinning in the popular press and in lawyer newspapers about the Attorney General's suit. Some insurance company lawyers are screeching on how unfair it would be to apply the rule in *Lewis* retroactively. This position is, of

course, nonsense. By their very nature, 99.9 percent of the time, common law rules apply retroactively.

If auto insurers had wanted to perform repairs or replace parts utilizing used parts of a similar age, they should have created an efficient market for used parts. Such a thing would not be hard to do, given the financial power of auto insurers. Indeed, given computer technology, it's hard to see why such a market has not emerged. Perhaps it's the expense of determining the quality of the used parts. (Significantly, in determining the true values for applying

the Principle of Indemnity, that cost needs to be factored in.)

As is often the case, there is another way to look at the issue. Everyone involved in *Lewis* assumed that (1), (2) and (3) were separate options. That's not what the contract says. It says that the insurance company is responsible for paying the least of (1), (2) and (3). These are not necessarily separate options—separate ways in which an insurer might pay a tab. They are different ways to compute the value of the loss.

Now, assuming that the word "property" refers to damaged parts, rather than the entire vehicle only, one good way to determine the ACV of a damaged part is to determine the amount of money it would take to repair or replace it and then deduct the difference between the true value of the replacement part and the true value of the used part.

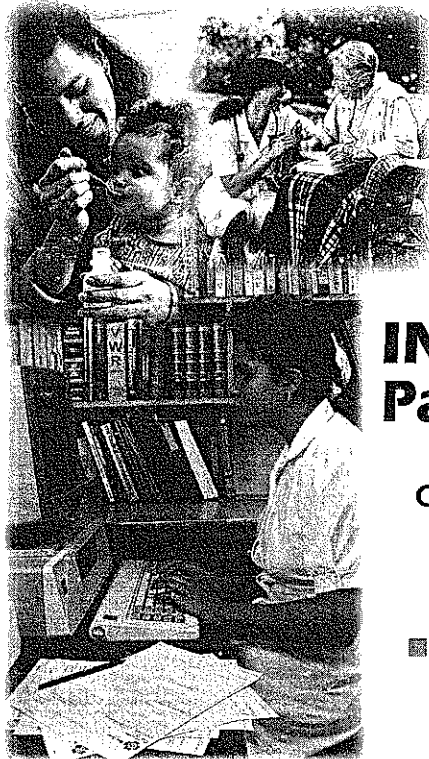
In many HO policies, replacement cost—as opposed to ACV—is added by endorsement. Perhaps this should be done for auto.

The problem here is that everybody in *Lewis* conceived of (1), (2) and (3) as separate options. It looks like the insurance company felt that way itself. It certainly wrote up documents as if that were true. The trouble is that, arguably if there is a course of dealing within which separate items are treated as separate options, it may create an ambiguity, and there's not much the court can do. (At the same time, it's not clear that the court should do much here. After all, one of the purposes of auto insurance is to get people back onto the road quickly, and that goal includes poor people, who can ill-afford reductions for depreciation.)

This is a matter that can be straightened out. In many homeowners policies, replacement cost—as opposed to ACV—is added by endorsement, and a separate charge is included. Perhaps this should be done in the case of auto insurance.

The outcome

One of the most interesting features of the Attorney General's suit will be to determine the extent to which auto insurers had actually thought this problem through. It



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will be extremely interesting to see documents generated by auto insurers over the years to determine how they thought about the relationship between ACV coverage and repair-or-replace coverage. It will be surprising if they had not thought about it in some detail. However, if some of them really did not think about it, that lack would be emblematic of extremely short-sited business practice. They should have thought about it.

Whether insurers should be fined under the Texas Insurance Code for violations will depend upon what those documents reveal, and what various insurance theoreticians have to say about the actual evolution of thinking on these issues inside the insurance companies.

These observations are probably academic, however, because cases like these are almost always settled before fines are imposed. Perhaps that will happen here. On the other hand, if the insurance companies did think about this matter, and if the *Lewis* court correctly conceptualize the situation, then the insurers' insistence upon co-inflating ACV coverage with repair-or-replace coverage options may well be a species of common law and statutory bad faith. If so, one would expect not only the attorney general's suit, but also private class actions. This is particularly true since attorneys' fees are recoverable in statutory bad faith actions, and many trial lawyers will be unable to resist that temptation.

Notice how important the logical structure of the insurance contract really is. Notice how important it is that response from insurers reflects the logical structure of the contract. Notice how important it is that adjusters be educated in the right sort of way. Notice how important it is that insurance coverages be advertised in the right sort of way.



About words

By the way, there is another temptation that should be resisted, and that is the temptation to use the barbaric word "betterment." Every time the insurance industry invents a term, it is inelegant (to say the least) and ugly (to speak the truth). "Betterment" is a word that should be eliminated from the English language. After all, we don't describe the act of placing butter upon bread as "butterment." 

Quinn is an Austin shareholder in the law firm of Sheinfeld, Maley & Kay. He is mostly involved in litigation problems involving insurance coverage. Many of the problems upon which he works involve conduct of lawyers. He testifies from time to time on insurance related issues and on issues pertaining to the conduct of lawyers.


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