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Law and Ordinance Coverage:

Is It Illusionary?

by Charles R. Tutwiler

Americans were lucky that the 2007 hurricane season turned out to be much milder than the preceding seasons of 2004, 2005 and 2006 which hit Florida and the Gulf Coast states hard and often. But if the forecasts for future years are to be believed, many catastrophic storms await in 2008 and beyond. Moreover, concern over such future storms is not limited to the Gulf Coast—homeowners and businesses along the Atlantic seaboard all the way to Massachusetts are being told to fear and prepare for the worst. Policyholders everywhere would be wise to note and learn from the problems that homeowners and businesses affected by the storms of 2004-06 had with their insurance claims.

"...code coverage may pay only for the code change requirement necessary to bring the structure up to code to the time of the loss, not the code and cost that would be required to actually repair or rebuild the damaged property, when a code change follows the storm..."

One common problem in such claims was the illusory nature of "law and ordinance" coverage which is designed to kick in when a storm that causes a policyholder's loss leads to changes in building codes that increase the cost of reconstruction of the damaged or destroyed property.

Catastrophic losses (commonly referred to as "CAT" losses) are very destructive and often occur across wide geographical areas. Given this level of destruction, communities take a long time to recover and rebuild. One needs only to recall the recent 24-hour news coverage of the two-year anniversary of Hurricane Katrina, which demonstrated the difficulty the affected Gulf Coast communities have encountered in their recovery efforts.

CAT Events Can Trigger Changes in Coverage

Most CAT events are soon followed by clamor from officials berating the lack of strict and up-to-date building codes and espousing the need for reconstruction to be completed in a manner that will prevent or mitigate future CAT events. Remember that following Hurricane Andrew, the State of Florida passed legislation requiring code or law and ordinance coverage in all homeowners' policies issued in Florida. The initial legisla-

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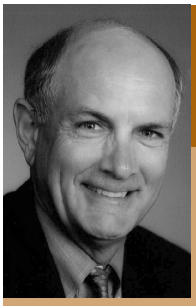

who's who

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We hope you have found this issue of *The Loss Advisor* to be of interest. We invite you to contact the editor, Marshall Gilinsky, at (212) 278-1513 or mgilinsky@andersonkill.com, with your questions and/or concerns.

tion required that carriers offer an *additional* 25% of "Coverage A" to apply to the increased cost of more stringent building codes. This coverage was automatic with some companies while others offered it and required a signed statement if rejected by the policyholder. Subsequent CAT events in Florida caused the legislature to revisit this and now homeowners can purchase up to 50% of additional limits to cover law and ordinance coverage. Clearly, state officials recognize the need for this coverage to be a matter of great public policy. In January 2006, Florida's Office of Insurance Regulation published a paper, "Law and Ordinance Coverage." The benefit of requiring non-compliant buildings to conform to current building code as well as the recognized benefit of new code-compliant buildings is validated in part by Florida's Citizens Insurance Company providing mitigation money to condominium associations if they make the recommended retro fixes. Florida has also implemented grant programs to help homeowners. My Safe Florida Home program provides grants up to $5,000. New strict building codes work and it is to everyone's benefit that they be implemented.

Nuances to Increased Cost and Demolition Endorsement Coverage

Because we have not implemented new codes to existing grandfathered-in buildings, we face future billions in losses given where we have built and the condition of our structures. While various government entities have interceded in some ways, the insurance industry has for some time provided endorsements in property policies such as Law and Ordinance coverage a/k/a Increased Cost and Demolition Endorsement Coverage. These endorsements are certainly a step in the right direction. Although it is expensive and in some cases for commercial risks unobtainable, there are some nuances to this coverage that need to be considered.

One of the most widely recognized provisions of this coverage is that policyholders have to incur the code cost before the carrier will pay. The Florida Supreme Court weighed in on this issue in September 2007, seemingly (but perhaps not necessarily) settling this issue under Florida law. In *Ceballo v. Citizens Property Insurance Company*, the court found that "to incur" means "become liable for the expense but not necessarily to have actually expended it." Notwithstanding this new dynamic of "incurred," this policy provision requires policyholders to go on the hook for the cost to upgrade their homes at a time when they are at greatest financial

peril. In the past, Florida offered a solution in the form of informational bulletins suggesting that a signed contract to do the work met the incurred and/or intent requirement. It will be interesting to see how the insurance industry views this Florida Supreme Court opinion as it relates to the definition of "incurred" going forward with law and ordinance and perhaps additional living expense and extra expense claims.

Another detail of this coverage that seems to be widely overlooked is the provision that it will only pay for the code requirements "that are in effect at the time the insured loss occurs."

Surprisingly, Florida's Law and Ordinance paper did not explain the nuance of this "at the time" of loss provision. Even more surprising is that Florida made significant code changes in 2005, yet no notice was sent to policyholders with an explanation of how those changes may affect homeowners still struggling to recover from the four 2004 CAT events.

What's in the Pipeline?

Most troubling is the January 2006 Office of Insurance Regulation Report's statement that "while the Florida building code is not the focus of this report, the fact that it may (and probably should) evolve in the years ahead to promote residential construction with even greater protection from hurricane force wind will continue to make law and ordinance coverage a subject of special interest."

Herein may lie a huge problem in that following large CAT events with officials calling for tougher and stricter building codes for the rebuild, code changes can be implemented after the loss has occurred and before the insured has reached a settlement and/or completed the repair rebuilding process. Thus the code coverage may pay only for the code change requirement necessary to bring the structure up to code to the time of the loss, not the code and cost that would be required to actually repair or rebuild the damaged property, when a code change follows the storm,

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as well as the often drawn out adjustment of the policyholder's claim.

Conclusion

So is law and ordinance or code coverage illusionary? Does it do what an insured expects it to do—i.e., cover the increased cost of post-loss repair due to new code requirements? Perhaps, but you can bet just as in the past when the insured policyholder tried to collect "replacement cost" following large CAT losses, and found out that replacement cost did not in fact mean full replacement cost, discourse and controversy will ensue.

Given the likely outcry from policyholder and/or consumer representatives following a CAT loss, the term "at the time of loss" needs to be clearly understood by the consumer prior to the loss, which is fostered (although certainly not accomplished) for other deceptively restrictive provisions by adding a separate notice and BOLD FACE emphasis to the provision. It is troubling that there is no explanation of "at the time of the loss" and its impact given what may occur with building code requirements months later, after the loss has occurred.

Interestingly, this conundrum may be one of those rare situations where folks with polar positions on the interpretation of insurance coverage could agree. Certainly an underwriter could advance a logical argument that it could not accept the unknown risk of future building codes; thus the need for restricting language such as "at the time of the loss."

On the other hand, insureds may feel that this is an illusionary coverage as they were told that they had code coverage and now, following a catastrophic loss and before their settlement and/or building repair/replacement has been completed, the code has changed and they will be denied all or a portion of the coverage they felt they purchased, and now need to rebuild.

Finally, the law and ordinance or code coverage is as revolutionary and necessary as the replacement cost endorsements that were offered in the past in order to make the insured whole by replacing the property instead of paying a depreciated amount. Code coverage is now of great importance to public policy. Its effectiveness remains to be seen, and the impact of the "big print giveth, the little print taketh away" principle as seen in law and ordinance coverage could be huge in the next big CAT event.

Policyholders everywhere should look at their policies and discuss with their brokers whether enhancements to the language in their "law and ordinance" coverage provides the coverage they expect and want, and what can be done to amend the existing language so that the policy meets the policyholder's needs. ■