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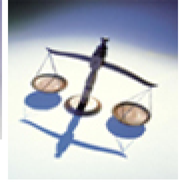

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WHAT CONSTITUTES CODE COMPLIANCE IN SATISFACTION OF THE DEMOLITION AND INCREASED COST OF CONSTRUCTION PROVISION OF FIRST-PARTY PROPERTY POLICY AND RESTORATION TO PRE-LOSS CONDITION

Last week, in *St. Luke's Episcopal Health System Corporation v. Factory Mutual Insurance Company*, 2007 WL 1217763 (S.D. Tex. April 24, 2007), Judge Lynn Hughes had the opportunity to address what type of evidence may support code compliance in satisfaction of the Demolition and Increased Cost of Construction Provision of a first-party property coverage policy. St. Luke's basement flooded during Tropical Storm Allison, causing damage to its electrical system. Factory Mutual funded repairs to restore power and fix the electrical system. Under the Demolition and Increased Cost of Construction provision of the policy, St. Luke's argued that its repaired equipment must be replaced with new equipment to meet City of Houston building codes. The City of Houston, however, did not enforce replacement of equipment.

Because the Demolition and Increased Cost of Construction provision required enforcement by a governmental agency before the insurer would pay for the new equipment, Factory asked for additional information supporting the hospital's claim. In response to Factory's request, the hospital provided a letter from the Texas Department of Health at the request of FEMA. The TDH's letter addressed the expiration of temporary relocation waivers granted to hospitals after the flood allowing them to move patients to a location not covered by its license. It also expressed TDH's position that when functional components are repaired or replaced, the system must still meet code standards.

Out of the hospital's $95,630,993 Proof of Loss, the parties agreed on $60,599,879 as undisputed. Factory rejected the remainder, refusing to replace the repaired equipment with new equipment. Factory argued that TDH's letter was not technically a deficiency notice and, therefore, did not constitute administrative action directed to the hospital. St. Luke's then sued Factory to recover the costs associated with replacing the relevant equipment. St. Luke's sought summary judgment that Factory was contractually obligated to cover the cost of replacing the equipment under the DICC coverage.

The Court first observed the express terms of the DICC provision, which required Factory to pay reasonable and necessary costs to satisfy the minimum requirements of the enforcement of a law regulating the repair of structures at an insured location so long as: (a) the law was in force when the insured loss occurred; (b) the law's enforcement is a direct result of the insured loss; and (c) the law is not one with which the hospital would have to comply with had the insured loss not occurred. Next, the Court noted that "enforcement" has been defined to mean the "carrying out of a mandate or command." Notably, the phrase "enforcement of law" focuses not on what the code technically says but on what building officials actually require. The city carries out the "mandate or command" of a code provision by executing building standards and withholding permits for construction in violation of those standards. However, in this case, the Court noted that no positive action was undertaken by city officials nor was the hospital sanctioned as a result of the alleged non-compliance.

The Court then turned to the TDH's 2002 letter. According to St. Luke's, the 2002 letter mandated compliance with new construction requirements. However, the Court rejected such argument, expressly noting that when the TDH intends to notify a hospital of a rule violation, it issues a deficiency notice. The 2002 letter was not a deficiency notice. The 2002 letter addressed only the temporary relocation waivers and required repaired or replaced equipment to function properly. The letter did not mandate the replacement of an entire system as a result of repairs or replacements to that system.

Finally, the Court addressed a 2006 TDH letter. The Court, however, found that the 2006 letter related to a new addition and expansion to the hospital. Again, the Court reiterated that TDH issued deficiency notices in the event of non-compliance. St. Luke's had been open and operating its repaired equipment, with TDH approval, for more than five years. TDH had inspected the repaired equipment before allowing the hospital to reopen, and had frequently inspected the hospital since. The Court found that there had been no enforcement of law or ordinance as required under the policy. Thus, Factory had complied with all applicable policy provisions.

In a companion opinion issued that same date, the Court also addressed the Condition Clause relative to evidence necessary to establish that repairs had been made and satisfied and the insured restored to its pre-loss condition. *See*, 2007 WL 1217766 (April 24, 2007). Essentially, the hospital argued that the repaired equipment needed to be replaced with new equipment because the repairs did not restore it to its pre-loss condition. The Court began its analysis by observing that, in the event of a physical loss, the policy required Factory to pay for the cost to repair the property to pre-loss condition. To prevail, the insured must show that the repairs did not restore the equipment to substantially its pre-loss condition. Notably, it was not the carrier's burden to show that the repairs did, in fact, restore the property to its pre-loss condition.

Next, the hospital argued that because it knew little about the replacement equipment, it cannot be as reliable as the originals or have an equal life expectancy. Noting the average useful life of a transformer of this type was twenty to thirty years and that the hospital's transformers had been in operation for more than thirty years, having already exceeded their normal life expectancy before the flood, the replacements, which were supplied and tested before installation by the hospital's own contractor, would last longer than the original transformers. Because the equipment passed the tests performed by the hospital's own factory authorized repair contractor, it is irrelevant whether the equipment complied with industry standards. The insured cannot have its agents test and accepts equipment it then later rejects. Where the insured's agent selected, purchased, refurbished, tested and installed the equipment, the insured cannot later complain that such equipment must be replaced to restore the insured to its pre-loss condition.

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