

## A Solid Strategy Puts an Association's Insurance Pieces in Place

by Joel W. Meskin, Esq., CIRMS ♦ Featured in Condo Media, November 2006

It was mid-morning on a Monday when I received a phone call. The young man on the other end of the phone was not quite sure where to start. He was not sure whether he should feel foolish for having accepted the position as president of his condominium board at the special election. The former president of 10 years had sold his unit and retired to Florida. Amongst the stack of papers the former president left him were portions of insurance policies - some current, some old, some naming old management companies, and the names of two different insurance agents appearing on the documents. The young man, whose only significant investment was his condominium unit, asked what should he do to evaluate the association's insurance program.

What I first did after I listened to the young man's story was to congratulate him for acknowledging the issue confronting him. Second, I told him that he was in fact ahead of the game, because I usually get this call as a result of an association being confronted with a large claim for which they have no idea if it is covered or not. That circumstance is the basis of a very different article.

I told the young man to get a pen and paper and to take notes. For the remainder of the telephone call, I described to him the details of a basic association insurance audit. I admonished him, however, that this audit as a board member, which within the board's fiduciary obligation, is only the beginning; it should also be completed in conjunction with the appropriate community association professionals, such as a community association insurance agent, attorney, reserve specialist, accountant and last, not but least, a community association manager. Like any other specialist we may choose to engage, it is imperative that you confirm their expertise, in this case, their expertise in community associations.

### Governing Documents

The first step in auditing the association's insurance program is to determine what the association's governing documents require. The governing documents will general include: Articles of Incorporation (or declaration of trust); bylaws; and the Covenants, Conditions & Restrictions (CC&Rs). In addition to the basic documents, there may be amendments to the documents and there may be items reflected in board minutes reflecting insurance decisions.

Once the insurance requirements are identified, it must be determined whether the requirements are appropriate for the association. On occasion, the insurance requirements set forth in the governing documents are part of a boilerplate set of documents. This may ultimately depend on a professionals' advice.

### Statutory Obligations

Virtually every state has a statutory framework applicable to community associations. This could be a specific state condominium act or law governing common interest developments. In the alter-

native, the association may be subject to the state's laws governing corporations.

### Exposure Evaluation

Before you can fully appreciate whether the insurance policies in force are appropriate for the association, you need to understand what constitutes the association's insurable interests. Again, this should be done in conjunction with a professional.

One place to begin is if the association has a current reserve study. Reserve studies are very often required by either statute or the governing documents. Unfortunately, many associations ignore this requirement. This is probably one of the most valuable tools for maintaining the value of the association by identifying the life span and anticipated repair and replacement requirements of the association. It should be noted that there are many services that specialize in community association reserve studies, and once the initial investment is made, the follow-up updates are generally very reasonable. What the study does from an insurance standpoint is identify the key elements of the association that may be subject to the risks for which the insurance is being procured.

The list below is not intended to be an exhaustive list, but it involves items for which there is a potential exposure for which the association has an insurance interest or potential liability.

### Insurance Types

Once you have received the documents, the laws and the exposures, now it is time to review that insurance is currently in place. What should be done next, if you do not already have one, is to pit together an insurance schedule. This should include the following: type of coverage, insurer, A.M. Best rating, policy number, effective date, limits and premium.

*Property Coverage.* Property coverage is probably the most common coverage that people are concerned with. Specifically, when you close on your unit, you are required to provide your lender with evidence of the master insurance covering the building, if it is a condominium or cooperative. If it is a single family homeowners association, you would be required to purchase a homeowner's policy. This coverage is very critical and is very dependent on where you are in the country. Does the policy include full replacement cost coverage, building ordinance coverage, all risk coverage or specified perils? Do you have sewer backup coverage? Do you need flood, windstorm and earthquake?

Important questions to ask also include: Are you insured to value? Who has done an appraisal, if anyone? Who has determined the replacement cost number? There is no short cut. You need to be aware of agents who may be claiming that the replacement value is less, because they want to prevent a lower premium to entice you.

*General Liability.* The general liability coverage is critical.

What makes a community association is the existence of commonly owned property. Why this is critical is that you do not individually control the common area. Thus, you are placing trust in the association and its management mechanism to properly maintain and control the common areas. Although you may not be subject in most states to being personally sued for an action arising out of alleged damages involving the common area (such as a slip and fall, or damage to a third party's property), you, as an association member, will ultimately be responsible for any non-insured or an undersigned incident. The most common example would be a judgment in excess of the association's limit of liability. This is all too possible in this day and age of runaway judgment awards.

For example, let's say there is a horrific incident where someone drowns in a pool. If there is a \$5 million judgment and there is only \$1 million in general liability coverage, the excess judgment will have to be satisfied in some alternative manner. Most likely, this will be done by the way of board issuing a special assessment against the association members. This special assessment, if it is large, or extended over a long period of time, may impact the value of the unit in the eyes of potential purchasers. In addition, any reserve funds or monies may be at risk to satisfy the judgment. Thus, an otherwise diligent association, which has done things by the book and have properly funded capital reserve accounts may find those accounts used to satisfy other-wise uninsured losses.

In the general liability context, some of the key used to look for are: the definition of insured – does it include the non-compensated directors & officers, volunteers or committee members; and the existence of personal injury coverage, which in conjunction with the definition of insured may determine the extent to which personal injury coverage will be critical to include within the Director's & Officer's policy.

*Director's & Officer's Liability Insurance.* The Director's & Officer's Liability Insurance (D&O), although not one of the largest ticket items from a premium standpoint, is both one of the most critical and one of the most complicated. The coverage is critical, because the association wants to attract the best people to join the board and manage two of your greatest assets: your home and your lifestyle. If you do not have talented people in those roles, you will have to take a more active role to monitor these investments. It is one of the most complicated, because there is more variance in the types of coverage available than with other community association insurance products.

The first step in the evaluation is whether the D&O the association has is an endorsement imbedded in a package policy or whether it is a stand-alone policy. As a general rule (although not an absolute rule), the coverage that is imbedded in a package policy tends to provide much more narrow coverage. This is not an area where the association should be attempting to save a few hundred

dollars.

The association must also beware when they are purchasing these package policies with an imbedded coverage for other reasons as well. First, the broker selling the package policy may only have this coverage to sell and therefore is not going to take the time to tell you about coverage they do not have. Second, since this is not a high ticket item, the agent may not be motivated to talk you into a broader policy where they will only be making a few more dollars. It is a cost/benefits analysis for the agent.

The imbedded policies tend to provide much more narrow coverage. For example, the embedded policies tend to be limited as follows:

- The definition of insured is limited to the board during the policy period;
- The insuring agreement is limited to "non-monetary" claims;
- The policy excludes personal injury coverage;
- The policy may be a reimbursement policy with no defense obligation;
- The policy excludes claims involving the failure to maintain or obtain insurance;
- The policy excludes claims involving the breach of third-party contracts.

The other option is the stand-alone D&O policy. The D&O stand-alone policies, although not all created equal, generally provide much of the coverage that is not included in the imbedded product discussed above. What is a true shame is the cost differential between the stand-alone policy and the imbedded coverage is minimal.

*Fidelity / Crime Coverage.* The good news is that Fidelity & Crime issued are not a chronic problem in the community association context. The bad news is that it is one of the least understood and the least focused product. Community associations are inherently budget-driven entities. Part of this process is to maintain operating funds and reserve funds. What associations need to do is protect their assets. The assets are protected in two basic manners. First, the placement of checks and balances. Second, the placement of the proper insurance.

The single most effective risk management tool is the separation of duties, including the distribution of duplicate bank statements going to different individual to obviate any motivation by one individual to take advantage of opportunities.

On the insurance side, there are two separate sides to the potential coverage. First is the fidelity coverage, which is coverage when an employee, or someone included in the definition of employee, steals from the associations. On the other side are various crime coverages, which mirror the fidelity coverage, but is triggered when a "non-employee" steals. In the community association context, it is critical the definition of "employee" includes "directors and offi-

cers,” committee members, volunteers, property managers, and other employees. The crime side is often ignored and many associations do not have crime coverage. The last key issue with fidelity/crime coverage is the requisite limits of coverage. This should be governed by the following basic formula:

The association should have limits equal to the greater of the following:

- The amount required by the association’s governing documents;
- The amount required by statute; or
- Three times the monthly operating budget plus the amounts of any cash on hand and all reserve funds.

*Other Insurance.* In addition to the coverages above, there are other possible insurance that an association may need on a case by case basis:

- Workers Compensation
- Automobile Liability
- Elevator or other mechanical break-down insurance
- Fiduciary Coverage (if there is a defined benefits plan)

The insurance puzzle is both complex and not an exact science. In the association context, the key is informed decision making. The more the board knows about insurance and its potential exposures, the better chance it will have the coverage that it needs.

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**Items at Risk for Exposure**

**Building**

The condominium building itself  
 Club house  
 Pool house

**Out Buildings**

Storage sheds  
 Laundry buildings  
 Gate house

**Garage**

**Common Areas**

Association controlled roads  
 Sport courts  
 Play grounds  
 Beaches  
 Pools  
 Golf courses  
 Boat slips

**Mechanical Exposures**

Elevators  
 Boilers

Pool equipment

**Vehicles**

**Bank Accounts**

Operating funds  
 Investments  
 Reserve funds

**Employees**

**Commercial Exposures**

**Contractual Obligations**

Hold harmless and/or indemnity provisions  
 Leases

**Association Office & Equipment**

**Board of Directors, Committees & Volunteers**

**Special Events or Activities Sponsored by the Association**