



## California Department of Insurance Oversteps Its Authority with Proposed Regulations Regarding Homeowners' Insurance Replacement Value

*By Robert W. Hogeboom*

When the California Department of Insurance (“CDI”) seeks to promulgate regulations that create new duties, impose additional standards and establish a new “unfair trade practice” violation on insurers and insurance producers, the proposed regulations get wide attention from the industry.

The CDI’s proposed regulations on standards and training for estimating replacement value on homeowners’ insurance (“Proposed Regulations”) follow a similar theme that was last seen in the CDI’s failed agent/broker fiduciary regulations. The latter sought to impose new disclosures, standards and penalties on producers.

In oral testimony given at the hearing held in connection with the Proposed Regulations on May 17, 2010, and in filed written comments and objections submitted on behalf of our client, Insurance Agents and Brokers Association of California, we challenged the CDI’s authority to promulgate the Proposed Regulations.

### Background of Replacement Cost Valuations

In issuing quotes on homeowners’ insurance, a determination is made on the value of the home at the point of issuance. The valuation becomes vital to setting limits on the home value in the case of a total loss. The CDI asserts that, following the 2003, 2007 and 2008 wildfires, it received complaints from homeowners that replacement value estimates were too low resulting in under insurance in the rebuilding and replacement of the home. The CDI has not supplied information to verify either the number of complaints or that replacement value estimates have created underinsurance problems for homeowners.

The CDI asserts that replacement value estimates used to quote homeowners’ insurance must be accurate and updated regularly. The CDI further

asserts that the software used by producers to estimate replacement value does not take into consideration various costs including, for example, demolition expenses, engineering reports, architect plans, and overhead and profit of the contractor.

Many producers use estimates from reliable “source” vendors selected by the insurer. Producers are able to access the software valuation “tool” provided by the vendor, under which the customer provides answers to a series of questions relating to the home, much like the FSC rater used for automobile insurance quotes. The software has built in geographical data based on the cost of construction and applies information derived from the questions pertaining to type of construction, roofing, foundation, etc. The software then generates a report on the replacement value of the home. Depending on the sources used, estimates may vary. Some producers and smaller insurers use other less sophisticated ways to determine replacement value.

### Legislation

Following the 2003 Southern California wildfires, legislation was enacted in 2005 pursuant to California Insurance Code (“Code”) Section 1749.85 (effective 2006) to impose new educational instruction requirements upon producers. The legislation authorized the CDI’s curriculum board to establish educational instruction guidelines for insurance producers who sell homeowners insurance. The guidelines are to address the proper methods of estimating the replacement value and explaining levels of coverage. Courses on these topics are available to producers.

The 2005 legislation also precluded anyone other than a fire and casualty broker/agent, personal lines broker/agent, insurer, underwriter, actuary, or other

person identified by the insurer, from estimating replacement value or explaining various levels of coverages. Appraisers were not included in the list.

A “clean-up” bill was enacted the following year after the Government Relations Subcommittee of the Appraisal Institute realized that its members were no longer authorized to estimate replacement value costs of homes due to the prior legislation. Subsection (c) was added to Code Section 1749.85 to include appraisers. In addition, the following subsection (d) was added:

“However, if the Department of Insurance, by adopting a regulation, establishes standards for the calculation of estimate of replacement value of a structure by appraisers, then on or after the effective date of the regulation a real estate appraiser’s estimate of replacement value shall be calculated in accordance with the regulation.”

The CDI is apparently relying on subsection (d) of Code Section 1749.85 as the authority/reference for the Proposed Regulations, which establish standards and disciplinary violations applicable to producers and insurers on replacement value estimates.

## Regulations

2188.65. Implements Code Section 1749.85(a) by requiring licensed producers to complete a 3-hour training course on homeowners’ insurance valuations prior to soliciting customers. This section sets forth the topics for the training course. The course must also include the new record-keeping requirements and standards on estimates as contained in the Proposed Regulations.

2190.2. – 2190.3 Amends existing regulations 2190.2 and 2190.3 (pertaining to the records that producers are required to maintain) to include the records required by Section 2695.182 of the Proposed Regulations (as discussed below). The record information is required on all estimates provided notwithstanding whether a policy is issued.

Article 1.3 – 2695.180 - 2695.183 Creates new Article entitled “Valuation of Homes” consisting of Sections 2695.180 - 2695.183 of the Proposed Regulations.

2695.181. Contains standards for real estate appraisers. Actually this section does not establish any standards. It merely references Code Section 1749.85(d) and declares that if the CDI establishes standards for the calculation of estimates of replacement value of a structure by “appraisers”, then a real estate appraiser must comply with the provisions of Section 2695.183 of the Proposed Regulations with respect to any such estimate in connection with a homeowners’ policy.

2695.182. Requires licensees who make estimates to maintain certain described documentation in the applicant's/insured's file including all documents used to determine the estimate (e.g., the source or method by which the replacement value or construction cost was determined).

2695.183. This is the key section of the Proposed Regulations. It sets forth **standards** and requirements that a producer must follow in order to estimate replacement cost, rely on a replacement cost, or set or recommend a policy limit on a homeowners’ policy. In essence, it sets forth items that must be included in the replacement cost estimate including all expenses described in the Proposed Regulation. It also specifies items that cannot be relied upon in preparing the estimate.

A key provision is in subsection (e) which declares that if a producer relies on an estimate produced by another source or recommends or sets the policy limit, the producer must take “reasonable steps to verify that the sources and methods used in the estimate are kept current to reflect changes in costs and labor.”

Subsection (g) makes the producer responsible for the estimate even though the information relied upon to estimate the replacement cost was obtained from a third party source.

Subsection (j) creates violations. It provides that using any form of the word “replace” or “replacement” in any estimate of construction costs that does not conform to the standards of subsections (a)-(e) of 2695.183 constitutes a “misleading statement” and a prohibited act in violation of Code Section 790.03 (pertaining to unfair practices), subjecting the licensee to penalties of up to \$5,000 for each act (\$10,000 in the case of a willful act). In

particular, the standards require that all expenses to rebuild the structure be included in the estimate and, in the case where the estimate is provided by another source, that the producer verify that the source and methods used to estimate replacement cost estimates are kept current.

Subsection (k) refers to situations in which the insurer requires the producer to use a specific source to create an estimate. The insurer is required to prescribe procedures to be followed by the producer as well as training the producer to use the source or tool. It also makes the insurer responsible for the noncompliance of subsections (a)-(f) including potential liability under Code Section 790.03.

## **Conclusion**

The CDI, through the Proposed Regulations, is establishing standards and requirements for producers and insurers to follow if they utilize

estimates on replacement cost valuations in connection with the sale of homeowners' insurance. The Proposed Regulations use the CDI's broad authority to establish education requirements and record keeping as authority/reference for this part of the Proposed Regulations. The CDI then creates the 2695.183 standards under the Proposed Regulations to apply to replacement cost estimates that, if not followed, have Code Section 790.03 consequences.

The Code does not govern replacement value estimates other than in Article 13.5 "Prelicensing and Continuing Education." While Code Section 1749.85 was added to the Code in 2005 to instruct the Code Section 1749.1 curriculum board to make recommendations for education of producers in estimating replacement value, it did not give authority or be used as a reference to establish regulations that create standards on replacement value estimates.

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