



# ADJUSTING TODAY

Adjusters International Disaster Recovery Consulting

## Ordinance or Law Coverage: Code for Recovery!

### EDITOR'S NOTE

*More Firsts for Adjusting Today!*

*Those who have followed Adjusting Today since its inception know that we have regularly sought the input of our readers in covering topics that address their needs and interests. Many of the articles we have featured have been the result of comments and suggestions received.*

*We're pleased to note that the subject addressed in this issue was the direct result of reader requests. Ordinance or Law Coverage is a subject about which relatively little has been written. Yet it is a very real and timely concern for today's insurance professional—whether involved at the agent/broker level, as an insured or risk manager, or in the claims settlement process.*

*This issue also includes another first, as we're pleased to welcome distinguished insurance writers Paul O. Dudey, CPCU and Donald S. Malecki, CPCU to our editorial board.*

*We hope you'll find this issue interesting and helpful!*

*—Sheila E. Salvatore, Editor*



*By Paul O. Dudey, CPCU  
Contributing: Donald S. Malecki, CPCU*

After a severe property loss, the first shock comes in learning that rebuilding a damaged or destroyed structure so that it conforms to the latest building codes can add 50 percent or more to recovery costs.

Then comes the unpleasant surprise of discovering that the "Ordinance or Law" exclusion in the property insurance policy

will prevent a full recovery—even though replacement cost coverage is provided, limits are sufficient to fully cover the replacement, and no coinsurance or similar limitations are applicable.

With building codes continually changing—requiring features like new or improved sprinkler systems, better wiring and



handicap accessibility—this dilemma is not uncommon. That's why, more than ever, it is important to understand the Ordinance or Law Exclusion—and the coverage that addresses it. First, some background.

### **What is the Ordinance or Law Exclusion?**

The Ordinance or Law Exclusion (found in current Insurance Services Office Commercial Property Causes of Loss forms as exclusion B.1.a.) states that the insurer will not pay for loss or damage caused directly or indirectly by:

“The enforcement of any ordinance or law:

- (1) Regulating the construction, use or repair of any property; or
- (2) Requiring the tearing down of any property, including the cost of removing its debris.”

Most other property insurance forms, including Homeowners and Highly Protected Risk forms contain a similar exclusion.

This exclusion is aimed at the application of building codes of various kinds—construction, electrical, plumbing, fire safety, etc.—that may require more expensive reconstruction materials, installations, design or methods after the loss than those used in the existing building; and zoning laws that may prohibit present occupancy, or that impose onerous building or lot size or frontage requirements or restrictions.

Some laws, even when allowing reconstruction with the same materials or design, also require



that if the building is damaged beyond a specified percentage of its value (50, 60 or 75 percent is typical), the remaining portion of the building must be demolished before reconstruction can begin.

Of fairly recent origin are laws regarding environmental and pollution control that can require elaborate and expensive decontamination or, on reconstruction, require employment of elaborate and expensive pollution control devices or prohibit certain existing practices.

Also, more and more laws are being enacted relative to construction practices in earthquake, hurricane and flood zones. Restrictions on rebuilding along known earthquake faults or requirements that reconstruction meet earthquake resistant standards are common in many earthquake-prone areas, while in flood zones and coastal hurricane areas, laws prohibiting rebuilding or requiring elevation of buildings

above the flood or tidal level are commonplace.

Most building and zoning laws include a “grandfather” clause that permits existing structures or occupancies to continue in use without needing to conform to the new requirements, but with the proviso that if the property is substantially damaged, compliance with the current law will be required in order to repair or rebuild.

### **Three Areas of Loss**

Application of the Ordinance or Law Exclusion can produce three distinct and separate areas of uninsured loss:

- (1) Loss of the value of the undamaged portion of a building when the building must be torn down or modified to meet the current code requirements, when building damage exceeds the percentage specified in the code or when reconstruction of the building at the site is not permitted under the code;



(2) Cost of demolition and removal of the debris of undamaged portions of the structure that must be torn down or modified (note the need here to distinguish between debris of *damaged property [covered]* and debris of *undamaged property [excluded]*); and

(3) Increased cost of reconstruction—the added cost to repair or rebuild in accordance with the current code. This may include such things as installing a sprinkler system or other fire protection equipment in a previously unprotected building, rebuilding with a heavier class of construction, i.e., fire resistant construction replacing brick, wood joint construction, or redesigning to meet earthquake or hurricane resistant standards.

Often included in this cost will be extensive architects' and engineers' fees needed to determine what will be required to meet current code requirements. Because time is of



the essence in getting construction under way, premium prices will often be involved in this work. But in applying the exclusion to these costs, only those costs involved in upgrading to meet code requirements are excluded, while the routine architects' and engineers' fees associated with rebuilding or restoring the property after loss—even though involving premium prices—are covered unless the policy contains the now archaic architects' and engineers' fees exclusion.

### ***When and How the Exclusion Applies***

The question naturally arises at this point: How can we determine whether the exclusion will apply in any given case and what will be its probable effect on a loss adjustment?

Agents, brokers, risk managers and consultants are well advised to become familiar with local and state building and zoning laws and with the construction and occupancy details of any property with which they are involved. The problem is that it is not always easy to determine the precise, applicable codes or laws.

Consultation with the city or county building department will often be the most helpful in this regard. These officials may even be aware of federal laws that might come into play or be able to offer the names of persons who are knowledgeable in this area.

Some basic questions should be raised:

—Do any existing codes prohibit rebuilding with present construction, occupancy, size or

location, or require demolition if more than a given percentage of the building is damaged? What percentage?

—Since the present building was constructed or operations began, have there been changes in any of the codes that could adversely affect the property or operations? What are they? What would be their probable effect in the event of a severe loss?

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As an alternative, it might be advisable for agents, brokers and consultants to recommend that clients seek the assistance of competent attorneys involved in real estate law.

### ***Worst Case Scenario***

Given answers to these questions it is then possible to construct a “worst case scenario” involving the effects of these laws in the event of possible loss to the property. Based on this scenario, appropriate insurance can then be arranged, nullifying the Ordinance or Law Exclusion and replacing it with one or more of the three coverage extensions available to provide adequate protection.



## Historic Coverages

The three coverages available are aimed at the three separate areas of exposure outlined earlier in this article. They have a curious history, and adjusters may encounter any of several variations in the coverage available.

Prior to ISO's introduction in the mid-1980's of commercial property endorsement CP 04 05, three separate coverages—each provided by a separate endorsement—were available:

—The Contingent Liability for Operation of Building Laws endorsement covered the loss of the value of any undamaged portion of the building, destruction of which was necessary after an insured loss. No additional insurance was required, but an additional rate factor was applied to the property insurance premium.

—The Demolition Cost endorsement covered the added cost of tearing down the remainder of a building damaged by an insured peril, when demolition is

required by law. This endorsement required a separate amount of insurance.

—The Increased Cost of Construction (Excess of Replacement Cost) endorsement covered the additional cost of rebuilding to comply with current code requirements. It was offered only with replacement cost coverage and required an additional amount of insurance beyond the amount carried for building replacement cost.

## Building Ordinance Coverage

In conjunction with the adoption of ISO's simplified commercial lines forms, Building Ordinance Coverage endorsement CP 04 05 was introduced. It combined the three described coverages into a single coverage.

The endorsement provided no additional insurance as such, but was available only with replacement cost coverage and presumed that the amount of insurance chosen would be high enough to cover demolition costs plus the increased cost of reconstruction in accordance with current code, in addition to normal cost of replacement new-for-old without code considerations.

## Ordinance or Law Coverage

The Building Ordinance or Law Coverage endorsement, first introduced in the mid-1980s, gave way to revisions in 1990, 1995, 2000 and 2002. The latest (2002) endorsement CP 04 05 continues to provide three coverages but subject to considerably more conditions than the earlier endorsements.

Coverage A — Coverage for Loss to the Undamaged Portion of the Building. This covers the loss of value of the undamaged portion of the building when it must be demolished to comply with code requirements.

Coverage B — Demolition Cost will pay for the cost to demolish and clear the site of the undamaged portions of the covered building, where the law requires its demolition.

Coverage C — Increased Cost of Construction Coverage, to the extent of an otherwise covered cause of loss, and when increased cost is a consequence of the enforcement of an ordinance or law, will pay—if the building is repaired, reconstructed or remodeled—for (1) the repair or reconstruction of the undamaged portions of the building; and/or (2) the reconstruction or remodeling of the undamaged portions, whether demolition is required or not.

This coverage (C) also applies to the increased cost of repair or reconstruction of: excavations, grading, backfilling and filling; building foundation; pilings; and underground pipes, flues and drains. These items of property, however, remain as property not covered against their physical loss or damage under the building and personal property and other applicable coverage forms.

Coverage, however, only applies when the reconstructed or remodeled property is intended for similar occupancy, unless a zoning or land use ordinance does not permit it. If a law requires relocation, the most the insurer is obligated to pay is the lesser of (1) the increased

**“As with the property coverage, having determined what impact enforcement of these laws might have, it is necessary to construct a worst case scenario and decide the maximum amount of coverage that might be needed.”**



cost of reconstruction at the new premises, or (2) the limit of insurance shown for Coverage C in the endorsement schedule.

Payment is made under Coverage C only after the property has been repaired or replaced on the same or another site "as soon as reasonably possible" after the loss or damage, not to exceed two years (unless the time period is extended by the insurer in writing). No coinsurance is applicable to either Coverage B or C, but 80 percent or higher coinsurance is required under the basic building coverage, including any loss under Coverage A. If an agreed value clause is selected, the coinsurance

percentage may be suspended, but with the recent use by insurers of a margin clause in relation to blanket insurance, the agreed value provision may see more limited use.

None of these three coverages applies when (1) an insured fails to comply with a code requirement that existed prior to a loss; and (2) an insured must incur costs because a law requires it or others to respond to or assess the effects of pollutants.

### ***Fungus, Rot or Bacteria Exclusion Added***

Newly added with the 2002 edition of the Ordinance or Law Coverage endorsement CP 04 05

is the exclusion, not previously applicable, excluding the costs associated with any ordinance or law requiring the insured to respond in any way to "fungus," wet or dry rot, or bacteria.

This exclusion applies to Coverage A, B and C and precludes not only the enforcement of any ordinance or law that requires demolition, repair, etc., of covered property from contamination by "pollutants," as well as due to the presence of "fungus," wet or dry rot, or bacteria, but also the costs associated with testing, monitoring, cleaning, removing, containing or detoxifying or neutralizing any of them.

The term "fungus" is defined in standard ISO endorsement CP 04 05 to mean "any type or form of fungus, including mold or mildew, and any mycotoxins, spores, scents or by-products produced or released by fungi."<sup>1</sup>

### ***How Much Coverage is Needed?***

Once the need for Ordinance or Law Coverage is established, the question must be raised: How much of each coverage is needed?

For Coverage A, if demolition may be required after a substantial loss and the intent is to rebuild afterwards, the basic amount of insurance should equal 100 percent of the anticipated replacement cost of the building. If the property would not be replaced, then 100 percent of the actual cash value is called for. Each of these assumptions presumes that there is a significant likelihood that under the worst circumstances the loss could reach or exceed the percentage stipulated in the code



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that would require demolition after loss. If this is not the case, then the need for Coverage A with its added cost, may be open to question.

For Coverage B, the same question of need applies as for Coverage A, but the equation is much simpler.

What percentage of loss will require demolition—50 percent? 60 percent? 75 percent? Assume under the worst loss situation that the damage just reaches that percentage, so that demolition is required. Then insure for the estimated cost of demolition of the difference—50 percent of the property value, 40 percent, or 25 percent as the case may be. A demolition contractor can probably give at least a rough estimate of what this cost might be.

For Coverage C, the problem involves ascertaining the kind of upgrading that will be required to meet current code requirements. Two approaches can be used: (1) Arrive at a “ball park” figure for possible upgrade to code

requirements and buy a little more than this figure to be safe. (Will an unsprinklered building require sprinklers? Will additional parking be required? Will earthquake resistant construction be required? Etc., etc. And what, in round figures, is the probable additional cost?); or (2) Do an elaborate study of the current codes as they relate to the present property, obtain cost figures for compliance, and buy the same amount of coverage these figures call for (or a little bit more).

The second method fits nicely into a well-designed disaster plan, as it does much of the work before a loss that would otherwise have to be done hastily after a loss occurs.

### **Exception – States With Valued Policy Laws**

An exception to the general application of the Ordinance or Law Exclusion should be noted in states with valued policy laws. These laws, which apply to building insurance, provide that when a building damaged by a peril stipulated in the law (always fire and often explosion, windstorm and various other perils), is totally destroyed, the full amount of the policy must be paid, irrespective of the building’s actual cash value at the time of loss.

In the case of partially damaged buildings that must be demolished or significantly modified to satisfy a building or zoning law—resulting in a loss to the insured equaling or exceeding the value of the structure—the laws in most of these states consider this to be a constructive total loss, notwithstanding the Ordinance Law Exclusion, and require payment of the full limit of the building insurance.

But it must be kept in mind that even in valued policy states, no more than the limit of insurance is payable. Unless a high enough limit has been selected to cover the cost to replace in compliance with current codes, plus demolition cost if this may be required, the insurance will be inadequate to cover the entire cost to rebuild. Also, unless the increased cost to comply with building law is recognized and Ordinance or Law Coverage is provided, underwriters may be reluctant, especially in valued policy states, to insure for an amount in excess of the apparent replacement cost without considering this increased cost.

### **Height and Area Limitation of Replacement Building**

A significant change in Coverage C, Increased Cost of Construction, was also made with the introduction of endorsement CP 04 05 10 90. *See sidebar story page 7, for a discussion of this important change.*

### **The Business Income Ordinance or Law Exclusion**

The Ordinance or Law Exclusion (as found in the ISO Causes of Loss forms) also applies to the Business Income (formerly Business Interruption) and Extra Expense coverages, and can, in fact, sometimes have an even greater impact on either or both of these coverages than on the property loss settlement.

Any delay in restoration of occupancy or operations occasioned by the need to redesign or extend the period of construction to comply with current requirements is excluded



from the business income or extra expense recovery, notwithstanding the adequacy of the coverage in all other respects.

When the code requires demolition of the existing structure before reconstruction can begin, an even greater delay can be expected; or if rebuilding on the present site is prohibited, a new location must be found, again with a delay in resumption of operations.

In such cases the adjustment will be based on the time it would have taken to re-establish normal operations, restoring the property “as is” as opposed to the actual time needed in meeting current requirements. Obviously, this will introduce a second area of

conjecture, beyond the basic question of how the business would have done had no loss occurred, and can complicate the adjustment even more than would normally be the case.

For example, assume an interruption due to a fire. In attempting to repair the building and restore operations—which apart from the code violations would take two months—it actually takes five months. The measure of loss under the basic business income coverage would be what the business would have done in the two months of shutdown versus what the business actually did in these two months. In computing the additional loss due to operation of

building laws, the comparison is between the added three months of shutdown and what the business would have done in this same period of time. This additional loss is not covered unless the Ordinance or Law Exclusion has been eliminated by endorsement.

### ***Increased Period of Restoration***

The effect of the Ordinance or Law Exclusion on this coverage can be overcome by use of ISO endorsement CP 15 31 (or its equivalent), the Ordinance or Law—Increased Period of Restoration endorsement. This extends the Business Income or Extra Expense Coverage to include

## Height and Area Limitation Eliminated

*With the introduction of the 10 90 edition of endorsement CP 04 05, a significant limitation under the Increased Cost of Construction Coverage was eliminated. Curiously, neither this limitation nor its eradication have triggered much attention within the insurance industry, nor did ISO mention the change in introducing the 10 90 endorsement.*

Historically, since the Increased Cost of Construction Coverage came into common use, payment for the cost of repairing or replacing the building in compliance with current building or zoning laws was limited to property of “the same height, floor area and style” as the building damaged or destroyed.

Surprisingly, there seems to have been little or no judicial interpretation of this limitation, nor even mention of the limitation

in descriptions of the coverage as found in insurance texts or articles discussing the coverage. Application of the limitation would obviously work a hardship on any insured who, having recognized the exposure of building law requirements, purchases a significant amount of the coverage, only to discover after loss that because of this limitation, the insurance will not pay fully for restoration in compliance with current code requirements.

Consider, for instance, such requirements as ramps or enlarged restrooms for handicap access, off-street parking requirements or similar building or zoning code provisions that have come into common use in recent years, that prohibit reoccupancy without additional floor area or height to achieve the same level of useable space and function that existed prior to loss.

In the 04 02 endorsement, this limitation is shown as applying only to Coverage A, where it is of no consequence, but not to Coverage C where its application could severely limit the insurance recovery. Any insureds who arranged Increased Cost of Construction Coverage taking into account the old limitation should review their situation in light of this change and, if faced with requirements of increased building area to achieve the same function as before the loss, can now buy an increased amount of this coverage to pay fully for the cost of compliance with current requirements.

Similarly, insureds who have not provided this important coverage can now purchase adequate coverage to allow full recovery for the cost of compliance with building laws that require increased building size to achieve the same function as before the loss.



the additional time needed to restore operations, when delayed because of the enforcement of building or zoning laws. Unlike the property coverages, where any one or more of three separate coverages may be needed, this endorsement covers the additional time needed to restore operations whatever the reason for the delay occasioned by the application of these laws.

As with the property coverage, having determined what impact enforcement of these laws might have, it is necessary to construct a worst case scenario and decide the maximum amount of coverage that might be needed. The



endorsement does not provide for a specific additional amount of insurance nor a specific time period; it simply waives the effect of the Ordinance or Law Exclusion. If a substantial delay can be expected, so that more coverage is needed, choosing a higher

coinsurance percentage with a reduced rate may be appropriate, so the cost of the added coverage is not proportionate with the amount of added coverage needed.

\* \* \*

While the increased costs associated with rebuilding to current codes might bring a rude awakening, they need not result in an unpleasant surprise for the insured who has experienced a major property loss. Properly planned and placed Ordinance or Law Coverage will help make sure that the full recovery to which the insured believes they are entitled actually takes place.



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Associated with the insurance industry for more than 50 years in a variety of roles, Mr. Dudey was associate editor for over two decades of *The Fire, Casualty and Surety (FC&S) Bulletins*, published by The National Underwriter Company. Earlier in his career, he had worked as a risk analyst, an underwriter and a broker.

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