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Building Codes Are BAD For Business Income Clients

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Of the 10 factors controlling an entity's return to full "operational capability," governmental involvement could have the most detrimental effect. Ordinances and laws often skew the estimated rebuilding schedule and extend the time the operation will be shut down.

Unendorsed time element forms specifically exclude from the defined "period of restoration" further complicating the calculation of the eligible business income loss. Any increase in time directly attributable to government intervention is specifically excluded from ISO's definition of "period of restoration" as follows:

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"Period of restoration" ***does not include*** *any increased period required due to the enforcement of any ordinance or law that:*
(1) Regulates the construction, use or repair, or requires the tearing down, of any property; or
(2) Requires any insured or others to test for, monitor, clean up, remove, contain, treat, detoxify or neutralize, or in any way respond to, or assess the effects of "pollutants."
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Throughout the three previous "period of restoration" commentaries, a worst-case-scenario loss has been assumed; the same assumption applies in this post. However, a structure's failure to meet a jurisdiction's ordinances or laws could turn what is only a partial loss into a worst-case-scenario total loss just by the presence of such building codes. Understanding this **increase-in-loss** scenario necessitates an awareness of all issues surrounding ordinances and laws - collectively, the building codes (as they will be referred to for the remainder of this article) to which the building is subject.

Source of Building Codes

Ordinances and laws are enforced by local jurisdictions but the building codes are promulgated by an assortment of contributors. Local jurisdictions, the state and Federal government each add something to the jurisdictionally-enforced building codes.

But the vast majority of building and building-products-related codes are promulgated by advisory organizations such as the National Fire Protection Association (NFPA). A 1996 study conducted by the National Institute of Standards and Technology (NIST) found that over 93,000 codes are established by over 700 advisory organizations. Luckily only a relatively small number of these codes actually apply to most insureds.

When Governments Get Involved

Specific legal requirements stipulate the point at which a structure must be brought into compliance with local building codes. Existing structures are usually "grandfathered" and are not required to immediately comply with all current building codes unless certain statutorily-specified events occur. "Major structural damage" is one of those qualifying events.

Major structural damage (major damage) does not offer a universal definition; each jurisdiction establishes and applies its own interpretation of the term. There are, however, two broad "major damage" categories into which most state and local building codes fall:
• ***The Jurisdictional Authority Rule***: States using this as the measure of major damage allow the authority having jurisdiction (the local government) to decide when a damaged

building must be brought into compliance with the current building code; and
• ***The Percentage Rule***: States and jurisdictions applying this rule require a building damaged beyond a certain percentage of its "value" be brought, in its entirety, into compliance with local building code.

Both rules present unique problems. The ***jurisdictional authority*** rule is subjective in its application; and the definition of "value" differs among the states that apply ***percentage rule***. Agents are charged with knowing which "major damage" rule their insured is subject to and how the jurisdiction in control applies the chosen rule.

How This Extends the Period of Restoration

Regardless which rule subscribed to by a particular jurisdiction, building code violations have the potential to turn a partial loss into a functional **total loss** - greatly extending the time required to return to full "operational capability" - the "period of restoration."

Assume, for example, the insured structure is located in a jurisdiction subscribing to the "percentage rule." Any structure damaged beyond 50 percent of its value must be brought into compliance with current building code. Bringing the building up to code may require its demolition and complete reconstruction.

A little more than half (60 percent for argument sake) the structure is damaged by fire on June 1. Had the insured been allowed to use the existing structure and simply rebuild the damaged section, the building would have been completed, retooled and restocked by December 1 (six months). However, because the damage exceeded the building code's "percentage" threshold, it must be brought into full compliance with the current building codes. To accomplish this, it must be torn down and rebuilt. As a result, the building does not return to "operational capability" until March 1 - nine months after the loss.

Based on the "period of restoration" definition found in the unendorsed policy, the three additional months of lost income is excluded from coverage. Any income lost due directly to the application of building codes is paid out of the insured's own pocket. This could be quite an expensive gap without the proper endorsements.

Of course, no building-code-related loss can be pinpointed or proven this easily, by either side; this is but an example to spotlight the incredibly expensive effect of building codes. The additional work and time required to bring a damaged building into compliance with current building codes is a function of:
• The building codes to which the structure is subject (is FEMA in any way involved);
• The rule (as discussed above) to which the building is subject;
• How far out of compliance the building is;
• The political climate and speed of action (how quickly can/will a decision be rendered); and
• Is the operation subject to any special or unusual regulations or laws (i.e. the EPA, Historical societies, etc.)?

Estimating the additional time required to return to "operational capability" because of the adverse application of building codes is impossible. The only good news is that the insured does not have to know or delineate which building codes to which the structure is subject.

Ordinance or Law - Increased Period of Restoration (CP 15 31)

The period of restoration is redefined by attachment of this endorsement to include the increased period of operational suspension caused by or resulting from the enforcement of ANY building code in force at the time of the loss.

No time limit is mandated by this endorsement. Any additional loss of income directly related to the application of the jurisdiction's building code is paid by the insurance carrier when this endorsement is attached - **provided adequate limits have been purchased**. Attaching the CP 15 31 requires the insured to adjust the period of restoration, coinsurance and limit of coverage to account for the additional time period covered by the endorsed policy. The coinsurance penalty is not altered by the attachment of this endorsement so all limits and amounts must reflect the estimated increase in time.

A highlight of this coverage extension is that it will indemnify the insured income lost while the building is being rebuilt to meet **ALL** applicable building codes. This includes building codes related to losses not generally covered in the commercial property forms; flood damage is a prime example.

Flood damage is nearly always excluded in ISO property forms. However, structures located in special flood hazard areas (SFHA's) are required to meet specific flood plain management regulations unless "grandfathered." Should that structure suffer damage sufficient to cross the FEMA threshold amount (outside the scope of this article - see the Flood Series), the building must be brought into compliance with current flood plain management requirements. Even though flood damage is not covered by the policy, the CP 15 31 will pay for the additional loss of income sustained while the building is being brought into compliance with the flood-related building code.

There is no limit on which building codes are covered by the endorsement. The form specifically covers "ANY" ordinance or law affecting the structure.

Importance of the CP 15 31

If business income is the most important coverage the insured can have (as was postulated in the first article), this is the most important endorsement to the coverage.

Most buildings fail, in some way, to meet current building code. Age has a lot to do with it, but so, too, does the number and breadth of building code changes since the building was constructed and/or renovated. Any building over five years old should have this endorsement; and it is almost a requirement on any building over 10 years old.

How much time will the application of the building codes add to the period of restoration? Three months, six months - there is no way to know. But without this endorsement (available to all three time element forms), any additional loss of income would come out of the insured's pocket.

Following

All 10 "period of restoration" factors have now been exhaustively discussed, detailed and explained. Estimating the period of restoration directly affects the coinsurance choice and the coinsurance choice directly affects the limit of coverage.

The next post will tie all of this together to discuss how to pick the correct limit of coverage.

More from this Series

1. Business Income Demystified At Last - A Series
2. The Scary Part of Business Income: The Business Income Worksheet
3. The Scary Business Income Worksheet - Part II
4. Finishing Up The Business Income Worksheet - The Expense Section
5. Calculating The Correct Business Income Coinsurance
6. Business Income's 'Period Of Restoration'! How To Estimate The Time Required.
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