No. 126446

IN THE SUPREME COURT
STATE OF ILLINOIS

JARRET SPROULL, individually and on behalf of all others similarly situated Plaintiff-Appellee, v. STATE FARM FIRE AND CASUALTY COMPANY, Defendant-Appellant.	)	Appeal from the Appellate Court, Fifth District, No. 5-18-0577 Third Judicial Circuit Madison Co., No. 16-L-1341 The Honorable Hon. William A. Mudge Judge Presiding

BRIEF OF PLAINTIFF-APPELLEE JARRET SPROULL

Christopher W. Byron, #6230810
Christopher J. Petri, #6257456
Byron Carlson Petri & Kalb, LLC
411 St. Louis Street
Edwardsville, Illinois 62025
Phone: (618) 655-0600
Fax: (618) 655-4004
cwb@bcpldaw.com
cjp@bcpldaw.com

T. Joseph Snodgrass, #6319907
LARSON • KING, LLP
30 East Seventh Street, Suite 2800
St. Paul, MN 55101
Tel: (651) 312-6500
Fax: (651) 312-6618
JSnodgrass@LarsonKing.com

David T. Butsch #06205434
Christopher E. Roberts #6302857
BUTSCH ROBERTS & ASSOCIATES LLC
231 South Bemiston Ave., Suite 260
Clayton, MO 63105
Tel: (314) 863-5700
Fax: (314) 863-5711
Butsch@ButschRoberts.com
Roberts@ButschRoberts.com

Counsel for Plaintiff-Appellee Jarret Sproull

Oral Argument Request Pursuant to Illinois Supreme Court Rule 352(a)

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Carolyn Taft Grosboll
SUPREME COURT CLERK

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POINTS AND AUTHORITIES

NATURE OF THE ACTION

Defendant-Appellant State Farm Fire and Casualty Company ("State Farm") appeals the Fifth District Court of Appeal's unanimous decision affirming the trial court's order (A.81) resolving a Section 2-615 motion to dismiss in favor of policyholder, Jarrett Sproull ("Sproull"). A.53.[1] After reformulating the trial court's Rule 308 certified question (A.71, ¶41), the Fifth District held that when a homeowners policy does not define the terms "actual cash value" or "depreciation," or explain how ACV is calculated (A.55, ¶6), an average, ordinary homeowner, could reasonably understand that depreciation would only apply to "physical structures, as those lose value with age, use, and wear and tear…. Our resolution is in keeping with the primary purpose of an indemnity clause in an insurance contract." A.71, ¶39. This Court should affirm the Fifth District's decisions and similarly answer the certified question in the negative.

ISSUE PRESENTED FOR REVIEW

State Farm's appellate brief contends that the issue presented for review to this Court is the certified question as formulated by the trial court (SF Br. at 2), and *not* the certified question as reformulated by the Fifth District. However, State Farm does *not* argue that the Fifth District's reformulation was improper.

Accordingly, the issue presented for review to this Court should only be the narrower question addressed by the Fifth District:

> [W]hether the cost of labor can be depreciated when determining the actual cash value of a loss as defined under "Coverage A" of the State Farm policy at issue.

[1] Citations to "A." are to the Appendix attached to State Farm's opening appellate brief filed on January 22, 2021 (hereinafter cited as "SF Br."). Citations to "SR." are to the Supporting Record filed with the Fifth District Appellate Court on December 14, 2018.

A.71, ¶41.

STATUTES AND REGULATIONS INVOLVED

50 Ill. Adm. Code 919.80(d)(7)(C) and 50 Ill. Adm. Code 919.80(d)(8)(A):

> Section 919.80. Required Claim Practices – Private Passengers Automobile – Property and Casualty Companies
>
> ***
>
> 7) Required Practices – Fire and Extended Coverage Claims.
>
> ***
>
> C) If partial losses are settled on the basis of a written estimate prepared by or for the company, the company shall supply upon request of the insured, a copy of the estimate upon which the settlement is based. The estimate prepared by or for the company shall be reasonable, in accordance with applicable policy provisions, and of an amount which will allow for repairs to be made in a workmanlike manner. If the insured subsequently claims, based upon a written estimate which he obtains, that necessary repairs will exceed the written estimate prepared by or for the company, the company shall review and respond promptly in writing to the insured in regard to his written estimate and provide the insured with the name of a repair shop or contractor that will make the repairs in a workmanlike manner. Failure of the company to so inform the insured of the name of a contractor shall require the company to provide written notice to the insured that any and all reasonable costs incurred for repair or replacement related to the partial loss in excess of the company's estimate will be reimbursed by the company.
>
> 8) Actual Cash Value Losses.
>
> ***
>
> A) When the insurance policy provides for the adjustment and settlement of losses on an actual cash value basis on residential fire and extended coverage as defined in Section 143.13 of the Code [215 ILCS 5/143.13], the company shall determine actual cash value, except for instances in which the insured's interest is limited as set forth in subsection (d)(8)(B), as follows: replacement cost of property at time of loss less depreciation, if any. Upon the insured's request, the company shall provide a copy of the claim file worksheet(s) detailing any and all deductions for depreciation, including, but not necessarily limited to, the age, condition, and expected life of the property.
>
> ***

STATEMENT OF FACTS

I. STATE FARM WITHHELD CERTAIN LABOR COSTS FROM ACV PAYMENTS AS "DEPRECIATION" EVEN THOUGH SUCH WITHHOLDING IS NOT PERMITTED BY THE POLICY LANGUAGE.

This appeal concerns a State Farm homeowners insurance policy effective from November 25, 2015 to November 25, 2016 ("the Policy"). A.40, n.4. This appeal only addresses whether labor may be withheld as "depreciation" from a payment under the Policy's "actual cash value" ("ACV") coverage terms for a *structural* damage loss, *e.g.*, property damage to a dwelling under "Coverage A" of the Policy. A.54, ¶5; A.71, ¶41.[2]

As it relates to this narrow issue, there are three categories of property insurers in Illinois. First, certain property insurers do not withhold labor costs as depreciation from ACV payments, like the Nationwide Mutual Group. SR.12, at ¶19. *Amici* United Policyholders, the seminal national policyholder advocacy group,[3] estimates that 50% of property insurers fall within this category.

Second, certain property insurers withhold labor from ACV payments, but only under policy forms or endorsements that expressly state that labor costs may be withheld from ACV coverage payments. These types of forms, which have been around for over a decade, are colloquially known as "labor permissive forms." Exemplar Illinois labor permissive forms in the record include forms by the Shelter and Farmers insurance groups. *See* SR.434 (allowing labor withholding in the definition of "depreciation"); SR.455 (allowing labor withholding in the definition of "ACV"). Certain labor permissive forms and endorsements only allow withholding for certain types and categories of claims. *See*

[2] Conversely, this appeal does *not* address *personal* property, *e.g.*, clothes and furniture. These types of losses arise under Coverage C of the Policy. A.272.

[3] *See* https://www.uhelp.org/about/mission (last visited February 19, 2021).

SR.499 (allowing labor withholding only for property damage to roof caused by wind or hail).

This case deals with a third, smaller category (by percentage) of property insurers—those that withhold labor costs as depreciation from ACV payments despite the absence of a labor permissive form. State Farm began using labor permissive forms in Illinois in February 2016. A.39, ¶16. However, this coverage dispute arises under a 2015 policy. A.120.

II. XACTIMATE® SOFTWARE ALLOWS AN INSURER TO DEPRECIATE LABOR BUT ITS DEFAULT SETTING IS TO DEPRECIATE "MATERIALS ONLY."

In December 28, 2015, Sproull's home suffered wind damage. A.33, ¶4. On January 23, 2016, a State Farm adjuster inspected plaintiff's home and determined that plaintiff sustained a covered loss. The adjuster used an electronic software program called Xactimate® to prepare the repair estimate. A.35, ¶7.

Like all of today's claims estimating software platforms,[4] Xactimate® contains an option that allows an adjuster to depreciate labor as well as materials when calculating ACV. A.35, ¶7. In the absence of active intervention, Xactimate® automatically defaults to depreciating materials only. *Id*.; SR.1028, ¶19 ("State Farm … admits that the Xactimate software contains a default setting by which only materials are depreciated, when depreciation is applied at all, to line items in a structural damage repair estimate.").

[4] On August 5, 2019, United Policyholders filed an *amicus* brief before the Fifth District in this case, which included a discussion of and screenshots from all prevalent software platforms that allow the insurance company-user to choose whether or not to depreciate labor costs. Brief of *Amicus Curiae* United Policyholders, at 15-16, Case No. 5-18-0577 (5th Dist. App. Ct. filed Aug. 5, 2019), and Appendix A51-A53 thereto.

Specifically, the insurer, with a single click of a mouse, can instruct Xactimate® to withhold certain labor costs as depreciation by changing Xactimate®'s default settings. *See* Don Wood *et al*., *Insurance Recovery After Hurricane Sandy: Correcting the Improper Depreciation of Intangibles Under Property Insurance Policies*, 42 TORTS, INS. & COMPENSATION L.J. 19, 24 (Winter 2013) (SR.648–54) ("'Depreciate Material Only' [setting] is there because it has been the option for much of insurance claim settlement history.")). In this case, State Farm's adjuster purposely depreciated certain labor repair components. A.35, ¶7.

The Xactimate® estimate State Farm provided to Sproull contained twenty-six line items of which seven contained depreciation for both labor and materials. A.56, ¶¶7-8. State Farm's Xactimate® estimate indicated that ACV was calculated by replacement cost at $1,711.54 less $394.36 in depreciation, or $1,317.18. A.56, ¶8; A.103.

State Farm's withholding of labor in the Xactimate® estimate was not uniformly applied to all labor costs. For example, State Farm did *not* withhold labor for roofers or drywallers (Line Items 27-28). A.110. State Farm also did not withhold labor costs to prepare the site for repair work (content manipulation), to remove and replace drywall and insulation, to texture drywall, to seal and prime, and to remove debris after the repair process (Line Items 2-4, 6-7, 9, 11-15, 17-19, 21, 25-26). A.105-108.

Rather, only labor costs associated with painting and fiberboard replacement were depreciated (Line Items 5, 8, 10, 16, 20, 22). A.105-107. State Farm admits in its Answer that labor costs were, in fact, withheld only from these six line items. SR.1027, at ¶ 16; SR.1032, at ¶ 38 ("State Farm denies that the labor component of the cost to repair … must be paid … as part of actual cash value.")).

III. THE LANGUAGE OF STATE FARM'S POLICY DOES NOT PERMIT WITHHOLDING OF LABOR COSTS AS "DEPRECIATION".

The Fifth District's opinion referenced multiple features of State Farm's Policy. First, the court noted the Policy defines the term "property damage" as "physical damage to or destruction of *tangible* property, including loss of use of this tangible property." A.70, ¶36 (emphasis in original).

Second, the following coverage terms reference ACV payments under Coverage A in the Policy's Loss Settlement provisions:

> **Coverage A—Dwelling**
>
> 1. A1—Replacement Cost Loss Settlement—Similar Construction
>
> a. We will pay the cost to repair or replace with similar construction and for the same use on the premises shown in the Declarations, the damaged parts of the property covered ***, subject to the following:
>
> (1) until actual repair or replacement is completed, we will pay only the actual cash value at the time of the loss of the damaged part of the property, up to the applicable limit of liability shown in the Declarations, not to exceed the cost to repair or replace the damaged part of the property;
>
> (2) when the repair or replacement is actually completed, we will pay the covered additional amount you actually and necessarily spend to repair or replace the damaged part of the property, or an amount up to the applicable limit of liability shown in the Declarations, whichever is less;
>
> (3) to receive any additional payments on a replacement cost basis, you must complete the actual repair or replacement of the damaged part of the property within two years after the date of loss, and notify us within 30 days after the work has been completed; ***." A.55, ¶5; A.276.

Third, there is an *absence* of any policy terms defining or describing "ACV," "depreciation" or the applicable ACV calculation methodology:

> The State Farm policy does not define the term "actual cash value" or explain how actual cash value is calculated. It does not inform the policyholder that actual cash value is the replacement cost of the property at the time of loss, less depreciation, if any. The policy does not define

> "depreciation," and it does not indicate that labor costs are subject to depreciation. A.55, ¶6.

Finally, the Policy does *not* expressly allow State Farm to withhold labor costs as depreciation from ACV payments. Specifically, the Fifth District noted that State Farm chose *not* to use a labor permissive form of the type used by other carriers and eventually used by State Farm. A.60, ¶15. The Court further noted State Farm's acknowledgement that it had introduced "Form FE-3650 Actual Cash Value Endorsement" in Illinois. A.60, ¶16. In the 2015 copyrighted endorsement, State Farm defined the term "actual cash value" to expressly state that labor costs were subject to depreciation.[5] *Id.*

IV. PROCEDURAL HISTORY

State Farm moved to dismiss Sproull's complaint for failure to state a claim pursuant to Section 2-615 on the ground that State Farm's "method for calculating Plaintiff's 'actual cash value' payment fully complied with applicable Illinois Insurance regulations and the terms of the policy." SR.37, Motion to Dismiss at ¶ 9.

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[5] Form E-3650 provides:

> The following is added to any provision which uses the term 'actual cash value':
>
> Actual cash value means the value of the damaged part of the property at the time of loss, calculated as the estimated cost to repair or replace such property, less a deduction to account for pre-loss depreciation. For this calculation, all components of this estimated cost including, but not limited to: 1. materials, including any tax; 2. *labor, including any tax*; and 3. overhead and profit; are subject to depreciation. The depreciation deduction may include such considerations as: 1. age 2. condition; 3. reduction in useful life; 4. obsolescence; and 5. any pre-loss damage including wear, tear, or deterioration; of the damaged part of the property. All other policy provisions apply.

A.60, ¶16 (emphasis added).

Sproull opposed the motion, arguing, among other things, that the term "actual cash value" was ambiguous as undefined in the policy, that depreciation of labor was contrary to Illinois insurance regulations and that the insurance industry's historical practice has been to not depreciate labor. S.R.387 *et seq*.

A. The Trial Court's Ruling

The trial court denied State Farm's motion to dismiss. A.81. The trial court found the term "actual cash value" as used in the State Farm policy was ambiguous and should be construed against State Farm. A.87. The trial court surveyed law from other jurisdictions, finding that decisions from jurisdictions that found labor depreciation unlawful were most "consistent with contract law and general principles of indemnity." A.84-87.

The trial court also found that the Illinois Administrative Code did not expressly allow for the depreciation of labor, explaining: "the Illinois Administrative Code provides the parameters for the calculation of ACV—it does not expressly allow depreciation of labor nor has it been interpreted by any Illinois court to depreciate labor." A.84.

The trial court further held that, as the drafter of the insurance contract, State Farm could have "easily" drafted the contract to permit the depreciation of labor and in failing to do so, the term [actual cash value] is to be "construed liberally in favor of the insured." A.87. The trial court also emphasized that Illinois courts have repeatedly held that the purpose of an insurance contract is to indemnify the insured and that "Defendant's arguments that labor is plainly and logically depreciable is unpersuasive." *Id*. The trial court concluded:

> The practice of depreciation of labor would not unjustly enrich the insured, but rather, the reverse is true, the insured could be in a worse position and,

> ultimately, not be made whole after the loss. Accordingly, it is not logical for the Court to interpret the undefined term in the Policy and permit labor depreciation because: 1). it's not logical to depreciate labor and 2). The interpretation could lead to under indemnification of the insured, defying the purpose of the insurance policy.

Id. State Farm sought interlocutory appellate review pursuant to Illinois Supreme Court Rule 308, and this Court issued a supervisory order directing the Fifth District to allow State Farm's interlocutory appeal. A.75.

B. The Fifth District's Decision

The Fifth District framed the certified question as: "whether the cost of labor can be depreciated when determining the actual cash value of a loss as defined under 'Coverage A' of the State Farm policy at issue." A.71, ¶41.

A unanimous panel of the Fifth District answered the question as "no" explaining its rationale as follows:

> In answering the certified question before us, we remain mindful that we must consider whether the average, ordinary, reasonable person, for whom the policy was written, would have understood that the "actual cash value" of a covered loss meant replacement costs of property less depreciation for materials *and labor. Outboard Marine*, 154 Ill. 2d at 115. We think not. We conclude that an average, ordinary homeowner who purchased the State Farm policy at issue would have reasonably expected that depreciation would apply only to property, *i.e.*, physical structures and tangible materials, as those lose value with age, use, and wear and tear. We further conclude that it is not reasonable to believe that an average homeowner would consider labor to be a tangible asset included within the definition of depreciation…. Our resolution is in keeping with the primary purpose of an indemnity clause in an insurance contract.

A.71, ¶39 (emphasis in original).

In addition, the Fifth District noted that Illinois' ACV Regulation, 50 Ill. Adm. Code § 919.80(d)(8)(A), provides that actual cash value is calculated as "replacement cost of *property* at time of loss less depreciation, if any." A.69-70, ¶36 (emphasis in original). The court held that this regulation refers to property, rather than intangibles, and that an

ordinary layperson would reasonably interpret "depreciation, if any" to describe the depreciation of physical, tangible materials and not labor. *Id*.

STANDARD OF REVIEW

This Court applies *de novo* review to all the issues raised by this appeal. *See Rozsavolgyi v. City of Aurora*, 2017 IL 121048, ¶ 21 (2017) (applying *de novo* review to certified question); *Addison Ins. Co. v. Fay*, 232 Ill. 2d 446, 451 (2009) (applying *de novo* review to issue of policy construction); *People ex rel. Madigan v. Ill. Commerce Comm'n*, 231 Ill. 2d 370, 380 (2008) (applying *de novo* review to issue of statutory interpretation).

The following well-established principles govern resolution of the certified question before the Court:

> If the policy language is susceptible to more than one reasonable meaning, it is considered ambiguous and will be construed against the insurer. Importantly, a policy provision that purports to exclude or limit coverage will be read narrowly and will be applied only where its terms are clear, definite, and specific.

Gillen v. State Farm Mut. Auto. Ins. Co., 215 Ill. 2d 381, 393 (2005) (internal citations omitted).[6] It is equally well-established that, "[w]here competing reasonable interpretations of a policy exist, a court is not permitted to choose which interpretation it will follow. Rather, in such circumstances, the court must construe the policy in favor of the insured and against the insurer that drafted the policy." *Id.* (internal quotation marks omitted).[7]

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[6] Regulations are similarly deemed ambiguous when they are capable of more than one reasonable interpretation. *Madigan*, 231 Ill. 2d at 381. In such instances, Illinois courts consider "the purpose and necessity of the regulation, the evils sought to be remedied and the goals to be achieved." *Id.*

[7] The insurer's interpretation will *not* be adopted even where it is more reasonable than the insured's interpretation. *See, e.g., Stearns v. Millers Mut. Ins. Ass'n of Ill.*, 278 Ill. App. 3d 893, 897–99 (5th Dist. 1996) (construing policy ambiguity against insurer because, although interpretation offered by insurer was reasonable, "it is not the only reasonable interpretation"), *overruled on other grounds by McKinney v. Allstate Ins. Co.*, 188 Ill. 2d

These contract interpretation principles support Sproull's interpretation that insurers like State Farm should not be permitted to withhold labor costs from ACV payments as "depreciation" absent an express policy form permitting the practice and, as discussed below, are consistent with many appellate decisions across the country.

ARGUMENT

I. AN OVERVIEW OF "REPLACEMENT COST VALUE" COVERAGE, "ACTUAL CASH VALUE" COVERAGE AND "DEPRECIATION"

There are two forms of homeowners insurance coverage: ACV and replacement cost value coverage ("RCV"). Under RCV coverage, the insured is intended to be placed in a *better* position than he or she was in before a loss. Specifically, the insured's building is replaced with all new building materials regardless of cost. "Replacement cost coverage … in contravention of the general rule that an insured cannot profit through insurance, results in the insured being better off than he or she was prior to the loss, since the insured ends up with a more valuable property." Allan D. Windt, 3 INS. CLAIMS AND DISPUTES § 11:35 (6th ed. April 2020 Update); *see also Arnold v. State Farm Fire & Cas. Co.*, 268 F. Supp. 3d 1297, 1309 n.17 (S.D. Ala. 2017) ("the very point of an RCV policy is to place the insured in a better position than she previously occupied").

Unlike RCV coverage, ACV coverage is an indemnity coverage intended to return the policyholder's building to the same condition it was in right before the loss, or "*status*

493 (1999); *accord TKK USA, Inc. v. Safety Nat'l Cas. Corp.*, 727 F.3d 782, 791–92 (7th Cir. 2013) (applying Illinois law) (resolving ambiguity against insurer even though insured's interpretation "was not the more persuasive one").

quo ante."[8] The insured party should be restored to the same position they were in before an insured loss. *See* Steven Plitt, *et al.*, COUCH ON INSURANCE §175.5 (3d ed. 2020) (hereinafter "COUCH") ("to place him or her in the same financial condition" as if there had been no casualty).

Stated differently, "ACV is determined prospectively at the time of the loss as an estimate of what it would cost to repair—that is, what it would cost to return the structure to its state prior to the loss[,]" whereas RCV "is determined retrospectively, and is paid subsequent to the completion of repairs, in the amount of the actual cost of repairs." *Johnson v. Hartford Cas. Ins. Co*., No. 15-04138, 2017 WL 2224828, at *5 (N.D. Cal. May 22, 2017).

Finally, in the property insurance context, depreciation is "the amount an item has lessened in value since it was purchased, taking into account age, wear and tear, market conditions, and obsolescence. Although depreciation has been defined in several ways, *the principal definition attributable to that term refers to 'physical deterioration.*'" Richard J. Cohen, et al., 5 NEW APPLEMAN ON INS. LAW LIBRARY ED. §47.04[2][a] (2020) (emphasis added; hereinafter "APPLEMAN"); *see also id.* at [2][b][iii] ("Depreciation in the insurance context is often used interchangeably with physical deterioration."). Further, while "economic depreciation" may be one possible definition of depreciation, physical deterioration is the preferred definition in the insurance property context. *See Dickler v. CIGNA Prop. and Cas. Co*., 957 F.2d 1088, 1099 (3d Cir. 1992) (citing Note, *Valuation and Measure of Recovery Under Fire Insurance Policies*, 49 COLUM. L. REV. 818, 823

[8] Courts have referred to this ACV interpretation as the "*status quo ante*." *Mitchell v. State Farm Fire & Cas. Co.*, 954 F.3d 700, 706-07 (5th Cir. 2020); *Coleman v. Penn. Fire Ins. Co. of Philadelphia, Pa.*, 41 So.2d 477, 478 (La. Ct. App. 1949).

(1949) ("Insurance law is not concerned with the estimated depreciation charged off on the books of business establishments, but rather with the actual deterioration of a structure by reason of age and physical wear and tear, computed as of the time of loss.")).

A simple example illustrates the differences between RCV and ACV. Assume a residential home has siding that has deteriorated by half of its useful life at the time it is destroyed by wind. RCV is simply the cost to remove and then replace all damaged siding with brand new siding. For purposes of this hypothetical, assume that replacement cost is $30,000.

To determine ACV, the next step is to subtract and withhold the proper amount of depreciation. In doing so, it is critical to indemnify the policyholder, *i.e*., to restore the insured to her pre-loss condition. In this illustration, the siding was installed before loss – not simply stacked in a garage.

How is this accomplished? First, labor to remove and dispose of damaged siding must be ascertained and paid. Second, depreciated value of the siding materials must be determined and can be withheld. Finally, labor cost to re-install siding back to the same way it was installed before the loss must be calculated. If payment is made pursuant to this formula, the insured has funds to return her building to pre-loss condition.

The policyholder in this hypothetical is not receiving replacement cost coverage because she must fully pay, out of her own pocket, the difference between half deteriorated and brand-new siding. The withholding of physical depreciation accounts for the deterioration of the siding.

Of course, in the real world, businesses do not sell "used" siding. As a result, the concept of depreciation determines the cost of used materials. In the above hypothetical, if

we simplistically assume RCV was half removal and re-installation labor ($15,000) and half new siding ($15,000), then the proper ACV payment would be 100% of the labor costs ($15,000) and 50% of the value of siding ($7,500), resulting in a total ACV payment of $22,500. In contrast, if labor was also depreciated by 50%, the ACV payment would decrease to $15,000.

As demonstrated, if the labor for removing and re-installing replacement siding is partially withheld, the policyholder is left in a worse position. State Farm's theory leaves the insured in a worse condition than before the loss. *See Hicks v. State Farm Fire & Cas. Co.,* 751 Fed. App'x. 703, 706 (6th Cir. 2018) ("the cost of labor to install a new garage would be [the] same as installing a garage with 10 year old materials." (internal quotation marks and citation omitted)).

II. THE "*SMITH* RULE" PRECLUDES STATE FARM'S EFFORTS TO SURREPTITIOUSLY ADOPT THE "BROAD EVIDENCE" RULE IN ILLINOIS.

In the United States, courts applying and interpreting the phrase "actual cash value" have generally adopted one of three different tests: (1) replacement cost less depreciation; (2) fair market value; and (3) the broad evidence rule. The replacement cost less depreciation test is most favorable to policyholders because an insurer is not allowed use evidence of market value to lower the ACV payment. *Chicago Title & Trust Co. v. U.S. Fidelity & Guar. Co*., 511 F.2d 241, 245 (7th Cir. 1975) (Illinois law).

The replacement cost less depreciation test was first adopted in Illinois in *Smith v. Allemania Fire Ins. Co*., 219 Ill. App. 506 (3d Dist. 1920). In *Smith*, the Third District held that a policyholder is entitled to be indemnified under an ACV policy, and ACV "means

reproduction value less depreciation for age *and not market value*." *Id*. at 512-13 (emphasis added).

Application of the *Smith* rule[9] to a commercial claim was reaffirmed in *C.L. Maddox v. Royal Ins. Co. of America*, 208 Ill. App. 3d 1042 (5th Dist. 1991). There, the Fifth District rejected the broad evidence rule "which would permit the introduction of market value evidence." *Id*. at 1055. It reaffirmed the *Smith* rule holding ACV means "reproduction value less depreciation for age *and not market value*." *Id.* (emphasis added). Although *C.L. Maddox* involved a commercial loss, the court noted an Illinois Department of Insurance ("IDOI") Rule required ACV to be defined as replacement cost less depreciation for residential policies. *Id*. at 1054-55.

Finally, the *Smith* rule was more recently applied in *Carey v. American Family Brokerage, Inc.*, 391 Ill. App. 3d 273, 281-82 (1st Dist. 2009). In defining ACV as replacement cost less depreciation, the court reiterated that Illinois has repeatedly rejected both the "market value" and the "broad evidence" tests. *Id*. at 281-82. The court also defined "depreciation" as physical depreciation—*not* the depreciation arising from an accounting context. Citing BLACK'S LAW DICTIONARY, the *Carey* court held that "[d]epreciation in an insurance context, which is different than depreciation in an accounting context, means the decrease in the actual value of property based on its *physical condition, age,* use, and other factors that affect the remaining usefulness *of the property*. BLACK'S LAW DICTIONARY 473 (8th ed. 2004)." *Id*. at 281 (emphasis added).

[9] Both the appellate decision in this case and the *Chicago Title* opinion refer to the replacement cost less depreciation methodology as "the *Smith* rule." A.67-68; *Chicago Title*, 511 F.2d at 245.

Smith, *C.L. Maddux* and *Carey* uniformly hold that market value, accounting and economic considerations are *irrelevant* to the replacement cost less depreciation analysis. Further, these cases make clear that "depreciation" in the insurance context refers to physical depreciation of tangible property.[10] The Fifth District's decision in this case is in accord. *See* A.67-70, ¶¶33-37 (holding "the plain, common, and ordinary meaning of depreciation is a reduction in value of a property because of aging and wear and tear to the physical structure of that property.").

In contrast, State Farm seeks to broadly define "depreciation" well beyond physical deterioration to account for lower market "value" considerations. Specifically, State Farm argues that ACV should be limited because a policyholder may ultimately need to replace worn out roofing materials *in the future* in the absence of a covered casualty. *See* SF Br. at 10-11 (repeatedly arguing that withholding labor from an ACV payment should be allowed to reflect "the value" of a roof that may eventually need replacement). But broadly defining "depreciation" in this fashion impermissibly turns Illinois' "replacement cost less depreciation" methodology into the "broad evidence" rule. Rejecting such an approach, the Third Circuit Court of Appeals explained:

> CIGNA has attempted to blur the distinction between the "replacement cost less depreciation" rule and the "broad evidence" rule by positing a very broad definition of the term "depreciation." CIGNA would have us define "depreciation" to include all of the factors that go into calculating actual

[10] To avoid the ordinary meaning of depreciation, given the absence of a definition in its Policy, State Farm urges the Court to consider how depreciation is applied in other unrelated contexts, including tax law, maritime law and appraisals. SF Br. at 32-33. However, courts addressing labor depreciation have repeatedly rejected State Farm's argument. *Arnold*, 268 F. Supp. 3d at 1312, n.24 (rejecting identical State Farm argument and refusing to charge "a reasonable insured" with knowledge of whether and how labor depreciation occurs in the context of tax law, maritime law and appraisals); *see also Lammert v. Auto-Owners (Mut.) Ins. Co.*, 572 S.W.3d 170, 179 (Tenn. 2019) (refusing to apply technical definition of depreciation in construing undefined ACV policy term).

> cash value under the "broad evidence" rule. However, New York courts have consistently distinguished between the "broad evidence" rule and the "replacement cost less depreciation" rule, regarding them as mutually exclusive.
>
> …
>
> Commentators have also consistently distinguished the "broad evidence" rule from the "replacement cost less depreciation" rule. *See, e.g.,* Note, *Valuation and Measure of Recovery Under Fire Insurance Policies,* 49 Colum. L. Rev. 818, 820-824 (1949); *Insuring Real Property,* § 24.01[4] at 24-7 to 24-9. Judicial decisions and scholarly commentaries such as these would make no sense if the term "depreciation" subsumed within it the very factors taken into account under the "broad evidence" rule.
>
> Rather, we hold that, in the present context, depreciation is properly defined as physical deterioration. *See, e.g., Depreciation as Factor in Determining Actual Cash Value for Partial Loss under Insurance Policy,* 8 A.L.R.4th 534, 535 n. 2 (1981) ("The type of depreciation considered under insurance law is that which purports to measure the deterioration of property by reason of age and physical wear and tear"); Note, *Valuation and Measure of Recovery Under Fire Insurance Policies,* 49 Colum. L. Rev. at 823 ("Insurance law is not concerned with the estimated depreciation charged off on the books of business establishments, but rather with the actual deterioration of a structure by reason of age and physical wear and tear, computed as of the time of loss.").

Dickler, 957 F.2d at 1098.

The Third Circuit's reasoning in *Dickler* applies with equal force here, particularly given the uniform holdings of *Smith*, *C.L. Maddux* and *Carey*, which the Fifth District appropriately considered and applied here. State Farm should not be permitted to broadly expand its otherwise undefined policy term "depreciation" to include labor costs.

III. STATE FARM'S POLICY DOES NOT UNAMBIGUOUSLY PERMIT STATE FARM TO WITHHOLD LABOR COSTS FROM ACV PAYMENTS.

State Farm's Policy does not define "actual cash value" or "depreciation," nor does it detail the way ACV is to be calculated. A.55, ¶55. Nevertheless, the parties agree that the appropriate methodology to calculate ACV under the Policy at issue and Illinois' ACV Regulation, 50 Ill. Adm. Code § 919.80(d)(8)(A), and the methodology used by State Farm,

is to estimate the cost of repair and replace the damaged property and to subtract depreciation—*i.e.*, the "replacement cost less depreciation" methodology. A.89-9, ¶14.

> But where the two parties differ is on the question that necessarily follows: what costs of the loss should be depreciated? State Farm argues that in calculating the Actual Cash Value payment, *both* the cost of materials *and* the cost of the labor should be depreciated. [Sproull], by contrast, argues that *only* the cost of physical materials should be depreciated, not the cost of labor.

Mitchell v. State Farm Fire & Cas. Co., 954 F.3d 700, 703 (5th Cir. 2020) (emphasis in original) (holding that a policy with identical two-step loss settlement language did not unambiguously permit labor depreciation in calculation of ACV based on replacement cost less depreciation methodology); *accord Perry v. Allstate Indem. Co.,* 953 F.3d 417, 421-22 (6th Cir. 2020) (similar holding where "[n]either the insurance policy nor the Ohio Administrative Code defines 'depreciation'" and recognizing insurer's "interpretation just begs the question of what 'depreciation' means in the first place.").

A. State Farm Fails To Meet Its Burden Of Demonstrating That "Depreciation" Unambiguously Includes Labor.

State Farm failed to draft unambiguous policy language to convey the intent that it now claims to have had all along—namely, that in calculating Sproull's ACV payment, *both* the costs of materials *and* labor would be withheld as "depreciation." This is true despite State Farm being actively involved in the ongoing, national dispute concerning the propriety of depreciating labor for over a decade. As one district court aptly stated when concluding that State Farm's undefined ACV term does *not* unambiguously permit labor depreciation:

> [T]he defendant has not explained why it should be judicially protected from this foreseeable consequence of its own imprecise drafting regarding an issue of which it has actually been aware (as the defendant in *Redcorn*) since at least 2002. *That the defendant scraped by with a 5-3 decision might*

> *well have prompted a reasonable insurer to consider defining ACV so as to eliminate the controversy*.

Arnold, 268 F. Supp. 3d at 1310, n.18 (emphasis added).

In Illinois, "there is a strong presumption against provisions that easily could have been included in the policy but were not." *Illinois Ins. Guar. Fund v. Nwidor,* 2018 IL App (1st) 171378, ¶ 34 (internal citation omitted); *see, e.g., Gillen*, 215 Ill. 2d at 396 ("Had State Farm intended to include a setoff for payments made in accordance with the Pension Code, it easily could have modified the policy language to so provide."). If State Farm wanted to withhold labor costs from ACV payments as "depreciation," it had both the means and responsibility to draft explicit language to that effect. *Nat'l Union Fire Ins. Co. of Pittsburgh, Penn. v. Glenview Park Dist.*, 158 Ill. 2d 116, 123 (1994) (ruling in favor of policyholder because insurer "could have easily modified its insurance policy"). "State Farm could have removed any ambiguity by simply writing its policies to expressly include labor depreciation when calculating ACV. In other states, State Farm has done just this." *Hicks,* 751 Fed. App'x at 709 (noting "following this decision, State Farm can ensure that the wording of any new homeowner's insurance policy it offers in Kentucky defines ACV depreciation to include both labor and materials.").

Numerous other Illinois insurers have engaged in this simple task. *See* SR.378; SR.382; SR.383. In sharp contrast, Sproull's policy contains *no* language explicitly allowing State Farm to depreciate labor costs when calculating ACV.

State Farm's position that it need not add clarifying language to its Policy is contradicted by the insurance industry itself. For instance, National Underwriter Company is a 124-year-old insurance industry publisher. FC&S Bulletins (or FIRE, CASUALTY & SURETY) provide coverage interpretation guidance to insurance underwriters and adjusters

and have been issued for several decades by National Underwriter.[11] Consistent with Sproull's arguments here, National Underwriter has formally stated its position that "depreciation should not apply to labor unless a policy explicitly states that it should." FC&S Bulletin, *Should depreciation be applied to demolition, cleaning, and odor control costs following a fire loss?* (Nat'l Underwriter Co. December 5, 2014).

Insurance regulators have also notified carriers that they should use clarifying policy language before engaging in the practice depreciating labor, especially in the absence of controlling case or statutory law. *See, e.g.,* Mississippi Department of Insurance ("MDOI") Bulletin 2017-8 (Aug. 4, 2017) ("There is no statutory law in Mississippi prohibiting the practice of labor depreciation in the adjustment of property loss claims," but "[i]f such a practice is used, the insurer should clearly provide for the depreciation of labor in the insurance policy.").[12] After the Arkansas Supreme Court precluded withholding labor under a policy that does not so allow, *Adams v. Cameron Mut. Ins. Co.*, 430 S.W.3d 675 (Ark. 2013), the Arkansas legislature enacted a statute precluding

[11] Because National Underwriter's advice is directed to claims and underwriting professionals themselves, FC&S Bulletins "are particularly persuasive as interpretive aids where they support coverage on behalf of the insured." *Golden Eagle Ins. Co. v. Ins. Co. of the West*, 121 Cal. Rptr. 2d 682, 688 (Cal. Ct. App. 2002); *accord Travco Ins. Co. v. Ward*, 468 Fed. App'x. 195, 2012 WL 666230, at *200, n.6 (4th Cir. Mar. 1, 2012) (FC&S Bulletins are "an insurance industry publication which provides expert analysis on insurance policy interpretation"); *Eder v. Allstate Ins. Co.*, 60 F.3d 833, 1995 WL 398822, at *5 (9th Cir. 1990) (holding it is difficult to interpret insurance policy contrary to FC&S Bulletin as it reflects interpretation by the insurance industry); *Casetech Specialties, Inc. v. Selective Ins. Co*., No. 13-11792, 2013 WL 6835098, at *7 n.4 (E.D. Mich. Dec. 23, 2013) (relying on FC&S Bulletin); *Glendale v. National Union Fire Ins. Co*., No. 12-380, 2013 WL 1296418, at *11-12 (D. Ariz. Mar. 29, 2013) (same).

[12] *Available at:* https://www.mid.ms.gov/legal/bulletins/20178bul.pdf (last visited Feb. 22, 2021).

labor depreciation in the absence of permissive language in the policy. Ark. Code Ann. § 23-88-106. These authorities ensure that policyholders are informed consumers.

There is simply no language in State Farm's policy that indicates "to the average, ordinary, normal, reasonable" insured that the policy term "depreciation" encompasses both material and labor costs, the Fifth District's and trial court's rulings are well supported. *Gillen*, 215 Ill. 2d at 395; *Valley Forge Ins. Co. v. Swiderski Elec., Inc.*, 359 Ill. App. 3d 872, 886 (2d Dist. 2005), *aff'd*, 223 Ill. 2d 352 (2006); *see* A.71, ¶40 ("it is not reasonable to believe that an average homeowner would consider labor to be a tangible asset included within the definition of depreciation …."); A.86-87 ("A reasonable insured, armed only with policy language and everyday meaning of words used could reasonably have understood depreciation in its everyday sense applies only to physical deterioration because labor does not sustain physical deterioration since it is not a physical component."); *Jenkins v. State Farm Fire & Cas. Co.*, No. 15-CH-08242 (Ill. Cir. Ct., Cook Cty. Feb. 4, 2016) (SR.371–72) ("[B]ecause labor does not lose value over time or due to wear and tear, the logic being depreciating materials does not apply to labor."), *aff'd on other grounds*, 2017 IL App (1st) 160612-U.

B. A Majority Of Appellate Decisions Favor Sproull.

"Where competing reasonable interpretations of a policy exist, a court is not permitted to choose which interpretation it will follow. Rather, in such circumstances, the court must construe the policy in favor of the insured …." *Gillen*, 215 Ill. 2d at 396; *see also, supra,* note 7. Therefore, to prevail on its interpretation, State Farm must demonstrate that *no* reasonable insured could possibly understand that State Farm's undefined ACV policy term, and the ACV Regulation upon which it is purportedly based, includes

depreciation of both materials and labor costs. *Gillen*, 215 Ill. 2d at 396; *see, e.g., Arnold v. State Farm Fire & Cas. Co.*, No. 17-0148, 2017 WL 5451749, at *7 (S.D. Ala. Nov. 14, 2017) (holding State Farm "failed to sustain its burden of showing that the undefined term 'actual cash value' unambiguously contemplates depreciation of labor costs"). However, to reach such a conclusion, this Court must find not only the Fifth District's decision here, as well as the Illinois trial court decisions in *Jenkins* and below, to be fundamentally unreasonable, but also a growing spate of decisions involving similar policy language and/or state laws or regulations like Illinois, which prescribe a replacement cost lest depreciation methodology for calculating ACV. A.53-72; A.81-87; SR.371–72.

State Farm repeatedly argues that a "majority" view supports its policy interpretation and, therefore, the Fifth District erred in accepting Sproull's liability theory. *See* SF Br. at 12, 18, 24, 26, 28-29, 33-34, 36, 38 (repeatedly arguing Fifth Circuit should have adopted so-called "majority" view in favor of State Farm). However, even excluding the unanimous Fifth District's decision in this case, appellate decisions are now tilted adverse to State Farm, given last year's clear trend (3-1) in favor of policyholders. The following two tables illustrate the current divide:[13]

[13] State Farm briefly argues that "the mere fact that judges have disagreed on the meaning of particular policy language … does not mean that the policy language is ambiguous under Illinois law." SF Br. at 38-39. While a split in authorities *alone* does not make a policy term ambiguous in Illinois, it still supports the conclusion that the term is subject to more than one *reasonable* interpretation. *See, e.g., Outboard Marine Corp. v. Liberty Mut. Ins. Co.*, 154 Ill. 2d 90, 121–22 (1992) (holding conflicting courts' interpretations of undefined term in standard form policy "are both reasonable interpretations of this term in the context in which it appears" and the term "is, at a minimum, ambiguous as used in these policies"); *O'Rourke v. Prudential Ins. Co.*, 294 Ill. App. 30, 33 (1st Dist. 1938) (finding "the contrariety of the opinions of the courts where language in the policies involved is almost identical with the language in the policy before us" establishes policy ambiguity).

APPELLATE COURT DECISIONS FAVORING POLICYHOLDERS

Case Name	Replacement cost less depreciation methodology jurisdiction or agreement?	Holding	Majority / dissent
Cranfield v. State Farm Fire & Cas. Co., 798 Fed. App'x 929 (6th Cir. 2020) (Ohio)	Yes	Ambiguity	3-0
Perry v. Allstate lndem. Co., 953 F.3d 417 (6th Cir. 2020) (Ohio)	Yes	Ambiguity	3-0
Mitchell v. State Farm Fire & Cas. Co., 95 F.3d 700 (5th Cir. 2020) (Mississippi)	Yes	Ambiguity	3-0
Lammert v. Auto-Owners (Mut.) Ins. Co., 572 S.W.3d 170, 178 (Tenn. 2019)	Yes	Ambiguity	5-0
Hicks v. State Farm Fire & Cas. Co., 751 Fed. App'x 703 (6th Cir. 2018) (Kentucky)	Yes	Ambiguity	2-1
Shelter Mut. Ins. Co. v. Goodner, 477 S.W.3d 512 (Ark. 2015)	Yes	Public policy	4-2
Adams v. Cameron Mut. Ins. Co., 430 S.W.3d 675 (Ark. 2013)	Yes	Ambiguity	5-0
TOTAL APPELLATE JUDGES			26-3

APPELLATE COURT DECISIONS FAVORING INSURERS

Case Name	Replacement cost less depreciation methodology jurisdiction or party agreement?	Holding	Majority / dissent
Accardi v. Hartford Underwriter Ins. Co., 838 S.E.2d 454 (N.C. 2020)	No. Broad evidence	Permitted	7-0
Graves v. Am. Family Mut. Ins. Co., 686 Fed. App'x. 536 (10th Cir. 2017) (Kansas)	Yes	Permitted	3-0
Henn v. American Family Mutual Ins. Co., 894 N.W.2d 179 (Neb. 2017)	No. Broad evidence	Permitted	5-0
In re: State Farm Fire and Cas. Co., 872 F.3d 567 (8th Cir. 2017)	No. Fair market value	Permitted	3-0
Redcorn v. State Farm Fire & Cas. Co., 55 P.3d 1017 (Okla. 2002) and *Branch v. Farmers Ins. Co.,* 55 P.3d 1023 (Okla. 2002) (companion cases)	No. Broad evidence	Depreciation allowed for installation labor but not removal labor	5-3
TOTAL APPELLATE JUDGES			23-3

As demonstrated above, the Fifth District's ruling that labor may not be depreciated where ACV is calculated pursuant to the "replacement cost less depreciation" method and the policy does not further define depreciation, is identical to at least *five separate Federal Circuit Courts of Appeals decisions*—four of which involve the *identical obsolete State Farm form at issue here*[14]—and numerous state supreme court rulings, from foreign "replacement cost less depreciation" jurisdictions. As one example, on April 15, 2019, a unanimous Tennessee Supreme Court held, "labor may not be depreciated when the insurance company calculates the actual cash value of a property using the replacement cost less depreciation method." *Lammert*, 572 S.W.3d at 179.

The foreign authority split can be largely harmonized by looking at whether the dispute in question is governed by the "replacement cost less depreciation" methodology or the "broad evidence rule." In *Hicks v. State Farm Fire & Cas. Co.*, the Sixth Circuit provided a simple analysis harmonizing the existing case law from throughout the United States. The court found:

- Kentucky is a "replacement cost less depreciation" state;
- State Farm's supporting case law was *not* from "replacement cost less depreciation" states; and
- Authority from "replacement cost less depreciation" states favors policyholders.

751 Fed. Appx. at 708-11. Specifically, the Sixth Circuit stated that the identical authority relied upon by State Farm here is distinguishable because it comes from broad evidence jurisdictions, *not* "replacement cost less depreciation" jurisdictions:

[14] *Mitchell*, 954 F.3d at 706-07; *Cranfield*, 798 Fed. App'x at 930; *Perry*, 798 Fed. App'x at 423; *Hicks*, 751 F. App'x at 709; *Stuart v. State Farm Fire & Cas. Co.*, 910 F.3d 371, 373-74 (8th Cir. 2018) (Arkansas).

> State Farm overlooks the fact that the cases on which it relies—*Redcorn*, *Henn*, *Wilcox*, *LaBrier*, and *Graves—come primarily from states where the broad evidence rule applies* or where the policies at issue expressly define ACV. On the other hand, courts that have endorsed the minority position come from states with laws or regulations like Kentucky, *which prescribe a replacement cost less depreciation formula*.

Id. at 710-11 (holding insurer cannot depreciate labor costs when calculating ACV pursuant to the replacement cost less depreciation methodology (emphasis added)).

State Farm's reliance on the identical set of decisions in this case[15] is misplaced for the same reason. Such decisions do *not* involve the circumstances found here—*i.e.*, state law prescribes a "replacement cost less depreciation" methodology, and the policyholder simply disputes whether labor costs can be withheld as depreciation.

Courts in replacement cost less depreciation jurisdictions are near unanimous in disallowing the withholding of labor as depreciation in the absence of an express policy form authorizing the practice. As the Sixth Circuit held in *Hicks*, "the instructive precedents are not those from states that reject reproduction cost, but those that define actual cash value as replacement cost less depreciation, *like Illinois*, Ohio, and Alabama." *Hicks*, 751 Fed. App'x at 711 (emphasis added); *see, infra,* Argument Section IV (discussing labor depreciation decisions from states with regulatory schemes similar to Illinois).

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[15] *See* SF Br. at 20-21, 24-28. State Farm's reliance upon the North Carolina Supreme Court's February 2020 decision in *Accardi v. Hartford Underwriters Ins. Co.*, 838 S.E.2d 454 (N.C. 2020), is similarly misplaced. *See* SF Br. at 21, 25. North Carolina is a "broad evidence rule" jurisdiction, which allows insurers to consider "market value" in lieu of reproduction cost. *See Kinlaw v. N.C. Farm Bureau Mut. Ins. Co.*, 389 S.E.2d 840, 844 (N.C. Ct. App. 1990). Consistent with a broad evidence methodology, the *Accardi* court expressly allowed for fair market value consideration to reduce the value of an ACV payment. 838 S.E.2d at 457 ("The value of a house is determined by considering it as a fully assembled whole."). No appellate court that has addressed labor depreciation since *Accardi* has followed the decision. *Compare Accardi*, 838 S.E.2d 454, *with Perry*, 953 F.3d 417 (issued Mar. 18, 2020); *Cranfield*, 798 Fed. App'x 929 (issued Mar. 23, 2020); *Mitchell*, 954 F.3d 700 (issued Mar. 30, 2020).

Four state supreme courts from "replacement cost less depreciation" jurisdictions (or where the insurer and insured have agreed to that methodology) have addressed labor depreciation in some fashion—*i.e.,* Arkansas, Mississippi, South Carolina and Tennessee. In all four cases, the state supreme courts found that labor is *not* depreciable when ACV is calculated by applying the "replacement cost less depreciation" methodology. *See Adams*, 430 S.W.3d at 678 ("We … simply cannot say that labor falls within that which can be depreciable."); *Bellefonte Ins. Co. v. Griffen*, 358 So.2d 387, 389-90 (Miss. 1978) (policy term allowing "deduction for depreciation" is ambiguous because it "does not specifically prohibit or allow depreciation on the cost of labor"); *S.C. Elec. & Gas Co. v. Aetna Ins. Co.*, 120 S.E.2d 111, 118 (S.C. 1961) (holding that the costs of labor (winding and installation) "would not be depreciable" while "the cost of materials, would be depreciable"); *Lammert*, 572 S.W.3d at 179 ("labor may not be depreciated when the insurance company calculates the actual cash value of a property using the replacement cost less depreciation method.").

The Tennessee Supreme Court's unanimous decision in *Lammert* is particularly instructive as it demonstrates the proper analysis—both in Tennessee and Illinois[16]—for interpreting an insurance policy that is silent on whether labor costs may be withheld as depreciation in a "replacement cost less depreciation" jurisdiction. The *Lammert* court

[16] The rules governing policy interpretation in Illinois and Tennessee are well-established and indistinguishable. The construction that courts in both states give to an insurance policy "should be a natural and reasonable one. Undefined terms will be given their plain, ordinary and popular meaning, *i.e.*, they will be construed with reference to the average, ordinary, normal, reasonable person." *Gillen,* 215 Ill.2d at 393 (internal citations omitted); *accord Lammert*, 572 S.W.3d at 178-79 ("terms of a contract of insurance are to be construed according to their plain, ordinary, popular sense unless they have acquired a technical sense" that is "clearly conveyed in the policy itself").

correctly described the policyholder's interpretation as "ordinary" and dismissed the insurer's interpretation as "technical," explaining:

> In the end, this case turns on our standard for interpreting insurance contracts because both parties have presented plausible interpretations of the policies, neither of which explicitly states whether labor expenses are depreciable when calculating the actual cash value. On the one hand, the homeowners' position that labor is not depreciable is well-taken. "Depreciation in insurance law is not the type that is charged off the books of a business establishment, but rather it is the actual deterioration of a structure by reason of age, and physical wear and tear, computed at the time of the loss." *Redcorn,* 55 P.3d at 1020. With this understanding, it is reasonable that a homeowner would understand that depreciation would only be applicable to material goods that can age and experience wear and tear. It is also reasonable that a homeowner, knowing that replacement costs include both labor and materials to rebuild a roof, would believe that the insurance company would only apply depreciation to the physical materials, those things that actually deteriorated. Auto-Owners argues that the homeowners' interpretation is not reasonable because depreciation is a numerical factor to be applied to the replacement cost to calculate the actual cash value and is not reflective of literal deterioration.
>
> ***
>
> Here, *Auto-Owners argues for a technical definition of depreciation that is not evident on the face of either policy*. *Taking the term in its ordinary sense, it applies to physical deterioration, which is the meaning attributed to it by the homeowners*. As this Court has previously stated, "if the disputed provision is susceptible to more than one plausible meaning, the meaning favorable to the insured controls." ….
>
> We conclude that the language regarding depreciation in the policies in question is ambiguous. Under Tennessee law, ambiguities in insurance contracts are strictly construed against the insurance companies and in favor of the insured. Therefore, with the insured's interpretation controlling, labor may not be depreciated when the insurance company calculates the actual cash value of a property using the replacement cost less depreciation method.

Id. at 178–79 (emphasis added; internal citations omitted).

The Tennessee Supreme Court's reasoning in *Lammert* fully supports the Fifth District's conclusions in this case. Both courts correctly held that the term "depreciation" must be read in its ordinary sense—it applies only to physical deterioration, which is the

meaning attributed to it by Sproull. A.71, ¶39; *Lammert,* 572 S.W.3d at 179. State Farm's argument to the contrary contravenes established Illinois law. A.71, ¶39; *Clayton v. Millers First Ins. Cos.*, 384 Ill. App. 3d 429, 435–37 (5th Dist. 2008) (refusing to apply technical definition proposed by insurer to undefined policy term where "insurance policy makes no reference to, and is not limited to, a statutory or 'legal definition'"); *U.S. Fid. & Guar. Co. v. Specialty Coatings Co.*, 180 Ill. App. 3d 378, 391 (1st Dist. 1989) (holding insurer's "reading of the [policy] term relies on the 'accepted, technical' meaning of 'damages'; however, it has been recognized that the term is 'ambiguous' to the non-legal community"; citing out-of-state decisions).

Ultimately, however, this Court need not adopt all the reasoning in the cases relied upon by Sproull to affirm—some of which involve indemnity principles, some of which rely on dictionary definitions, and some of which do not focus their analysis on the ordinary understanding of a reasonable insured. *Lammert*, 572 S.W.3d at 178-79 (declining to decide whether labor can logically depreciate or whether indemnity is achieved to answer certified labor depreciation question because "this case turns on our standard for interpreting insurance contracts"). Nevertheless, consistent with the Fifth District's conclusion here, these cases "point the way to the correct resolution of the [certified question], because they make clear that a reasonable insured, armed only with the Policy language and everyday meaning of the words used, could reasonably understand that ACV does not encompass depreciation of labor costs." *Arnold*, 268 F. Supp. 3d at 1312; *Lammert*, 572 S.W.3d at 178-79 (similar holding); *see also Titan Exteriors, Inc. v. Certain Underwriters at Lloyd's*, 297 F. Supp. 3d 628, 634 (N.D. Miss. 2018) (discussing conflicting labor depreciation case law and stating "[t]he Court need not decide which of

these interpretations is correct. It needs [sic] only find that each is reasonable, and the Court so finds that 'actual cash value' when defined as 'replacement cost less depreciation' is subject to more than one reasonable interpretation").

C. State Farm's Handling Of Sproull's Claim Highlights The Ambiguity In State Farm's Policy.

State Farm depreciated certain items of labor in Sproull's claims but did not depreciate other items. *See, supra,* Statement of Facts Section II. This further highlights that there are two possible interpretations of the Policy's undefined ACV and depreciation terms—one of which is that labor costs cannot be depreciated.

Since State Farm adopted Sproull's interpretation of the terms with respect to many labor items, State Farm must concede that Sproull's interpretation is at least reasonable. Consequently, because there are two reasonable interpretations of the undefined term—one that (in Sproull's view and as partially reflected within the estimate he received from State Farm) precludes labor depreciation and another that (in State Farm's view) permits such depreciation—the term is ambiguous under Illinois law. *Gillen*, 215 Ill. 2d at 396; *see also, supra,* note 7.

IV. THE ILLINOIS ACV REGULATION DOES *NOT* SUPPORT STATE FARM'S POLICY INTERPRETATION.

A. The ACV Regulation Does *Not* Direct That Labor Costs May Be Withheld When Calculating ACV.

Although it chose not to issue a labor permissive coverage form with Sproull's policy, State Farm argues that it may nevertheless withhold labor from Sproull's ACV payment because: (1) Illinois' ACV Regulation, 50 Ill. Adm. Code § 919.80(d)(8)(A), purportedly supplies the applicable insurance policy definition of ACV through the phrase "replacement cost of property at the time of loss less depreciation, if any"; and (2) the word

"depreciation" within this phrase must be given its broadest meaning possible so as to allow State Farm to minimize Sproull's ACV payment. *See* SF Br. at 13-21. State Farm's arguments fail for multiple reasons.

First, State Farm provides no administrative or judicial support for its argument that the ACV Regulation was ever intended to limit ACV payments by allowing an insurer to unilaterally define the term "depreciation" as broadly as possible. In fact, five Illinois jurists have uniformly held otherwise, rejecting the identical argument advanced by State Farm here. *See* A.71, ¶39 ("State Farm sought to apply a technical definition of depreciation that is not evident in the language of the policy or in the regulation upon which it relies."); A.84 (recognizing ACV Regulation "governs how an insurer is able to calculate the ACV in a policy like Sproull's, but it is important to note that, the [Regulation] provides the parameters for the calculation of ACV—it does not expressly allow depreciation of labor nor has it been interpreted by any Illinois court to depreciate labor"); *Jenkins*, No. 15-CH-08242 (SR.372) (the conclusion that labor costs are not logically depreciable "does not conflict with the Illinois insurance regulations which state that ACV should be determined as RCV less depreciation").

Second, "[a] contract term is unambiguous if it has an *established and precise* legal meaning. On the other hand, there may be *no requirement to satisfy the elements of a legal term if the policy does not explicitly purport to rely on or define the legal term*."[17] *Clayton*,

[17] State Farm argues that contract terms are not ambiguous in Illinois if they are defined by law and, in such instances, the terms cannot be construed against the insurer. *See* SF Br. at 36. But State Farm ignores that this rule applies *only* where the term in question "has an established and precise legal meaning" *and* the policy "explicitly purport[s] to rely on or define the legal term." *Clayton*, 384 Ill. App. 3d at 433; *see Nicor, Inc. v. Associated Electric & Gas Insurance Services Ltd.*, 223 Ill. 2d 407, 417 (2006) (recognizing only that "a policy term *may be* considered unambiguous where it has acquired an *established* legal

384 Ill. App. 3d at 433, 437 (holding "insurance policy makes no reference to, and is not limited to, a statutory or 'legal definition' of a ward" and therefore the term "'ward' is ambiguous and should not be restricted to a technical, legal definition") (emphasis added; internal citations omitted)); *Robinson v. Hertz Corp.*, 140 Ill. App. 3d 687, 688 (3d Dist. 1986) (explaining technical sense of term must be "obvious" from policy language).

State Farm's policy makes no reference, and is not limited, to a statutory, technical, or legal definition of "ACV" or "depreciation" that would allow State Farm to withhold labor costs from its policyholders' ACV payments. As the lower courts' rulings in this case make clear, no such "established and *precise* legal meaning"[18] of ACV exists in Illinois "since every insurance company can include the items to be calculated in determining the ACV." A.86; *see also* A.62, 70, ¶¶19, 37 (recognizing whether it was appropriate for State Farm to depreciate labor costs when ACV is not defined in the Policy, is a question of first impression in Illinois). State Farm's conduct here reflects the imprecision of its policy language—*i.e.*, depreciating *some*, *but not all*, labor charges when calculating Sproull's ACV payment. *See, supra,* Statement of Facts Section II.

Third, and perhaps more importantly, Illinois' ACV Regulation was promulgated by the IDOI pursuant to its authority under Illinois' Improper Claims Practices Act. 50 Ill. Adm. Code § 919.10; 215 ILCS 5/154.5, 154.6. *The purpose of the Act is to protect policyholders*. 215 ILCS 5/154.7, 154.8. As a result, the remedial regulations issued under the Act must be liberally construed in favor of Sproull to effectuate their purpose. *Price v.*

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meaning" (emphasis added)); *Nabor v. Occidental Life Ins. Co. of Cal.*, 78 Ill. App. 3d 288, 291–93 (1st Dist. 1979) (finding policy ambiguous and rejecting insurer's argument that insurance statute required provision in question). Here, State Farm has established neither prerequisite.

[18] *Clayton*, 384 Ill. App. 3d at 433 (emphasis added).

Philip Morris, Inc., 219 Ill. 2d 182, 234 (2005); *Robinson v. Toyota Motor Credit Corp*., 201 Ill. 2d 403, 417 (2002).

These remedial regulations should *not* be construed to limit a policyholder's recovery, as State Farm argues in contradiction of Illinois case law. Rather, the regulations are explicit that they only set a floor for claim dispositions to protect policyholders. *See* 50 Ill. Adm. Code § 919.20(b) ("The purpose of this Part is to set forth *minimum standards* for the … disposition of claims arising under contracts and certificates issued to residents of Illinois." (emphasis added)).

The ACV Regulation itself evidences the IDOI's concern about an insurance company's unfair depreciation calculations, providing in relevant part: "Upon the insured's request, the company shall provide a copy of the claim file worksheet(s) detailing any and all deductions for depreciation, including, but not necessarily limited to, the age, condition, and expected life of the property." 50 Ill. Adm. Code § 919.80(d)(8)(A). Significantly, this precise language within the ACV Regulation references *only tangible* property as the Fifth District correctly concluded:

> Indeed, the regulation relied on by State Farm states that actual cash value is calculated as "replacement cost of *property* at the time of loss, if any." (Emphasis added.) This provision specifically pertains to replacement cost of the damaged "property," less depreciation of that "property." According to the dictionary definitions, property refers to something tangible, something that is owned or possessed. Again, the insurance regulations governing required claims practices are to be construed together, and the terms used therein, unless otherwise defined, are to be given their plain and ordinary meaning. Thus, it is clear, based upon the plain language of the State Farm policy at issue and the language in the Code that "actual cash value" refers to real property—an asset that can lose value over time due to wear and deterioration, resulting from use or the elements, and does not refer to services such as labor.

A.69, ¶ 36 (emphasis in original; footnote of dictionary definitions omitted).[19]

The Fifth District's analysis is consistent with the rationale of decisions in states with similar regulatory schemes. For example, in *Hicks v. State Farm Fire & Cas. Co.,* the Sixth Circuit addressed Kentucky's ACV regulation, 806 Ky. Adm. Reg. 12:095(9)(2), which is virtually identical to Illinois' ACV Regulation.[20] *Hicks*, 751 F. App'x at 707–08. The *Hicks* court found both State Farm's policy language materially identical to the policy here *and* the administrative language ambiguous, holding:

> The State Farm policies at issue here do not define ACV. Instead, the parties agree that the policies incorporate the definition provided in Kentucky's ACV regulation, § 9(2)(a), which calculates ACV as replacement cost minus depreciation. However, the parties disagree on the effect of § 9(2)(a) because neither the ACV regulation nor State Farm's homeowner policies define the word "depreciation." Thus the sole question in this appeal is, as the district court held: "whether the installation of materials, *i.e.* the labor, is subject to depreciation?" In other words, does depreciation in § 9(2)(a) mean materials and labor, or simply materials?
>
> ***
>
> *Here, the State Farm policies are ambiguous because they do not define ACV but simply incorporate Kentucky's ACV Regulation which does not define depreciation. Thus, there are two levels of ambiguity: the contract is ambiguous because it relies on a regulation that is subject to multiple reasonable interpretations*.

Id. at 708 (emphasis added; internal citation omitted).

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[19] The Illinois' Partial Loss Regulation, 50 Ill. Adm. Code 919.80(d)(7)(C), also supports the Fifth District's ruling as it evidences the IDOI's concern that Illinois insurers afford their policyholders an amount sufficient "for repairs to be made in a workmanlike manner" so as to return damaged property to its pre-loss condition. *Id.* Allowing State Farm to withhold the labor necessary "for repairs to made in a workmanlike manner," *id.*, under the guise of "depreciation" would leave the policyholder with a significant out-of-pocket loss that is inconsistent with the principle of indemnity, generally, and Illinois' Partial Loss Regulation, more specifically. As discussed more thoroughly, *infra*, Argument Section IV.B., this Court views all provisions of an enactment as a whole when interpreting statutes and corresponding administrative regulations. *Madigan*, 231 Ill. 2d at 382; *Portman v. DHS*, 393 Ill. App. 3d 1084, 1093 (2d Dist. 2009).

[20] As in Illinois, 806 Ky. Adm. Reg. 12:095(9)(2) defines ACV as "replacement cost of property at the time of loss less depreciation, if any." *Id.*

Even more recently, in *Perry v. Allstate Indem. Co.*, the Sixth Circuit addressed Ohio's ACV regulation, Ohio Admin. Code § 3901-1-54(1)(2)(a), which also defines "ACV" similarly to Illinois' ACV Regulation.[21] *Perry*, 953 F.3d at 422. Like State Farm has argued here and in *Hicks*, Allstate, in *Perry*, argued that because the policy at issue left "depreciation" undefined, Ohio's ACV regulation supplied the necessary definition such that the policy unambiguously permitted labor depreciation. *See Perry*, 953 F.3d at 422.

The Sixth Circuit rejected this argument, explaining:

> Neither the insurance policy nor the Ohio Administrative Code defines "depreciation."
>
> ***
>
> Allstate makes much of the fact that the Kentucky regulations [like Illinois' ACV Regulation] say "depreciation, if any," while the Ohio regulations say "any depreciation." In its view, "any depreciation" means all types of depreciation. We read "any depreciation" as simply saying "whatever depreciation there happens to be." Allstate's interpretation just begs the question of what "depreciation" means in the first place.

Id. at 421-22. The Sixth Circuit held that both parties' respective interpretations of the Ohio ACV regulation and the undefined term "depreciation" as used therein and in neighboring provisions of administrative code, as well as in the policy at issue, "are reasonable to our eye and do not clear up the ambiguity." *Id.* at 421-22, n.4. Accordingly, the court construed the "ambiguous policy with competing reasonable interpretations … in favor of the insured," concluding Allstate improperly depreciated labor costs in calculating ACV. *Id.* at 423.

Thus, where depreciation is undefined in both the insurance policy *and* pertinent regulations—as it is here—an ambiguity arises that must be resolved in favor of the

[21] Ohio Admin. Code § 3901-1-54(1)(2)(a) defines ACV as "replacement cost of property at the time of loss, including sales tax, less any depreciation." *Id.*

insured. *See id.* at 421-23 and n.4; *Hicks*, 751 F. App'x at 710 (recognizing that "to the extent that the word 'depreciation' as used in [Kentucky ACV regulation] is ambiguous, this term should be interpreted in favor of the insured"; "State Farm's interpretation of the ACV regulation to include labor depreciation does not pass muster").[22]

In *Lammert v. Auto-Owners (Mutual) Ins. Co.*, a unanimous Tennessee Supreme Court referenced Tennessee's ACV Regulation, Tenn. Comp. R. & Regs. 0780-01-05-.10, which is also virtually identical to Illinois' ACV Regulation. *Lammert*, 572 S.W.3d at 178 n.6. The *Lammert* court held that the ordinary definition of "depreciation" is limited to physical deterioration. *Id*. at 178. If the insurer wanted to add "a technical definition of depreciation that is not evident on the face of either policy," the insurer needed to add clarifying language to its policy. *Id*. at 179; *accord Clayton*, 384 Ill. App. 3d at 433–37 (affording policy "term its plain and ordinary meaning" where technical meaning was *not* "explicitly" provided in insurance policy). The Fifth District correctly applied the same reasoning here, recognizing that "an average, ordinary homeowner who purchased the State Farm policy at issue would have reasonably expected that depreciation would apply only to property …. State Farm sought to apply a technical definition of depreciation that is not evident in the language of the policy or in the [ACV] regulation…." A.71, ¶¶39, 41.

Finally, in *Arnold v. State Farm Fire & Cas. Co.*, the district court addressed Alabama's ACV Regulation, Ala. Adm. Code § 482-1-125-09(2), which allowed an insurer

[22] In so holding, the Sixth Circuit in *Hicks*, specifically referred to the trial court's decision here as "instructive" because the Illinois and Kentucky ACV regulations similarly prescribe a replacement cost less depreciation formula for calculating ACV. 751 F. App'x at 710-11 (citing *Sproull v. State Farm Fire & Cas Co.*, No. 16-L-1341, slip op. at 2-3, 6 (Ill. Cir. Ct. Feb. 26, 2018) as "rejecting State Farm's contention that an Illinois ACV regulation—similar to Kentucky's—somehow permitted labor to be depreciated").

to use a "replacement cost of property at time of loss less depreciation" methodology. *Arnold,* 268 F. Supp. 3d at 1305. However, the district court in *Arnold* did not reach State Farm's argument that the regulatory language mandated the withholding of labor as depreciation, because State Farm (as in this case) failed to offer, in the first instance, any authority demonstrating that Alabama's ACV Regulation was intended to provide a policy definition limiting coverage to the detriment of an insured. *Id*. at 1306, n.13.

These cases support both the Fifth District's and trial court's rulings here. Illinois' ACV Regulation acts only as a floor. The regulation was never intended to allow an insurer to broadly define "ACV" or "depreciation" to the detriment of a policyholder without any supporting express policy language or clear definition. *Clayton*, 384 Ill. App. 3d at 433, 435; *see also Dickler*, 957 F.2d at 1098-99 (rejecting insurer's argument for "a very broad definition of the term 'depreciation'" where policy defined ACV as "replacement cost less depreciation" but did not define "depreciation; holding "depreciation is properly defined as physical deterioration" pursuant to rule that policy ambiguities are construed in favor of insured).

"State Farm's [regulatory] argument misses the mark" for the additional reason that the issue is not whether the ACV Regulation provides the applicable insurance policy definition of ACV, but rather "the issue is whether the average person, for whom the policy is written, would reasonably understand that State Farm[]" would withhold labor costs as "depreciation" when calculating ACV payments pursuant to that regulation. *Gillen*, 215 Ill. 2d at 395 (holding statutory phrase "'worker's compensation, disability benefits or similar law' would not convey to the average, ordinary, normal, reasonable person an intention to

include our pension statute within the setoff clause of the policy").[23] In other words, is State Farm's ACV policy provision "clear, definite and specific?" *Id.* "[T]he answer is 'no.' The [policy language] would not convey to the average, ordinary, normal, reasonable person [such] an intention[,]" *id.*, nor would the ACV Regulation as "it does not expressly allow depreciation of labor nor has it been interpreted by any Illinois court to depreciate labor." A.84.

Consistent with this Court's decision in *Gillen*, the Fifth District correctly held:

> In answering the certified question before us, we remain mindful that we must consider whether the average, ordinary, reasonable person, for whom the policy was written, would have understood that the "actual cash value" of a covered loss meant replacement costs of property less depreciation for materials *and labor. Outboard Marine*, 154 Ill. 2d at 115. We think not. We conclude that an average, ordinary homeowner who purchased the State Farm policy at issue would have reasonably expected that depreciation would apply only to property, *i.e.*, physical structures and tangible materials, as those lose value with age, use, and wear and tear. We further conclude that it is not reasonable to believe that an average homeowner would consider labor to be a tangible asset included within the definition of depreciation…. Our resolution is in keeping with the primary purpose of an indemnity clause in an insurance contract.

A.71 (emphasis in original). The trial court's decision is in accord. A.86-87. For these reasons, State Farm's regulatory argument fails, and the Fifth District's decision should be affirmed.

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[23] In *Gillen*, this Court further recognized that even if it concluded that State Farm's setoff clause, reasonably construed, could convey to the average policyholder that State Farm's liability would be reduced by payments made under Illinois' pension statute and a municipal ordinance, "*at best this results in an ambiguity*. That is, construing the setoff clause to include benefits authorized by the Pension Code would compete with an equally reasonable construction excluding such benefits." 215 Ill.2d at 395 (emphasis added). As such, the Court concluded that State Farm must honor its policyholder's claim for uninsured-motorist coverage with no offset for medical benefits paid to the insured pursuant to the Pension Code. *Id.* at 396.

B. The ACV Regulation Is Properly Construed In Favor Of Sproull.

Similar to Illinois' rules of construction for insurance policies, "[a]n ambiguity exists where [an Illinois] regulation is capable of more than one reasonable interpretation." *Madigan*, 231 Ill. 2d at 381; *Portman v. DHS*, 393 Ill. App. 3d 1084, 1089 (2d Dist. 2009). This is true where the brevity of detail within a regulation allows two or more reasonable interpretations. *Madigan*, 231 Ill. 2d at 382 ("We find the regulation ambiguous because on its face it contains no indication whether filing requires actual physical acceptance by a human being in the chief clerk's office."). In such instances, the Court must interpret the regulation to advance its purpose and necessity, considering the evils sought to be remedied and the goals to be achieved. *Id*.; *Portman*, 393 Ill. App. 3d at 1091. Further, in doing so, the Court "views all provisions of an enactment as a whole." *Madigan*, 231 Ill. 2d at 382; *Portman*, 393 Ill. App. 3d at 1093 ("In addition, we are to construe administrative regulations 'together with the statute pursuant to which they were adopted in order to insure a sound and effective legislative program.").

Here, at least one reasonable interpretation of the word "depreciation" is the one uniformly found by the Fifth District and trial court in this case, Judge Kathleen Kennedy of Cook County in *Jenkins*, *supra*, and dozens of other jurists from throughout the United States.[24] A.53-72; A.81-87; SR.371–72; *see also Perry*, 953 F.3d at 419, 423 (holding policyholder's "interpretation—that in calculating ACV depreciation does not include labor costs—has been recognized as reasonable by numerous state and federal courts, including our own, because depreciation traditionally refers to value lost from physical

[24] In fact, in *Arnold*, the court noted that State Farm "confirmed that some percentage of insurance adjusters, like some percentage of jurists, share the plaintiff's understanding." 268 F. Supp. 3d at 1312, n.23.

wear and tear."); *Mitchell*, 954 F.3d at 706-07 ("Mitchell's definition, which results in paying the costs necessary to place a homeowner in the *status quo ante*, is reasonable. Several other courts interpreting the term ['ACV'] where ['ACV'] is defined as 'replacement cost less depreciation' have reached the same conclusion."); *Arnold*, 268 F. Supp. 3d at 1312 ("[A] reasonable insured could reasonably understand that labor does not depreciate…. [T]his is a plausible conception for a wealth of thoughtful, knowledgeable judges, and it is even more so for lay insureds with no special competence in property or insurance matters."). Because the purpose of Illinois' Improper Claims Practices Act, and the ACV Regulation promulgated thereunder, is to protect policyholders and prohibit questionable depreciation claims handling practices, the ACV Regulation should be construed in favor of Sproull under governing law, and the certified question answered adversely to State Farm. *See Madigan*, 231 Ill. 2d at 382; *accord Perry*, 953 F.3d at 421-23; *Hicks,* 751 F. App'x at 709-10.

C. State Farm's Reliance On *Gee v. State Farm Fire & Casualty Co.* Is Misplaced.

State Farm erroneously argues that "[c]ourt decisions in Illinois support [the] conclusion" "that *all* costs associated with the replacement of damaged property[,]" including labor costs, may be depreciated when ACV is calculated pursuant to the ACV Regulation. SF Br. at 16-17. In support, State Farm cites a single unpublished federal decision, *Gee v. State Farm & Fire Casualty Co.*, No. 11-cv-250, 2013 WL 8284483 (N.D. Ill. Sept. 23, 2013), which is readily distinguishable. Indeed, State Farm *has already raised and lost this identical argument* in Illinois. *See Jenkins*, No. 15-CH-08242 (SR.371–72).

Gee stands for an inapplicable and unremarkable proposition—namely, that *sales tax* may be applied to tangible personal property. In Illinois, "tangible personal property"

is subject to sales tax, while labor is not taxable.[25] The insured's policy in *Gee* required his insurer to pay "the cost to repair or replace less depreciation" for damaged property that he did not replace. 2013 WL 8284483, at *1. In calculating depreciation *for tangible personal property* under this provision, the insurer reduced the personal property sales tax component by the same percentage of depreciation attached to the tangible personal property. *Id.* The *Gee* court agreed this was proper. *Id.* at *2.

In this litigation, Sproull's position has always been that materials depreciate. Sproull further agrees that the sales tax on tangible personal property necessarily depreciates at the same rate as tangible personal property. As a result, the holding in *Gee* is inapplicable to the issue of whether labor can be withheld from an ACV payment:

> To the extent *Gee* is persuasive, it can also be – it is also distinguishable. Sales tax and labor costs are two separate components of the RCV. Sales tax attaches to the cost of materials on a percentage basis, so it is logical that it could be depreciated as material costs are depreciated. Labor costs do not carry sales tax. Further, the rationale in *Gee* does not apply here because labor costs would remain the same regardless of the depreciation of materials.

Jenkins, No. 15-CH-08242 (SR.371–72).[26] For the same reasons set forth in *Jenkins*, State Farm's reliance on *Gee* is misplaced.

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[25] *See generally* Illinois Revenue, Questions and Answers, *Is labor taxable?*, *at:* https://www2.illinois.gov/rev/questionsandanswers/Pages/168.aspx (last visited February 22, 2021).

[26] The *Gee* court referred to two other cases upon which State Farm seeks to rely. *See* SF Br. at 17-18 (discussing *Tolar v. Allstate Tex. Lloyd's Co.*, 772 F. Supp. 2d 825 (N.D. Tex. 2011) and *Goff v. State Farm Fla. Ins. Co.*, 999 So.2d 684 (Fla. Dist. Ct. App. 2008)). In both decisions, the courts held that it was appropriate to include general contractor overhead and profit ("GCOP") in a depreciation calculation. *See Tolar*, 772 F. Supp. 2d at 831; *Goff*, 999 So.2d at 689–90. Because GCOP, like sales tax, is calculated as a percentage of material costs, the reasoning applied to distinguish *Gee* applies with equal force to *Tolar* and *Goff*.

V. STATE FARM'S ARGUMENTS CONCERNING THE IDOI'S "*APPARENT* INTERPRETATION" OF THE ACV REGULATION SHOULD BE REJECTED.

A. State Farm's Speculation Concerning The Position Of The IDOI Does *Not* Support Its Erroneous Policy Interpretation.

State Farm argues that the actions of the IDOI demonstrate that the department interprets the ACV Regulation as permitting depreciation of all estimated replacement costs, including labor, and that this "apparent interpretation" is entitled to the Court's deference. SF Br. at 29-30. However, the trial court correctly recognized that "unlike other state insurance departments of insurance, the Illinois Department of Insurance has provided no guidance as to the interpretation of the current regulation nor has expressly stated whether labor costs can be depreciated when calculating an ACV estimate." A-84; *cf.* MDOI Bulletin 2017-8 ("If such a [labor depreciation] practice is used, the insurer should clearly provide for the depreciation of labor in the insurance policy…."); Vermont Department of Financial Regulation, Division of Insurance Bulletin #184 (May 1, 2015) ("depreciation of labor costs is prohibited … and therefore is an unfair claim settlement practice …" (SR.406-07)); *see also* SR.404-07 (discussing various insurance regulators' positions on labor depreciation).[27]

[27] Despite State Farm's *amici's* suggestions to the contrary, several state regulators have expressly referred to the practice of *not* depreciating labor as the traditional insurance industry practice. *Compare, e.g.,* Brief of *Amici Curiae* American Property Casualty Insurance Association, et al. at 17 ("insurers for decades applied depreciation, in an appropriate percentage, to the full estimated RCV of, e.g., a damaged roof; they did not apply depreciation merely to the cost of materials") (hereinafter "SF Amici Br."), *with Market Conduct Examination of Sandy and Beaver Valley Farmers Mutual Insurance Company as of June 30, 2011*, Ohio Dep't of Insurance, at 4, 6 (May 21, 2012) (stating insurer should not depreciate labor on ACV claims "in order to be consistent with the industry practice of not depreciating labor"), *available at:* https://insurance.ohio.gov/static/Company/MC/Sandy%20and%20Beaver%20Valley%20Exam%20Report.pdf (last visited Feb. 17, 2021); *Market Conduct Examination of Allstate*

Nothing in the court record suggests that the IDOI has ever formally or informally considered the precise issue of labor depreciation. Nevertheless, State Farm speculates the IDOI's "apparent interpretation" in favor of State Farm can be discerned from the fact that the IDOI has "approved and allowed insurers to use structural damage policy forms regardless of whether they provide for payment of ACV without defining the term (like Plaintiff's policy) or with a definition expressly allowing for depreciation of all components of replacement cost, including labor explicitly." SF Br. at 30-31, 36-37.

State Farm's argument is illogical and without legal or factual support. Why would the IDOI or this Court, for that matter, assume simply because the IDOI approved both types of policy forms, that the insurer is allowed to interpret the one form lacking a clear and unambiguous definition of "ACV" narrowly and against the policyholder? State Farm does not say. Its silence is telling.

The only thing truly evidenced by the IDOI's approval of both forms is that the IDOI permits State Farm's construction only where the policy expressly provides for it through the use of clear and plain language informing insureds that the insurer is withholding labor costs from ACV payments. *See, e.g.,* MDOI Bulletin 2017-8. As State Farm knew such labor permissive forms were approved in Illinois, and was actually aware of the labor depreciation drafting issue since at least 2002 (as the defendant in *Redcorn*), it could have simply issued such a form but inexplicably chose not to do so for well over a decade. *Arnold,* 268 F. Supp. 3d at 1310, n.18; *see* SR.385 (State Farm Form FE-3650 explicitly permitting labor depreciation was not issued in Illinois until 2016). State Farm

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Insurance Company et al., Cal. Dep't of Insurance, at 16 (1998) (advising that acts of depreciating labor charges "are inconsistent with industry practice and are violations of" statutory fair claims practices laws) (SR.404).

should not be permitted to benefit from its own drafting imprecision to its policyholders' detriment. *Dungey v. Haines & Britton, Ltd.*, 155 Ill.2d 329, 340-41 (1993) (Bilandic, J. dissenting); *Elson v. State Farm Fire & Cas. Co.*, 295 Ill. App. 3d 1, 7, 11 (1st Dist. 1998).

Citing *Gaston v. Founders Insurance Co.*, 365 Ill. App. 3d 303 (1st Dist. 2006), State Farm further speculates the IDOI permits labor depreciation because it has taken no formal action against the practice. *See* SF Br. at 30. However, the plaintiff in *Gaston*, prior to filing suit, complained directly to the IDOI about the specific claims procedures at issue in the case—namely, the insurer's "direct repair program." 365 Ill. App. 3d at 307. In response, the IDOI sent plaintiff a letter expressly notifying her that the insurer "had not violated either the Illinois Insurance Code or any insurance regulations." *Id.* at 307–08. Nevertheless, a few months later, the plaintiff filed a class action complaint against her insurer for breach of contract and violations of Illinois Insurance Code, 215 ILCS 5/155, and Consumer Fraud and Deceptive Trade Practices Act, 815 ILCS 505/1. *Gaston*, 365 Ill. App. 3d at 308.

It was in *this specific context*—where the IDOI had *expressly taken a position* on the *precise* policy dispute at issue—that the First District held that "it can be inferred that the Director felt the provision did not violate any part of the Insurance Code." *Id.* at 318–19 ("[T]he [IDOI] not only approved the issuance of the policy and limit of liability at issue in this case, but also found that defendant did not violate the Insurance Code or the [IDOI] Regulations *in this particular instance.*" (emphasis added)).

Here, in sharp contrast, the ILDOI has "provided no guidance as to the interpretation of the current [ACV] regulation nor has expressly stated whether labor costs can be depreciated when calculating an ACV estimate." A.84. Nothing suggests that the

IDOI has ever considered whether an insurer can withhold labor from ACV payments without any language authorizing the practice. Accordingly, *Gaston* provides no pertinent guidance, and State Farm's otherwise conclusory IDOI arguments should be rejected.

B. IDOI Consumer Guidance Does *Not* Support State Farm's Erroneous Policy Interpretation.

State Farm and its *amici* also argue that general consumer guidance from the IDOI purportedly supports State Farm's policy construction that labor is depreciable. SF Br. at 37; SF Amici Br. at 9-10. This is patently incorrect, as the referenced IDOI consumer guidance does *not* address labor depreciation.

In *Hicks*, the Sixth Circuit rejected the identical State Farm argument that general consumer guidance explaining the concept of depreciation must allow *labor* depreciation. 751 F. App'x at 708, n.3. The Sixth Circuit explained:

> As relevant to this appeal, the document contains one paragraph alerting consumers that insurance companies often offer roof repair at a depreciated basis. There is also an example illustrating that ACV payment may be significantly less than replacement cost coverage. Even assuming this were an official interpretation of the ACV regulation, entitled to special agency deference, it nonetheless fails to address the issue at hand. The document says nothing about labor depreciation. As State Farm conceded during oral argument, the DOI website example is merely "guidance for consumers to consult."

Id.

Of course, when the Commonwealth of Kentucky Department of Insurance ("KDOI") chose to specifically address labor depreciation in a later bulletin, it explained, consistent with the holding in *Hicks*, that a carrier may depreciate labor costs only if "the policy defines in a clear and unambiguous manner the practice of withholding labor depreciation in the adjudication of a property claim payment…." Commonwealth of KDOI

Advisory Op. 2020-01 (Feb. 7, 2020);[28] *accord* MDOI Bulletin 2017-8 ("If such a practice is used, the insurer should clearly provide for the depreciation of labor in the insurance policy."). Like in *Hicks*, the IDOI's general consumer guidance does not support State Farm's and its *amici's* position here.

Indeed, the IDOI makes clear that its consumer guidance is *not* an official interpretation of IDOI policy, let alone an interpretation of the ACV Regulation itself. In fact, each of the consumer webpages and the IDOI disaster .pdf relied upon by State Farm and its *amici* specifically states:

> Note: This information was developed to provide consumers with general information and guidance about insurance coverages and laws. *It is not intended to provide a formal, definitive description or interpretation of Department policy*. For specific Department policy on any issue, regulated entities (insurance industry) and interested parties should contact the Department.

IDOI, Consumer Resources, Homeowners & Renters, Definitions, *available at:* https://insurance.illinois.gov/HomeInsurance/consumerHomeowners.html (last visited Feb. 24, 2021) (emphasis added); *Id.*, Consumer Resources, Shopping Tips & Information (same disclaimer); IDOI, "When Disaster Strikes – What to Do After an Insured Homeowners Loss," *available at:* https://insurance.illinois.gov/HomeInsurance/disaster.pdf (last visited Feb. 24, 2021) (same disclaimer).[29]

[28] *Available at:* https://insurance.ky.gov/ppc/Documents/AdvisoryOpinion2020-01.pdf (last visited Feb. 24, 2021).

[29] The IDOI disaster guide .pdf is particularly unhelpful to State Farm because the exemplar ACV calculation it highlights relates solely to personal property replacement, which is *not* at issue in this case. *See generally* A.88-113.

The Sixth Circuit's rejection of State Farm's consumer guidance argument thus applies equally to the identical argument State Farm makes here. *See Hicks*, 751 F. App'x at 708, n.3. The IDOI's consumer guidance is *not* an official interpretation of the ACV Regulation and it does *not* address the issue at hand—namely, whether State Farm may withhold labor costs as "depreciation" when calculating ACV payments in the absence of a policy form expressly permitting the practice. The Court should therefore reject State Farm's and its *amici's* bald argument that the IDOI's consumer guidance confirms the department's *alleged* view that the ACV Regulation permits labor depreciation. It does not.

VI. THE CERTIFIED QUESTION IS NOT SUBJECT TO APPRAISAL.

Both parties agree that the certified question before the Court presents a pure question of law as required by Illinois Supreme Court Rule 308(a). *See* SR.1098; *see also Outboard Marine*, 154. Ill. 2d at 108. However, the Court may question whether the legal issue on appeal is subject to appraisal. It is *not*—as the dispute centers on whether State Farm's policy allows the withholding of labor as depreciation.

Allowing an appraiser to interpret the policy would violate Illinois law, which precludes property insurance appraisers from determining coverage or liability. *See Lundy v. Farmers Group, Inc.*, 322 Ill. App. 3d 214, 219 (2001) ("[I]nterpretation of the policy … cannot be resolved through the appraisal process."); *Lytle v. Country Mut. Ins. Co.*, 2015 IL App (1st) 142169, ¶ 27 (holding plaintiff "was not entitled to an appraisal on the issue of insurance coverage or contract interpretation" where he presented "court with a *coverage* dispute rather than a dispute over the *amount* of a loss" (emphasis added)).

Even if the dispute could legally be sent to an appraisal panel, which it cannot, the panel would only be asked to decide the same disputed legal issue presented here. This is

because Sproull does not dispute any of the labor valuations by State Farm's adjuster such as the amount of labor hours or labor rates at issue. Instead, the relevant dispute is whether State Farm can withhold some portion of the agreed-to labor costs under the policy terms.

Almost uniformly, courts throughout the country hold that whether labor is depreciable is a question of law. *See, e.g., Adams*, 430 S.W.3d at 679; *Lammert*, 572 S.W.3d at 179; *Hicks*, 751 F. App'x at 706; *Titan Exteriors*, 297 F. Supp. 3d at 631. Two outlier decisions suggest that whether labor is depreciable is a question of fact. *See Wilcox v. State Farm Fire & Cas. Co.*, 874 N.W.2d 780, 785 (Minn. 2016) (Minnesota law); *In re State Farm Fire & Cas. Co. (LaBrier)*, 872 F.3d 567, 577 (8 Cir.) (applying unique Missouri law and adopting *Wilcox* analysis to conclude that arguments about whether labor costs may be depreciated when calculating ACV are best presented to an appraisal panel or via expert testimony before a jury).

However, both State Farm and Sproull agree here that *Lundy* and its progeny prohibit the Court from following the short line of authority derived from the *Wilcox* decision. Illinois courts recognize that "appraisal is a relatively limited process. Committing questions of contract interpretation to an appraiser, whose primary function is to ascertain the value of property or the amount of a loss, is simply not consistent with the nature of an appraisal." *FTI Int'l, Inc. v. Cincinnati Ins. Co.*, 339 Ill. App. 3d 258, 260–61 (2d Dist. 2003). "[I]n the present case, the dispute turns on the construction of the policy. The resolution of this issue will [] require the application of principles of contractual interpretation. These tasks are not the sorts of things that take place during an appraisal." *Id.* at 262–63 (citing *Lundy*, 322 Ill. App. 3d at 219). Accordingly, and consistent with the majority rule in labor depreciation cases, whether an insurer may properly withhold labor

costs as depreciation under its policy's ACV loss settlement provisions are not subject to appraisal.

VII. INDEMNITY PRINCIPLES REQUIRE STATE FARM TO PAY LABOR COSTS.

Both the trial court (A.87) and Fifth District stressed the historical purpose of property insurance to indemnify an insured. A.65, ¶27 (citing COUCH § 148.1). "The fundamental principle of a property insurance contract is to indemnify the owner against loss; that is to place the owner in the same position in which he or she would have been had no accident occurred." COUCH § 148:1. "[W]e note the general rule that the purpose of an insurance contract is indemnity and therefore the policy should be liberally construed with uncertainty resolved in favor of the insured." *Travelers Ins. Cos. v. P.C. Quote, Inc.*, 211 Ill. App. 3d 719, 724 (1st Dist. 1991)

Consistent with indemnity principles, both the trial court and Fifth District held that State Farm may not withhold removal or installation labor from an ACV payment. A.87 ("… The practice of depreciation of labor would not unjustly enrich the insured, but rather, the reverse is true, the insured could be in a worse position and, ultimately, not be made whole after the loss."); A.71, ¶39) ("Our resolution is in keeping with the primary purpose of an indemnity clause in an insurance contract."). Appellate courts from replacement cost less depreciation jurisdictions agree. *E.g.*, *Mitchell*, 954 F.3d at 706-07 ("Mitchell's definition, which results in paying costs necessary to place a homeowner in the *status quo ante*, is reasonable."); *Hicks*, 751 F.App'x 709 ("[D]epreciating labor does not make the policyholder whole but rather frustrates the indemnity purpose of [ACV] coverage [because] 'the cost of labor to install a new garage would be [the] same as installing a garage with 10 year old materials.'"); *Adams*, 430 S.W3d at 678–79 ("[A]llowing [the

insurer] to depreciate the cost of labor would leave [the insured] with a significant out-of-pocket loss, a result that is inconsistent with the principle of indemnity.").

In support of its interpretation, State Farm provides an illustration in which a hypothetical homeowner installs a roof with 20-year shingles, which is then destroyed by a storm 16 years later. In State Farm's view, it would be appropriate to not only consider the repair costs and physical depreciation, but also the homeowner's potential *future* cost of replacing an entire roof in exactly four years. *See* SF Br. at 10-11.

State Farm's argument is contrary to fundamental insurance principles because it is premised upon the unknowable *future* costs of an indeterminable *future* roof replacement, rather than focusing exclusively upon the ACV at the time of loss. *See* COUCH § 175:43 (repair costs determined exclusively at "time of damage or loss"). It is also contrary to State Farm's policy language. A.276 ("we will pay only the actual cash value at the time of the loss of the damaged part of the property"). Further, it is not determinable when an entire roof replacement, if ever, will take place. Twenty-year shingles may last ten years or fifty years. A policyholder may choose from a myriad of options far less expensive than a total roof replacement, such as patching or shingle relay. On the other hand, the policyholder may choose to not even reroof with shingles. None of these future, contingent events should be considered in determining ACV.

The Illinois Partial Loss Regulation reflects the principle of indemnity in Illinois law. This regulation mandates that, in the instance of a partial loss, an insurer's written estimate be "of an amount which will allow for repairs to be made in a workmanlike manner." Ill. Admin. Code tit. 50, § 919.80(d)(7)(C).

"Ultimately, [however], it is not necessary for this Court to reach the decision of whether labor can logically depreciate or whether indemnity is accomplished. It is enough [to] find the contract[] ambiguous and that under [the] standard of review, the interpretation of the insured must prevail." *Lammert*, 572 S.W.3d at 179. Here, as in both *Lammert* and *Arnold*, State Farm "has failed to show that [the mere temporary possibility of over-indemnification of the insured] has any bearing on how a reasonable insured would construe the undefined term 'actual cash value.'" *Arnold*, 268 F. Supp. 3d at 1309–10 (deeming any risk of over-indemnity irrelevant to court's analysis). Equally important, even if there is a risk of over-indemnity (which there is not), State Farm "has not explained why it should be judicially protected from this foreseeable consequence of its own imprecise drafting regarding an issue of which it has been actually aware … since at least 2002." *Id.* at 1310 n.18.

In the end, this Court should hold State Farm to the bargain it struck. State Farm drafted and issued to Sproull a standard-form homeowners policy without a labor depreciation permissive form. The undefined ACV term in Sproull's policy must be deemed ambiguous and construed in Sproull's favor. This result is consistent with Illinois insurance law and the principle of indemnity upon which it is based.

CONCLUSION

For the foregoing reasons, Sproull respectfully requests that the Court affirm the Fifth District's decision and answer the certified question adversely to State Farm, holding that labor may not be depreciated when the insurance company calculates the ACV of property damage using the replacement cost less depreciation method in the absence of a labor permissive form.

Respectfully submitted,

BYRON CARLSON PETRI & KALB, LLC

By: /s/ *Christopher W. Byron*
Christopher W. Byron, #6230810
Christopher J. Petri, #6257456
Brian R. Kalb, #6275228
411 St. Louis Street
Edwardsville, IL 62025
Tel: 618.655.0600
Fax: 618.655.4004
cwb@bcpklaw.com
cjp@bcpklaw.com
brk@bcpklaw.com

David T. Butsch, #06205434
Christopher E. Roberts, #6302857
Butsch Roberts & Associates LLC
231 S. Bemiston Avenue, Suite 260
Clayton, Missouri 63105
Tel: 314.863.5700
Fax: 314.863.5711
butsch@butschroberts.com

T. Joseph Snodgrass, #6319907
Larson • King, LLP
30 East Seventh Street
Suite 2800
St. Paul, Minnesota 55101
Tel: 651.312.6500
Fax: 651.312.6618
dlinder@larsonking.com
jsnodgrass@larsonking.com

Counsel for Plaintiff-Appellee
Jarret Sproull

CERTIFICATE OF COMPLIANCE

I certify that this Brief confirms to the requirements of Rules 315(c) and 315(d) and 341(a) and 341(c). The length of this Brief, excluding the Rule 341(d) Cover, 341(h)(1) Table of Contents, Points and Authorities and those matters to be appended to the brief under Rule 342(a), is 50 pages.

/s/ Christopher W. Byron
Christopher W. Byron

CERTIFICATE OF FILING AND PROOF OF SERVICE

I certify that on March 5, 2021, I caused the foregoing Brief of Plaintiff-Appellee to be electronically file with the Clerk of the Illinois Supreme Court of using the Odyssey eFileIL system.

I further certify that the other individual in this case, named below have been served by transmitting a copy via email to the addresses designated by those individuals on March 5, 2021.

Heyl, Royster, Voelker & Allen
105 West Vandalia, Suite 100
P.O. Box 467
Edwardsville, IL 62025
Patrick Cloud – pcloud@heylroyster.com
Craig Unrath – cunrath@heylroyster.com

Riley Safer Holmes & Cancila, LLP
70 West Madison Street, Suite 2900
Chicago, IL 60602
Joseph A. Cancila, Jr. – jcancila@rshc-law.com
Jacob L. Kahn – jkahn@rshc-law.com

Under penalties as provided by law pursuant to section 1-109 of the Illinois Code of Civil Procedure [735 ILCS 5/1-109], I certify that the statements set forth in this Certificate of Filing and Proof of Service are true and correct, except as to the matters therein stated to be on information and belief and as to such matters I certify as aforesaid that I verily believe the same to be true.

/s/ Christopher W. Byron