PROPERTY INSURANCE

LAW AND ORDINANCE COVERAGE - ILLUSIONARY?

Insurance, what you don't know or understand can and will cause you great financial harm should the winds of fate blow against you. Webster's New World Dictionary defines insurance "as being insured against a loss....under stipulated conditions a contract guaranteeing such protection." Black's Law Dictionary says it is a "contract whereby one undertakes to indemnify another against loss, damage or liability from an unknown or contingent event and is applicable only to some contingency or act to occur in the future."

Do you know what's in your first-party property insurance contract? Do you know what the stipulated conditions are? Consider the effects of hurricanes on peoples' lives and properties as well as their expectations of their insurance coverage. In the insurance adjusting profession a hurricane event is called a CAT loss. With this back drop we will explore an area of insurance coverage that is doubtful you know or understand.

CAT (Catastrophic) losses by their very term and description are very destructive and often occur to 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 Gulf Coast communities affected have encountered in recovery rebuilding efforts. Certainly this is not limited to Katrina as there is ample evidence of this problem looking back only as far as 15 years.

The likelihood of large CAT events occurring in the future is as certain as the expected clamor following future disasters from officials, in both the public and private sector, 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 legislation required that carriers offer an additional amount of Coverage A of 25% 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 our state caused the legislature to revisit this and now for the homeowners' lines you can purchase up to 50% of Coverage A for 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 titled, "Law and Ordinance Coverage." This paper provides a history of Florida building code legislation, explains the statutory requirements, and most importantly, gives demographic statistics of why the issue of law and ordinance and compliance with strict building codes is so important to the residents of the state of Florida given our housing stock and their location.

In August 2007 the New York Times published an article titled "In Nature's Casino," in which author Michael Lewis discussed in detail a number of issues regarding large catastrophic events, which include risk modeling firms that underwriters are using, and which are tied to the financial bets being made on Wall Street with products such as CAT bonds. Seemingly, we are at a point where the widely accepted conclusion is that the cost of future mega disasters may be far beyond the insurance industry's ability to pay. Thus, new ideas such as a national CAT fund as well as new financial schemes have emerged and have been proposed to help breach the void.

Mr. Lewis concluded that "the nation's priciest real estate faces beaches and straddles fault lines." He also pointed out that "Our most vibrant cities occupy our most hazardous lands." "Wealth has become far too concentrated (as in real estate) in a handful of extraordinarily treacherous places." The bottom line is that we have built our cities and homes in harm's way. The data submitted to the Florida Hurricane Catastrophic Fund in 2004 shows that 79% of Florida's total residential property exposure was located in 34 coastal counties.

If there is one glimmer of hope in this dark forecast it is that strict up-to-date building codes work and help to reduce losses. The difference in damages in the 2004 storms for structures that were built to the new codes versus those that were not was striking. New code-compliant homes were virtually undamaged while many non-compliant ones suffered either total loss or severe damage.

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 Citizens Insurance Company providing mitigation money to condominium associations if they make the recommended retro fixes. The state has also implemented grant programs to help homeowners. My Safe Florida Home program provided grants up to $5,000, but its funds are limited and, like any government program, there are allegations that it does not work and is being abused in one way or another. The bottom line is the new strict building codes work and it is to everyone's benefit that they be implemented.

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 in Florida, there are, however, some nuances to this coverage that need to be considered.

One of the most widely recognized provisions of this coverage is that you have to incur the code cost before the carrier will pay. The Florida Supreme Court recently weighed in on this in a September 2007 opinion seemingly settling this requirement, or did they? In the Ceballo Vs. Citizens Property Insurance Company case they accepted "to incur" to mean "become liable for the expense but not necessarily to have actually expended it." Notwithstanding this new dynamic of "incurred" this policy provision may have prevented unjust enrichment but at the same time it required the insured to go on the hook for the cost to upgrade the home at a time when they are at greatest financial peril. In the past the State offered a solution in the form of

informational bulletins suggesting that a signed contract to do the work meets 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, the State of Florida's Law and Ordinance paper did not explain the nuance of this "at the time of the loss" provision. Even more surprising is that Florida made significant code changes in 2005, yet no notice was sent to the insured with an explanation of how it may affect homeowners still struggling to recover from the 2004 four CAT events.

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 after a long drawn out adjustment rebuild recovery period.

The potential problem associated with the at-the-time-of-loss language can be best illustrated by a law passed by the Florida Legislature in May with an effective date of October 2007. This law, championed as a mitigation effort for future losses, would require all roof replacements to be done in a manner that: (1) roof deck attachment and fasteners would be required to be to code compliant as to strength and correctness; (2) secondary water barriers would be required to code to reduce water infiltration if shingles and roof tiles are lost; and (3) if a home is in the high wind-born-debris zone and its value is in excess of $300,000 roof to wall connections must be to

code.

As reported by the St. Petersburg Times (September 2007), these code costs can easily be expected to add another 25% to the cost of replacing a hurricane damaged roof. For adjusters going forward, do not forget to add a structural engineering fee or contractor's profit and overhead for the roof to wall connections, as this is a structural issue that a roofing company cannot do. Although no one could disagree that the spirit and intent of this law is correct, it could have become very problematic for Floridians. Had either of the two 2007 Category 5 storms (Dean/August and Felix/September) hit before the law went into effect, the roofing code that is going to be in effect in October, which would have applied given the typical adjustment and protracted rebuild period, is obviously significantly different.

If you think 3-5% hurricane deductible is bad, had any storm impacted Florida prior to October we all may have had to dig 25% deeper to get our roofs replaced. As an aside, nothing is mentioned about code upgrades for soffits. Water blowing in and running down the inside of homes is ubiquitous in windstorm losses, destroying drywall/ceilings and walls.

So is law and ordinance or code coverage an illusionary coverage? Does it do what an insured expects it to do? 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 the policyholder and/or consumer representatives following a CAT loss, the term "at the time of loss" needs to be understood by the consumer prior to the loss in a manner such as is required for other onerous insurance terms and provisions such as "Co-Insurance" and "Hurricane Windstorm Deductibles." In both those instances Florida has required that the policies be **BOLD STAMPED** and the term "Co-Insurance" and "Hurricane Windstorm Deductible" be displayed in a manner on the front of a property policy so as to alert the consumer to the potential financial perils the terms may have.
In fact, the Office of Insurance Regulation paper points to bold type language which states:

LAW AND ORDINANCE COVERAGE IS AN IMPORTANT COVERAGE

THAT YOU MAY WISH TO PURCHASE. YOU MAY ALSO NEED TO CONSIDER THE PURCHASE OF FLOOD INSURANCE FROM THE NATIONAL FLOOD INSURANCE PROGRAM. WITHOUT THIS COVERAGE, YOU MAY HAVE UNCOVERED LOSSES. PLEASE DISCUSS THESE COVERAGES WITH YOUR INSURANCE AGENT.

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 they 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, the insured 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. Indeed, it would be difficult to find someone who could argue that buildings built or replaced to current strict building codes are not only in the best interest of the insured, but also the insurer.

To limit one's ability to collect only the cost of the code requirement in place at the time of the loss may prove to be very problematic and perhaps will fail the reasonable expectation standard policyholders have regarding this coverage. The impact of the "big print giveth, the little print taketh away" provision in the law and ordinance coverage could be huge in the next big CAT event.

In closing if you have any questions regarding this matter please feel free to contact us. We encourage you to ask questions and learn as much about your insurance coverage as possible. Contact your agent/broker, your elected officials, your Department of Insurance and even your Governor. Send them a copy of this paper. Remember knowledge and information is power, the power you are going to need to survive the next big CAT loss.

Respectfully,

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