

# ADJUSTING TODAY

Adjusters International Disaster Recovery Consulting

## EDITOR'S NOTE

*Your business, including its landmark headquarters building, has been devastated by fire. Rebuilding will be a daunting task, but as you begin the process, you feel some comfort believing that since your insurance program was recently renewed, it will provide the reimbursement you need to fully restore your operations.*

*Then comes a surprise almost as shocking as the fire itself. Even though your policy contains a replacement cost provision, it does not cover the higher costs of construction you must incur to ensure that your rebuilt facility complies with the latest building codes. These codes change frequently and can impact features ranging from the electrical wiring, sprinkler and other emergency systems, to handicap accessibility. Driving the cost of compliance even higher can be the architects' fees and extra time it will take to design and build these features into the structure.*

*Increased cost of construction coverage can protect you against these higher expenditures, but it is a complex coverage that is too often misunderstood and too seldom applied.*

*In this issue of Adjusting Today insurance expert Donald Malecki discusses important aspects of this coverage, including how insurers and the courts have viewed increased costs of construction. It's valuable reading — and can help you avoid having one unpleasant surprise follow another!*



—Sheila E. Salvatore, Editor



## Increased Cost of Construction Coverage — Understanding the Complexities of this Important Protection

By Donald S. Malecki, CPCU

Among the many businesses damaged extensively by Hurricane Katrina in 2005 was a shopping plaza in Mississippi. At the time of the loss, this plaza, built in 1995, was 100 percent occupied. The most severe damage was to an anchor food store, which sustained damage to its electrical, heating, ventilation and air conditioning systems.

Over the course of one year following the hurricane, the insurer paid the managing members of the real estate investment corporation (the named insureds) slightly over \$2 million in property insurance. Of this amount, approximately \$1.8 million entailed building damage and about \$293,000 was for lost rent and income. The insureds,



however, submitted proofs of loss totaling some \$3 million. The insurer maintained that the difference was not covered because it largely represented “code upgrades.” Litigation followed.

The key questions in this case of *Southeast Real Estate Investment Corporation and Retail Management Group, Inc. v. Nationwide Mutual*

*Insurance Company, et al., U.S. Dist. Ct. S.D. MS (No.1:07cv1197-LTS-RHW 2008)* involved areas of the insurance policy that purported to exclude (with a limited exception) costs and expenses associated with ordinance and law provisions — also commonly referred to as “code upgrade” coverage.

A careful reading of the policy and

its endorsements by the court revealed no provision for increased cost of construction, with the exception of some limited coverage subject to a maximum of \$10,000. In looking at the Building and Personal Property Coverage Form, the court said that the cost of repair or replacement did not include the increased cost attributable to the enforcement of any ordinance or law regulating the construction, use or repair of any property. Likewise, the court said, the Causes of Loss Special Form also precluded the payment for loss or damage caused directly or indirectly by any increased costs incurred to comply with an ordinance or law in the course of construction, repair, renovation, remodeling or demolition of property, or removal of its debris, following a physical loss to that property.

From the court’s perspective, there was no way the insureds were going to convince it that the property policy covered any more than the limited, additional amount of \$10,000. This amount, incidentally, went to pay architects’ fees — undoubtedly for less than the insureds actually needed.

### ***Ways the Coverage is Provided***

Increased cost of construction coverage varies by insurer in both the provisions utilized and the available limits. Upon comparison, many of the basic coverage provisions are similar and provide the following:



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***“Increased cost of construction coverage varies by insurer in both the provisions utilized and the available limits.”***

- (1) The requirement that this coverage applies only when the building is written on a replacement cost basis;
- (2) Coverage does not apply where the insured was required to comply with an ordinance or law before the loss, even when the building was undamaged and the insured failed to comply;
- (3) No coverage applies for any costs associated with the enforcement of any ordinance or law requiring an insured to test for, monitor or clean up pollutants, or in any way respond to or assess the effects of pollutants;
- (4) No coverage applies to costs associated with any ordinance or law requiring an insured to respond to fungus, wet or dry rot, or bacteria;
- (5) The covered costs incurred are not payable until the property has been actually repaired or replaced at the same or another premises;
- (6) The insured generally has no more than two years to make the repairs or replacement.

### **Two Ways of Obtaining Coverage**

Insurance Services Office (ISO) offers two ways to obtain increased cost of construction coverage. The first is in conjunction with

its Ordinance or Law Coverage Endorsement (CP 04 05). It provides coverage not only for increased costs of construction (Coverage C), but also for losses associated with undamaged portions of the building (Coverage A) — as well as for demolition costs (Coverage B). These items are discussed in *Adjusting Today* issue #3009, “Ordinance or Law Coverage — Code for Recovery!”

The second way ISO provides increased cost of construction coverage is automatically through the “additional coverages” section of the Building and Personal Property Coverage Form (CP 00 10) and Condominium Association Coverage Forms (CP 00 17 and CP 00 18). In this case, the increased





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cost of construction coverage provides an additional amount of insurance limited to \$10,000 or 5 percent of the limit of insurance applicable to the building, whichever is less. If insurance applies on a blanket basis, the

5 percent is applied to the value of the building at the time of loss. The 5 percent limit also applies to each described building.

As noted, the automatic coverage applies only to the damaged

parts of the building, whereas the coverage provided under the Ordinance or Law Endorsement (CP 04 05) applies to both damaged and undamaged portions of the building.



Given the general availability of optional endorsement CP 04 05, one might ask why automatic increased cost of construction coverage is even necessary. This is an intriguing question, given that the automatic additional coverage is capped at \$10,000, whereas the optional CP 04 05 endorsement allows the insured to purchase a limit which will address the exposure for any given building.

According to one source, there are two possible answers. The first is to call the insured's attention to the need for this coverage at higher limits through purchase of the optional coverage endorsement CP 04 05. The second reason is to reduce the number of potential cases where insureds have been successful in maintaining that increased costs of construction are inherent in replacement cost coverage.<sup>1</sup> This is a common approach insurers take when opportunities exist for insureds to obtain coverage through ambiguities. By providing a small limit automatically, these attempts by insureds are all but thwarted.

Chances are that when an insured suffers a significant loss or damage that triggers the need to upgrade the property to meet current code requirements, the enforcement could increase the time necessary to repair or rebuild the building. With that exposure in mind,

insureds should not overlook purchase of the Ordinance or Law Increased Period of Restoration Endorsement CP 15 31. Available with the Business Income (and Extra Expense) Coverage Form, the Business Income (with Extra Expense) Coverage Form and the Extra Expense Coverage Form, coverage is extended to include the amount of the actual and necessary loss the insured sustains during the increased period of suspension of operations. The suspension, however, must be caused by or result from an ordinance or law

regulating the construction or repair of any property.

It is important to keep in mind that this coverage is triggered by a covered cause of loss occurring to the property. Of course, if the endorsement (CP 04 05) covering increased cost of construction is triggered, business income and/or extra expense will likewise be activated. The endorsement, CP 15 31, covering the increased period of restoration occasioned by the insured's compliance with ordinance or law, should insure



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<sup>1</sup>Jerome Trupin and Arthur L. Flitner, *Commercial Property Risk Management and Insurance*, 7th ed.p. 3.25, Malvern, PA: The American Institute for CPCU.



proper and adequate coverage for the increased duration of repairs exposure.

### **Establishing Appropriate Limits**

Although many insurance buyers and their insurance representatives or consultants try carefully to determine the proper amount of increased cost of construction coverage, some, such as the named insureds in the foregoing case, knowingly turn down the purchase of this extra coverage.

In the case of the Mississippi plaza, the insureds' agent testified in his affidavit that any time he obtained ordinance or law coverage on a

property for these insureds, it was when a mortgagee wanted it included. He also testified that the named insureds were asked after the storm whether they wanted to add the coverage to their policy and it was declined on the plaza, as well as on another location. With yet another facility that was refinanced, the insureds again declined to purchase the coverage.

It is safe to say that those who are candidates for code upgrade coverage want to obtain sufficient limits, particularly once they understand why the coverage is necessary and what can happen without it. The challenges that must be addressed are (1) the cost

and (2) calculating how much increased cost of construction coverage is needed. Unfortunately, this insurance is not inexpensive and there is no easy method or magic formula for determining the amount of coverage to obtain.

Many people oversimplify the process by using percentages of property replacement values to project appropriate coverage limits. For example, it has been suggested that for increased cost of construction, the amount of insurance should range from 15 percent to 25 percent of the replacement cost of a building. The lower amount of 15 percent would be used for a building between



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10 and 20 years old, and 25 percent would be a safer number for a building more than 20 years old. If the building is less than 10 years old or substantially older than 30 years, there are no real guidelines upon which to make an educated guess.

Short of obtaining the services of an architect or contractor to research the current code requirements and then estimating the incremental increases in construction costs associated with implementing the required upgrades, any other projected limits are a shot in the dark.

The difficulty lies in that no two buildings are the same and therefore are not likely to be subject to the same so-called “faults of management” — characteristics that may require improvements for safety reasons and for certain code upgrades following substantial loss or damage. For instance, not all buildings are subject to the requirements of the Americans With Disabilities Act of 1990 (U.S. Code at 42 U.S.C. Sec. 12101-12213). Or if they are, the requirements may differ based on the building’s characteristics.<sup>2</sup>

The owners of those buildings that are subject to the ADA, however, should recognize that having to retrofit a building to meet the

<sup>2</sup>In 2008, the President of the United States signed the ADA Amendments Act to reinstate some of the provisions that were eroded by the courts since the Act’s passage in 1990 to protect those who have both mental and physical disabilities.



requirements could be very costly. Making exterior and interior doors wider and modifying bathrooms to make them wheelchair compatible can be expensive. Other costly items that might have to be added include sprinklers, copper wiring, copper pipes and alternate means of egress. The list is endless. Very costly items may even be structural in nature, such as changes to make buildings “windproof” or “earthquake-proof.”

An additional hurdle is the policy requirement that the insured must prove its upgrade loss and have sufficient funds to make the upgrades. Upgrade coverage, like replacement cost, is an indemnity form of coverage, requiring the insured to rebuild the property — code compliant — and then seek reimbursement for the difference between the cash received for the

loss and the actual cost to rebuild, including the increased cost to become code compliant.

In this vein, what also needs to be kept in mind is that replacement cost should not be confused with market value. Market value of property can fluctuate. Witness the selling prices of commercial and residential properties throughout the United States during a recession. The cost of materials and labor, on the other hand can continue to rise, making the cost of repair or replacement of damaged property higher, while the market value of the property itself slipped lower.

In some isolated cases it might be possible to estimate a percentage upon which the amount of code upgrade insurance can be based, but it is unlikely that any



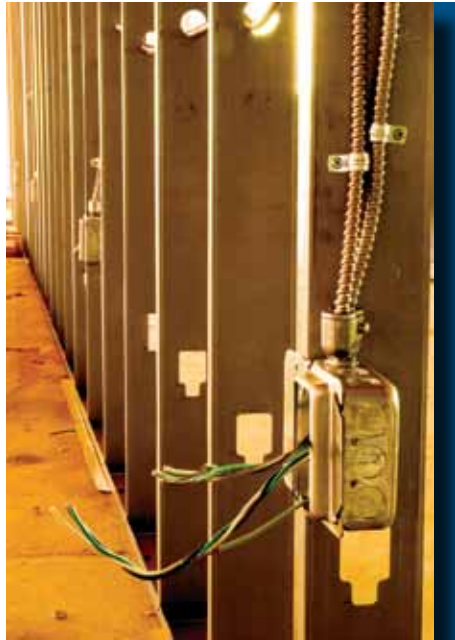
failsafe formula can be devised. Considering the time and expense it can take to examine each property to determine the exposure and make estimates, along with the extra cost of the coverage, many insurance buyers will simply hope for the best.

### **Litigating the Coverage Issue**

Because insureds often do not get the sympathy of the courts, litigating the issue of whether and to what extent coverage for code upgrade applies is a gamble. However, when they stand to lose large sums from their claims being denied, insureds will risk time and expense in efforts to convince the courts that the insurers are wrong.

In the case of *Chattanooga Bank Associates and Suntrust Bank v. Fidelity and Deposit Company of Maryland*, 301 F.Supp.2d 774 (U.S. Dist. Ct. E.D. TN 2004), the insureds attempted to recoup code upgrade coverage even for undamaged areas that were in violation of code. While this approach can work depending on the coverage form, in this case the attempt failed.

The premises in question was damaged by fire on two occasions in less than a month. After the fire, the building was inspected and found to be in violation of certain building codes. The violations involved damaged and non-code electrical wiring and fixtures, an inoperable and non-code fire alarm system, a non-code elevator emergency system, damaged and



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non-code stairway lighting and emergency signage, defective standpipe valves and other non-code matters. It was unclear which, if any, of the cited violations incurred in areas impacted by the

fire. The insureds argued that the insurer was nonetheless liable for all code violations discovered during the inspections, regardless of their relationship to the fire.

The insurer argued, however, that the discovery of code violations in areas not affected by the fire did not make it liable. The court agreed. In its explanation, the court first turned to the provision dealing with the perils insured against. Since the policy provided coverage for all risks of direct physical loss or damage to property unless a specific exclusion applied, the court concluded that this language acted to limit the insurer's liability to only those areas where the loss or damage resulted from a peril not otherwise excluded; in this case, specifically the peril of fire.

The demolition and increased cost of construction coverage provision was the next item referred to by the court. Of significance here, said the court, was the precondition phrase that read:

*In the event of loss or damage under this coverage part that causes the enforcement of any law or ordinance regulating the construction or repair of damaged facilities, the company shall not be liable for:*

- A. *The cost of demolishing the undamaged facilities, including the cost of clearing the site;*
- B. *The proportion that the value of the undamaged part of the facility bore to the value of the entire facility prior to loss;*





*C. Increased cost of repair or reconstruction of the damaged and undamaged facility on the same or another site and limited to the minimum requirements of such law or ordinance regulating the repair or reconstruction of the damaged property on the same site. Coverage is extended to include the amount of actual or necessary loss you sustain during the increased period of suspension of operations.*

*However, the company shall not be liable for any increased cost of construction loss unless the damaged facility is actually rebuilt or replaced.*

The insureds contended that because the inspection was triggered by the fire and resulted in the enforcement of the building

code, the fire was the cause of the enforcement of the building code. The court disagreed. In doing so, it stated that although the violations might have remained undiscovered if not for the fire, the violation in question existed independent of the fire, and therefore the fire could not be said to have caused the enforcement of a building code.

Finally, although the phrase reading “increased cost of repair or reconstruction of the damaged and undamaged facility” acknowledged some liability to portions of an undamaged facility, this liability, the court explained, was limited to repair or reconstruction; that is, not upgrading per se.

Currently, this kind of an issue is less likely to warrant the insured’s efforts to litigate. This is because insurers have clarified their increased cost of construction coverage provisions to spell out what they are and are not going to pay.

### **Rebuilding at Another Location**

When an increased cost of construction coverage provision gives the insured the option to rebuild on another site, the following questions arise: How much can the insured obtain to implement code upgrades? Is the amount limited to what the insured would have received if it repaired or rebuilt the existing property — or some other amount



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not to exceed the coverage limit? While the answer will depend on the particular coverage form, most likely it will be the amount that would have been payable otherwise had the building been repaired or replaced at the site of the loss. If, on the other hand, an ordinance or law requires a relocation, the insurer will be obligated to pay the increased cost of construction, subject to the coverage limit.

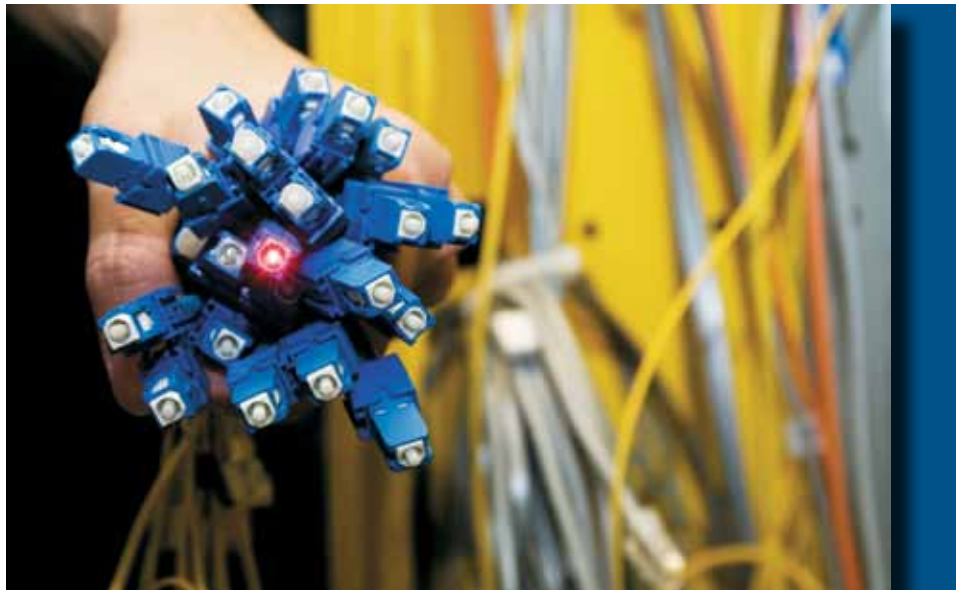
In one case, relocation was not required by ordinance or law, but the insured decided to purchase an existing building to replace the one damaged instead of repairing it. In doing so, the insured still sought payment for the increased cost of construction that was otherwise payable. The particular coverage had a limit of \$250,000 in any one occurrence. In the case of *Snoqualmie Summit Inn, Inc. aka First Western Investments v. Travelers Property and Casualty Company of America, et al.*, No. CV06-0517 (U.S. Dist. Ct. W.D. WA 2007), the court disagreed with the insured. In its ruling, the court said, “it would be illogical for [the] plaintiff to receive additional funds to pay for increased cost of construction when nothing is actually built.”

The fact that an insured sustains a loss where there are code violations that need to be corrected does not mean that increased cost of construction coverage automatically applies. The loss needs to be otherwise covered; that is, there must be

direct physical loss or damage from a covered cause. This same requirement applies to the other coverages available with optional endorsement CP 04 05. This was essentially the argument in the case of *Mark West Hydrocarbon, Inc., et al. v. Liberty Mutual Insurance Company, et al.*, 558 F.3d 1184 (U.S. Ct. App. 10th Cir. 2009).

An explosion in a natural liquid gas pipeline operated by Mark West (the named insured) caught the attention of the U.S. Office of Pipeline Safety (OPS), which

ordered a series of tests on the pipeline followed by repairs necessitated by discoveries made during those tests. When the named insured filed a claim with its insurer, it was denied. At the time of the accident, the named insured had maintained an “all risk” property policy with four insurance companies. The policy indemnified the insured against “all risks of direct physical loss or damage occurring during the period of the policy from any external cause, except as hereinafter excluded.”



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Attached to the policies was a Demolition and Cost of Construction (DICC) endorsement providing up to \$5 million in coverage for specific losses resulting from the enforcement of laws and ordinances regulating the “construction or repair” of damaged property. It also covered any increase in the business interruption and extra expense loss arising out of the additional time required to comply with state law or ordinance.

When the named insured reported this loss to the insurers, maintaining that coverage applied under the DICC Endorsement because of the explosion, the insurers disagreed, asserting that it was not explosion that caused the loss but instead, corrosion. The insurers also maintained that the expenses incurred by the named insured to comply with the corrective action order (CAO) of the OPS were in doubt, because even if the CAO were considered to be a law or ordinance, coverage would only apply if the OPS was regulating the construction or repair of the damaged pipeline. Thus, the insurers were of the opinion that while the CAO may have regulated the use of the entire pipeline, it did not appear to have regulated the repair of the damaged portion of the pipeline.

Another reason given by the insurers for denying coverage was that for coverage to have applied under the DICC Endorsement, an insured peril must have caused the

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enforcement of law or ordinance. Here, however, they argued that the OPS acted out of concern for corrosion in the pipeline and corrosion was a peril expressly excluded by the terms of the insured’s policy. The Court of Appeals agreed with the insurer. In doing so, it stated that even if the accident had been caused by an insured peril (valve failure), by everyone’s admission the peril damaged at most only a small stretch of the pipeline, causing less damage than the deductible amount of \$250,000.

### **Summary**

With increased cost of construction claims, unless the criteria for coverage are proven — along with the amount of damages — insurers may deny coverage and find refuge in a sympathetic court to

sustain their denial. Therefore, insureds desiring increased cost of construction coverage for direct physical loss or damage and the additional time element coverage required, must work carefully with their brokers to purchase the proper coverage.

There also must be an understanding that while the insured and broker can estimate or project how much coverage should be purchased to meet the code upgrade exposure, it is not the insured who will determine when or even if the increased cost of construction coverage has been triggered. That will likely be the role of some governmental body, most likely a state or local entity.

Once an order has been issued proclaiming that the property is





in violation of ordinance or law and that it needs to be repaired or replaced, the burden of proving that the loss is excluded will fall upon the insurer — if the policy is an “all risks” or causes of loss special form. The insurer, therefore, must be able to point to a specific exclusion to sustain its denial of loss. Conversely, the burden of proof rests with the insured if a named peril policy applies (basic or broad form). In other words, the insured must prove that one of the insured perils caused the loss in order to activate the coverage.

If a building is suspected of being subject to code changes since its original construction date, the owner would be well served to obtain the counsel of an architect or builder to determine its exposure to loss. This is a particularly important consideration when a building is in an earthquake or wind zone.

Whether the insured has sufficient limits of protection is a burden that falls solely upon the insured. Even though limits can be difficult to determine, no one but the insured is to blame if they are insufficient. As noted, increased cost of construction coverage does not become payable until after the property has been repaired or replaced.

Also, if coverage applies for increased cost of construction, then the time element coverage needed to account for the longer-than-anticipated time to repair or rebuild would be activated, to the extent that it was purchased. Like coverage applicable to property policies, time element coverage, such as loss of business income and/or extra expense, does become payable until there has been an otherwise covered loss involving the property.



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*Donald S. Malecki, CPCU*

Mr. Malecki is a principal of Malecki Deimling Nielander & Associates, LLC, an insurance and risk management firm. He began his career over 50 years ago and has held the titles of insurance underwriter, broker, insurance company claims consultant, archivist, historian and teacher.

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## ADJUSTERS INTERNATIONAL

**CORPORATE OFFICE**  
126 Business Park Drive  
Utica, New York 13502  
1.800.382.2468  
Outside U.S. (315) 797.3035  
FAX: (315) 272.2054

editor@adjustingtoday.com

**WEB ADDRESSES**  
[www.adjustersinternational.com](http://www.adjustersinternational.com)  
[www.adjustingtoday.com](http://www.adjustingtoday.com)

**PUBLISHER**  
Ronald A. Cuccaro, SPPA

**EDITOR**  
Sheila E. Salvatore

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