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Property Insurance Law

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Replacement Cost Coverage: Aesthetic Mismatching as Direct Physical Loss to Covered Property

The standard replacement cost policy of insurance requires an insurer to pay its policyholder for "direct physical loss" to "covered property." At first glance these provisions appear simple enough. However, disputes often arise regarding the interpretation of these two terms when replacement of the damaged property with comparable material and quality results in aesthetic mismatching—leaving the policyholder with a seemingly non-uniform repair. Given the amorphous inquiry into a policy's plain terms, courts addressing similar coverage disputes have reached conflicting results. This article addresses the recent decision in *Windridge of Naperville Condominium Ass'n v. Philadelphia Indemnity Ins. Co.*, 932 F.3d 1035 (7th Cir. 2019), which held that the ambiguity of policy terms require insurers to replace undamaged portions of a property that has sustained a direct physical loss if replacement of only the damaged area would result in mismatching. Replacement coverage for undamaged portions of a property to prevent mismatching is a significant departure from earlier decisions like *Mohr v. Am. Auto. Ins. Co.*, No. 01 C 3229, 2004 WL 533475, at *10, *14 (N.D. Ill. Mar. 5, 2004), whereby only spot repairs were deemed to be necessary.

Reasonable Policy Interpretation

"The interpretation of an insurance policy is a matter of state law." *Westfield Ins. Co. v. Vandenberg*, 796 F.3d 773, 777 (7th Cir. 2015). The Illinois Supreme Court has explained:

> An insurance policy is a contract, and the general rules governing the interpretation of other types of contracts also govern the interpretation of insurance policies. Accordingly, our primary objective is to ascertain and give effect to the intention of the parties, as expressed in the policy language. If the policy language is unambiguous, the policy will be applied as written, unless it contravenes public policy. Whether an ambiguity exists turns on whether the policy language is subject to more than one reasonable interpretation. Although "creative possibilities" may be suggested, only reasonable interpretations will be considered.

Hobbs v. Hartford Ins. Co. of the Midwest, 823 N.E.2d 561, 564 (2005) (internal citations omitted).

Further, "to ascertain the meaning of the policy's language and the parties' intent, the court must construe the policy as a whole and 'take into account the type of insurance purchased, the nature of the risks involved, and the overall purpose of the contract.'" *Travelers Ins. Co. v. Eljer Manufacturing, Inc.*, 757 N.E.2d 481, 491 (2001), quoting *American States Ins. Co. v. Koloms*, 687 N.E.2d 72, 75 (1997).

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Mohr – Qualification of Replacement Only as "Necessary"

In *Mohr,* the policyholders resided in a Cotswold-style home in Lake Forest, Illinois which featured a unique rolled cedar shingle thatched roof. *Mohr*, 2004 WL 533475, at *4. After the roof of their home was damaged during a hail storm, the Mohrs filed a claim with their homeowner's insurance carrier, American Automobile Insurance Company ("AAIC"). AAIC determined that any hail damage caused to the roof could be fixed for $15,000, and offered to settle the matter for that amount. The Mohrs disagreed, valuing the damage to their roof at $400,000. *Id.* After failing to agree on the amount of loss, the Mohrs sued, seeking declaratory judgment, as well as damages for breach of contract and for violation of §155 of the Illinois Insurance Code. *Id.*

The Mohrs' homeowner's insurance policy was in effect at the time of the hail storm, and the parties agreed that the policy covered roof damage caused by hail. *Id.* at *9. The parties stipulated that the relevant language of the policy appeared in paragraph 3.d. of the section entitled "Section I-Conditions," which governs the manner in which losses are settled. *Id*. The relevant language provided as follows:

> 3. Loss Settlement
>
> Covered property losses are settled as follows:
>
> d. Dwelling and other structures under Coverage A and B; at replacement cost without deduction for depreciation, subject to the following;
>
> (1) We will pay the cost to repair or replace with no deduction for depreciation, but not more than the least of the following amounts:
>
> (a) the limit of liability that applies to the damaged dwelling or other structure, plus any increase to this limit that may apply under Additional Coverages 14. Full Cost Replacement Coverage;
>
> (b) the replacement cost, on the same premises, of that part of the dwelling or other structure damaged; or
>
> (c) the necessary amount spent to repair or replace the damaged structure.
>
> (2) If you chose not to repair or replace and elect cash settlement, we will pay the amount that equals the cost to repair or rebuild that part of structure damages for like construction and use on the same premises.

Id. at *9-10.

AAIC argued that the "part of the dwelling" language in paragraph d(1)(b) was limited to the portion of the roof that was actually damaged by hail; the Mohrs disagreed, arguing that the "part of the dwelling" language referred to the entire roof. *Id.* at *10. The court maintained that the crux of the coverage dispute related to the terminology of paragraph d(1)(c), namely was it "necessary," to replace the entire roof, or only "necessary" to repair the hail damaged shingles, on a spot repair basis. *Id.*

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The *Mohr* court determined that the policy language ambiguous as to whether "a roof" could be divided up into various parts, and who was the arbiter of the "necessary amount spent to repair or replace" damaged property. *Id.* Even with these ambiguities, which are construed against the insurer and in favor of the policyholder, the court determined that $400,000 was not the "necessary amount" to repair or replace the roof in light of the extent of the hail damage. *Id.*

The Mohrs' experts testified that spot repairs for hail damage to the unique thatched roof were not recommended and were "problematic, at least in part, because they produced a patchwork effect, with the new shingles standing out like a sore thumb amongst the old, weathered shingles." *Id.* at *13. This aesthetic concern however was disputed by another expert which testified that the new shingles would fade and match the existing shingles within a year. *Id.* Ultimately, the court seemed to put great weight on the expert testimony that opined the replacement of an entire roof would not be considered unless at least 20% of the roof's shingles were damaged. The Mohrs' roof had sustained damage to approximately 10% of the roof, and thus did not warrant replacement of the entire roof. *Id.* at *14. The court held that the Mohrs had failed to show that $400,000 was the "necessary amount spent to repair or replace the damaged structure." *Id.*

Windridge – Damage to Part is Damage to All

In *Windridge,* an insurance coverage dispute arose between Windridge of Naperville Condominium Association ("Windridge") and Philadelphia Indemnity Insurance Company "Philadelphia") after a hailstorm physically damaged the aluminum siding on the buildings' south and west sides. *Windridge of Naperville Condominium Ass'n v. Philadelphia Indemnity Ins. Co.*, 932 F.3d 1035, 1036 (7th Cir. 2019). Philadelphia argued that all that was required under the insurance policy was to replace the siding on the south and west sides—the exposures that were physically impacted by hail. *Windridge*, 932 F.3d at 1036. However, Windridge argued that all four exposures, including the two undamaged exposures, needed to be replaced. Specifically, Windridge contended that the original siding color was no longer manufactured, and a repair of the two hail-damaged exposures with a newer, non-color match siding would result in a non-uniform, mismatched appearance with the two non-damaged exposures. *Id.*

Under the policy at issue, Philadelphia was obligated to pay for 'direct physical loss' to 'Covered Property' caused by or resulting from any 'Covered Causes of Loss.' *Id.* The policy defined 'Covered Property' to mean, among other things, the 'Buildings' described in the Declarations. *Id.* It further defined 'Buildings' to mean buildings or structures, and 'loss' to mean accidental loss or damage. *Id.* In interpreting this language, the district court construed the phrase "Covered Property" to include the buildings as a whole, not just the two elevations physically impacted and damaged by hail when a repair with non-matching materials would result in a non-uniform appearance. *Windridge of Naperville Condominium Assn. v. Philadelphia Indemnity Ins. Co.,* No. 16-CV-3860, 2018 WL 1784140 (N.D. Ill. April 13, 2018). The district court determined that matching was required because "the only sensible result is to treat the damage as having occurred to the building's siding as a whole." *Windridge*, 2018 WL 1784140 at *4. The court granted summary judgment to the policyholder, and Philadelphia timely appealed.

In its review, the appellate court took note of the fact that the insurance policy at issue was a replacement cost policy. *Windridge*, 932 F.3d at 1039. The court noted that a replacement cost policy, by definition, provides a 'make-whole' remedy" that "must strive to approximate the situation the insured would have occupied had the loss not occurred. *Id. citing FSC Paper Corp. v. Sun Ins. Co. of New York*, 744 F.2d 1279, 1283 (7th Cir. 1984). As applied to the facts of the case, the court determined that two phrases in the policy were ambiguous - "direct physical loss" and "covered property." *Windridge*, 932 F.3d at 1039. As such, Illinois law favored the total replacement position

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advocated by Windridge, because the unit of covered property to consider under the policy (each panel of siding vs. each side vs. the buildings as a whole) was ambiguous. *Id.*

Though the landscape on "matching" issues under a policy is varied, the appellate court found a District of Columbia case instructive. *Id.* at 1040. There, some, but not all of church's exterior limestone panels were damaged in an earthquake. The question presented to that court, identical to that in *Windridge,* was whether the property insurer was required under the policy to replace all of the limestone panels to ensure matching or just the panels that were directly damaged. *National Presbyterian Church, Inc. v. GuideOne Mut. Ins. Co.*, 82 F. Supp. 3d 55 (D.D.C. 2015). Because the policy was ambiguous as applied to the damage to specific portions of the building, at least where repairs to only those portions would leave aesthetic matching issues, the court held that matching was required and all of the limestone panels needed to be replaced. *National Presbyterian Church, Inc.*, 82 F. Supp. 3d 55, 60.

Similar to *National Presbyterian Church*, the court determined the policy in *Windridge* to be ambiguous and favored an interpretation that the unit of damaged property is the buildings as a whole—not solely each elevation or each panel of siding. The court highlighted hypotheticals wherein the storm damaged every other piece of siding on only the east elevations of the buildings, or that a storm damaged only the middle three feet of every piece of siding on the buildings. *Windridge* at 1040. The court applied its hypothetical to Philadelphia's position - that the unit of damaged property was an individual side of a building, or individual panels of siding—with such application of mismatched materials resulting in a horizontal or vertical striped effect on the buildings. *Id.* The court concluded that such an interpretation of a replacement cost policy was not reasonable, and the proper construction was that each building as a whole suffered direct physical loss as a result of the storm. *Id.* at 1041. The storm altered the appearance of the buildings such that they were damaged, and the appellate court held that buildings with mismatched siding are not a post-storm outcome that the insured was required to accept under a replacement-cost policy. *Id.*

In a final argument, Philadelphia contended that it did not control what siding is available on the market, or whether a siding company continues to manufacture a particular color of siding, which, in the *Windridge,* was the genesis of the mismatching issue. *Id.* Essentially, Philadelphia contended that when the mismatching arose because the matching replacement materials were no longer manufactured, it was not required replace all of Windridge's siding to create a uniform appearance. *Id.* The appellate court disagreed, and found that lack of matching building materials is a risk associated with the policy, and certainly a risk that the policyholder had even less control over than the insurer. *Id.* It held, therefore, that the language of the policy required Windridge to be made whole and have its buildings returned to their pre-storm status, requiring replacement of the siding on all four elevations of the effected buildings. *Id.* at 1041-42.

Conclusion

The takeaways from *Windridge* are three-fold. First, the case speaks to the well-established proposition that because an insurance company has control over the drafting of the language of its policy, any ambiguities in that policy are construed in favor of the insured and in favor of coverage. Second, when a building is only partially damaged, and the replacement materials do not aesthetically match those present on the structure, the damage should be treated as to the structure as a whole, not just the effected individual components. Lastly, the *Windridge* court placed great emphasis on the purpose underlying replacement cost insurance—to return the policyholder to a pre-loss condition. The decision leaves open the question as to an insurer's obligation when the property was in a mismatching condition to begin with.

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