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Profit & Overhead When Insureds Repair Their Own Damage

The VU Faculty

Abstract
Your insured is a contractor. He wants to repair insured damage to his own building to ensure that the job is done right. Or, let's say he negligently causes damage to a customer's property that is covered by his CGL policy and wants to make repairs himself. Is the insurer obligated to pay an amount that includes profit and overhead for the work done by its insured?

Q. "This question seems to come up ever three to four years. I have a customer who had a lightning loss to his premises. Damage was done to the building and contents. Since my customer is in the construction business, he repaired the building and contents with the blessing of the adjuster and submitted a bill for repayment. This included an amount for materials, labor, and overhead and profit.

"The adjuster is okay on materials, labor, and overhead, and but will not pay profit because it is against 'public policy.' Question: Does the insurance company owe profit? The adjuster admits that, if the customer had hired someone else to do work, he would pay them profit."

Q. "My insured is a drywall contractor. He improperly insulated a wall near a water pipe which subsequently froze, causing water damage to the owner's building. Part of the repair work is being done by my contractor, including the reinstallation of the other drywall. The insurance carrier has agreed that the cost of the drywall is part of the covered completed operations liability claim. However, we are back to the age-old issue of profit and overhead.

"This problem seems to keep re-occurring every decade. It is my belief that the contractor is allowed to add overhead costs and a reasonable profit to his labor and material costs for the repair work. If another contractor was hired to do the work, their bill would include profit and overhead. Do you agree or is the insurance company correct?"

Q. "Our insured just experienced an equipment breakdown claim when a control valve locked up on a boiler in his hardware store. The insured is a hardware store/plumbing contractor. Since this is his trade, his employee made the repairs himself. The adjuster says she will only pay his plumber some 'net' hourly rate and not the rate he charges when the plumber works somewhere else.

"She also wants the invoice from the supplier as she will not pay any mark-up on the part. The insured is upset. He says he'd be nuts to ever fix his own loss again. He states that if an outside repairman were brought in, the bill would have been a lot higher.

"He questions why there is no mark-up allowed with all the time involved to obtain this out-dated part or something that could substitute since he had to call eight wholesalers and one of them first delivered the wrong part. He

also says he could have had his plumber out working at the gross wage he gets everyday. Why should he have to lose money on the time the plumber spent repairing the loss?

"I can't find anything that really addresses this in any policy, i.e. insured can not charge his normal fees when repairing his own loss. I believe there is a clause somewhere indicating the insured cannot profit from a loss, although I can't find that either. It seems in this case the insured is required to lose from a loss."

A. This isn't the first time this has come up. It happens pretty often and it's not unusual for a company to INITIALLY balk at paying profit and overhead. **However, absent fraud, we question whether this is a legitimate claim denial. The main reason against paying for profit is that it theoretically violates the principle of indemnity...that an insured should be indemnified for actual loss sustained and not profit from a loss. But, as our faculty responses below indicate, the insured does not technically profit since he would otherwise suffer an opportunity cost.** Another reason for not paying for profit is that it potentially encourages fraud, which is also discussed below.

Faculty Response:

Of course they are entitled to profit and overhead if they are doing the work themselves. But let's get things straight....

Using the drywall contractor as an example, he bids to do work at a specific unit cost $Y x Z square feet = $Price.

The unit cost is made up of three elements: 1) Materials, 2) labor, and 3) profit and overhead.

The profit and overhead component is usually about 40%. The general contractor then will add to the subcontractor's bid an additional amount representing his profit and overhead. If the contractor is doing the work, he has already charged for the profit and overhead. If he is using a subcontractor, he should be entitled to his profit and overhead — as would a different general contractor if his insurer or he hired a third party to do the work. The insurer is not entitled to the work of its insured for free.

Faculty Response:

It is an age old problem. I tell my insureds to have someone else do the work to avoid the issue. I have never been able to get an insurance company to pay the same to the insured for their work. The important thing is that this should all be worked out and agreed upon prior to the performance of the work.

Faculty Response:

There is absolutely no reason why they should not be entitled to profit and overhead, but insurers often refuse to pay this on the basis that the insured "profits" from a loss. In my opinion, by doing this work, the insured suffers an opportunity cost (loss) since he could be spending his time doing the work for a customer that includes profit and overhead. The insurer is not engaged in a charitable, nonprofit activity, so why should the insured?

Faculty Response:

It appears that the adjuster is saying that the insured would profit from the loss and, as a violation of the principle of indemnity, this is against "public policy"...that an insured should be indemnified, or made whole, and not profit. However, that premise is incorrect in that the insured still has not been adequately compensated because he has incurred an opportunity cost by not being able to spend his time at a job that earns profit and overhead.

I can understand the position that paying this might encourage fraud, but if the insurer can't trust it's client, then it shouldn't renew the account. In the meantime, pay what is reasonable and customary for the job, regardless of who's doing it, then deal with this issue later.

Faculty Response:

I don't think there's a leg to stand on by denying a claim based on the guise that this violates "public policy" or the principle of indemnity. However, I understand the desire not to pay for profit based on the premise that doing so might encourage fraud. It is conceivable that an insured would damage his own property or that of others in order to gain work or profit. On the other hand, I would think that such motives are few and far between and it's not going to happen very often before there's a nonrenewal and the contractor faces an insurance availability problem.

Faculty Response:

There are a number of courts that have held that an insured undertaking its own repairs is entitled to include overhead and profit in its claim for reimbursement from its insurer. Most recently, the Sixth Circuit decided the following case (see other cases cited within this decision): **Parkway Associates, L.L.C. v. Harleysville Mut. Ins. Co., 129 Fed. Appx. 955, 963 (6th Cir. 2005)**

"After finding that Parkway was entitled to recover only the actual cash value of its loss, rather than the replacement value (a conclusion that the district court will have to reconsider in light of Parkway's equitable estoppel claim), the district court then concluded that contractor's overhead and profit should be deducted from the actual cash value. In reaching this conclusion, the district court noted that Tennessee requires anyone who engages in contracting to be licensed, and that all unlicensed contractors who engage in contracting are to receive only their actual expenses. Tenn. Code Ann. § 62-6-103(a)(1) & (b). Parkway intended to hire Jeff Fisher, an unlicensed contractor, to repair its property. The district court concluded that since Fisher could only recover his actual expenses. Parkway was not entitled to contractor's overhead and profit.

"Parkway's policy provides that it is entitled to recover the actual cash value of its loss. The actual cash value of a loss is equal to the repair or replacement costs less depreciation. Braddock v. Memphis Fire Ins. Corp., 493 S.W.2d 453, 460 (Tenn. 1973). The Tennessee courts have not determined what repair or replacements costs include.

"Other courts, however, have held that 'repair or replacement costs logically and necessarily include any costs that an insured reasonably would be expected to incur in repairing or replacing the covered loss.' Gilderman v. State Farm Ins. Co., 437 Pa. Super. 217, 649 A.2d 941, 945 (Pa. Super. Ct. 1994); accord Salesin v. State Farm Fire & Cas. Co., 229 Mich. App. 346, 581 N.W.2d 781, 790-91 (Mich. Ct. App. 1998); Ghoman v. N.H. Ins. Co., 159 F. Supp. 2d 928, 934 (N.D. Tex. 2001).

"Although there are some types of losses where the services of a contractor would normally not be utilized, 'there are many instances where the insured reasonably would be expected to call a contractor, especially where there is extensive damage.' Gilderman, 649 A.2d at 945. If a contractor would reasonably not be required to repair an insured's loss, then contractor's overhead and profit would not be included in replacement costs. In the instant case, however, Parkway would reasonably be expected to hire a contractor to repair its property. Since the actual cash value of a loss is the repair or replacement costs less depreciation, and since the cost of a contractor would reasonably be incurred in repairing Parkway's damaged property, then the costs of contractor's overhead and profit would be included in the actual cash value of Parkway's loss.

"The statute relied upon by the district court says nothing to the issue of whether an insured who contracts to receive the actual cash value of its loss must deduct overhead and profit because it plans to hire an unlicensed contractor. The fact that Jeff Fisher, if he ultimately repairs Parkway's property, would not be entitled to profit does not mean that Parkway is not entitled to what it bargained from Harleysville, which is the actual cash value of its loss.

"In essence, Harleysville complains that Parkway would receive a windfall if it paid Parkway contractor's overhead and profit where Parkway hires a contractor that is not entitled to earn a profit. The same general argument was raised in both Salesin and Ghoman. In those cases, the insurers argued that they were entitled to deduct contractor's overhead and profit from the actual cash value awards since the insureds, who repaired their damaged property themselves, did not incur the costs of contractor's overhead and profit. Salesin, 581 N.W.2d at 784, 791; Ghoman, 159 F. Supp. 2d at 934.

"Both courts concluded that the fact that the insureds did not incur the costs for contractor's overhead and profit was irrelevant because the insureds contracted to receive the actual cash value of their losses, which included contractor's overhead and profit since, in light of the damages the insureds incurred, it would have reasonably been necessary to utilize a contractor to make their repairs. Salesin, 581 N.W.2d at 791; Id.

"Similarly, in this case. Parkway contracted to receive the actual cash value of its loss. It is irrelevant to the determination of the actual cash value of its loss that Parkway might employ an unlicensed contractor who is not entitled to earn a profit. What Parkway actually spends to repair its property does not affect its right to recover the actual cash value of its loss, as the actual cash value is not calculated based upon what the insured ultimately pays to repair its property.

"Indeed, even if Parkway chooses not to repair its property at all, it would still be entitled to what it bargained for: the actual cash value of its loss, which includes contractor's overhead and profit where a contractor would reasonably be utilized to make repairs. We set aside the district court's order deducting overhead and profit from the actual cash value of Parkway's loss."

Faculty Response:

According to IRMI, "A Pennsylvania court recently held that an insured is entitled to recover overhead and profit where the use of a general contractor would be reasonably likely, even if no contractor is used or no repairs are made. The case is Mee v. Safeco Insurance Company of

America (Pa. Super. Ct., 2006)."

Adjusters, what do you think?

Do you have an opinion on this issue or would otherwise like to share your organization's philosophy on such claims? If so, please send your comments to Bill.Wilson@iiaba.net and we'll add them to this article. All feedback is included anonymously unless you expressly indicate otherwise in your email.

Subscriber Response

I was the one that had posed this question to the VU. I read the latest newsletter and your request for follow up from adjusters. Let me paste in the latest comment from my insurance company concerning this issue...

"I received a quick response from the attorney at PLRB (Property Loss Review Board). Due to confidentiality restrictions, I am not permitted to forward the e-mail response to you without their written consent. This is due to this being a member service for which we are signatory. If you feel it is necessary, I will see if they will give their consent. However, I will summarize their opinion.

"They advise that typically in this situation we are dealing with, the insured is not entitled to recover either 'overhead' or 'profit' when he does his own repairs instead of hiring a general contractor. They do note that if the insured is in the business of doing this sort of repairs that are required for the loss, some insurers might view a recovery as appropriate, 'if the insured can reasonably show how overhead can be attributed to the repairs'. The adjuster has agreed to paying the overhead, even though we have not required the insured to provide documentation to support this. That's fine. The adjuster has already agreed to this and we will stick by that.

"With regards to profit, they note that an insured making his own repairs is not entitled any 'profit' as a result of his loss. They conclude this based on the basic property insurance principle of indemnification, which allows the insured to be made whole again, but does not allow the insured to profit from their loss. They refer to the publication Thomas/Reed, Adjustment of Property Losses 190 (4th Ed. 1977).

"I know that in this particular case it is a small amount of money, but I hate to set a precedence on this issue. I don't know where the individual from the 'Ask An Expert' service came up with his conclusion. PLRB/LIRB is an insurance based website that we use regularly to assist in policy interpretation. As usual, we want to be fair with our policy holders and pay them what they are entitled to receive. I have reviewed this situation with the claims manager as well and she is in agreement with my findings."

As you can see I have not had a resolution to my issue as of yet. I have checked with some of my other insurance companies as well as an independent adjusting company. Everybody agrees that it is not an industry standard out there. Sometimes they pay depending on individual circumstances. I guess the good advice is to recommend to your customers that they not repair their own property, which unfortunately probably drives the cost of the claim even higher.

Faculty Response:

Thanks for the feedback. PLRB is an excellent service, but not infallible and, in cases like this, it's strictly a matter of opinion. I disagree with this statement from the insurer on a possibly factual basis:

"With regards to profit, they note that an insured making his own repairs is not entitled any 'profit' as a result of his loss. They conclude this based on the basic property insurance principle of indemnification, which allows the insured to be made whole again, but does not allow the insured to profit from their loss. They refer to the publication Thomas/Reed, Adjustment of Property Losses 190 (4th Ed. 1977)."

The point is, if the insured could have been working a normal job, rather than spending that time repairing his own property, he does have a loss (commonly referred to as an "opportunity cost") in the amount of the profit he would have earned if he had done that income-producing job rather than his own repair.

I think the premise that paying for profit could encourage fraud is a better one than the principle of indemnity. If you're going to use the latter, then I think the case is stronger that the insured is entitled to indemnity for such lost profit.

Subscriber Response

After reading "Profit & Overhead When Insureds Repair Their Own Damage", I am reminded of a similar situation that is presented to agents and their homeowners insurers.

Situation - Your homeowner insurance applicant is a contractor. He wants to insure his residence for "what it would cost him" to reconstruct it rather than use the estimated replacement cost generated by the homeowners insurance company. Most insurers would resist this and would rather not write this single applicant than have a potential messy claims adjustment process in the future.

I would like to see the VU faculty discuss this. I hope that your other readers enjoy your thought provoking newsletters as much as I do.

Faculty Response:

I think there are too many possibilities of future problems in the contractor's ability to handle the future construction. I would argue for the full replacement cost as the conservative approach.

Faculty Response:

I agree with those carriers who'd rather avoid this customer than fight about it. How many of these guys are there anyway? What's he trying to save, $70-90? It's just not worth the back and forth.

Faculty Response:

HO policies are predicated on replacement cost...it permeates the contract language. I think you'd have to manuscript the policy heavily to accomplish

this or at least use some sort of manuscript endorsement. For the premium involved, I can't imagine a company willing to incur the expense and the potential for future disagreements and litigation.

Faculty Response:

What happens if he's killed or disabled when his house is damaged or destroyed. If he has a spouse and children, can THEY act as their own general contractor? That's just one thought that immediately came to mind and I'm sure there are others. Is it worth the risk? It wouldn't be for me.

Subscriber Response

It seems the companies and adjusters are missing the point in not allowing the insured to make his normal profit while repairing damage to his own property. One response cited the basic property insurance principle of indemnification, which allows the insured to be made whole again, but does not allow the insured to profit from the loss.

I interpret that to mean the insured cannot collect $11,000 on a loss that everyone agrees could be repaired for $10,000. If everyone agrees the loss is $10,000, why would it be fair for the insurance company to pay only $8,000 because the insured (who is in the repair business) does his own repairs?

They won't let an insured insure his house for $200,000 because he will do his own repairs and everyone agrees it will take $250,000 to replace the house. The company can't have it both ways.

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