

INSURANCE ADVISORY

OCT '02 – AN INFORMATIONAL ADVERTISEMENT

EPSTEN GRINNELL & HOWELL APC

ATTORNEYS SERVING COMMUNITY ASSOCIATIONSSM

San Diego • Greater Inland Empire • Imperial Valley
Coachella Valley • Southern Orange County • Visalia

800.300.1704

Tips for Reducing Insurance Claims – Part 1 of 2

By Jay W. Hansen, Esq.

Associations are feeling the effects of multiple factors that have hit the insurance industry. Lower interest rates and a depressed stock market have reduced insurance company revenues. The 9/11 attacks unexpectedly depleted insurance company reserves, while the threat of terrorism has increased risks. Insurers of associations have seen increased claims, most often from water damage, as homeowner carriers have insisted that associations must process claims first, because owner policies are secondary to any coverage provided by the master policy. These factors have resulted in higher premiums for all associations and difficulty in obtaining coverage for associations with histories of water damage or mold claims. This advisory provides suggestions to reduce insurance claims and to prevent costs from spiraling out of control in the current insurance climate.

An association's governing documents are the starting point. Associations must comply with these requirements, and the board cannot implement these suggestions if the documents provide otherwise. Document amendments are an option, but it is always difficult to meet the amendment requirements. Also, changing insurance language may require lender approval. In an extreme case, where the governing documents may require an association to comply with all Fannie Mae requirements, to obtain an all-risk policy, to pay all deductibles, to insure virtually all attached property in all units against virtually all types of loss and to obtain lender consent for all amendments, there may be little point in reading further. However, if there is flexibility in any of these areas, there may be hope for gaining some control.

An important point is that many governing documents require the association to insure not only the building structure but also the attached components inside individual units, such as carpeting, other floor and wall coverings, built-in appliances, cabinets, plumbing fixtures and other built-in components. The documents may not allow an association to exclude coverage for these components. The lenders, who have a significant influence on insurance requirements in governing documents, consider that these components represent part of the purchase price and want insure that the association insures everything that forms part of the security for their loans.

An association might contemplate an amendment that requires owners to insure these components and not require the Association not to insure them. However, that type of amendment probably requires lender consent. Also, if it were adopted, and if there were a major casualty that destroyed the unit, the homeowner may not have individual coverage. Thus, the structure of the unit might be rebuilt, but the owner may lack the funds to install critical fixtures, like plumbing fixtures that are needed before the owner could obtain a certificate of occupancy. Under those circumstances, the owner may walk away from the unit causing the lender to foreclose. If an association adopted such an amendment improperly, the lender may seek to hold it liable for the cost of restoring the

unit. Since many directors and officers liability policies will not defend or indemnify directors on a claim that they failed to obtain the proper types or amounts of insurance, a lender claim like this may result in a denial of coverage.

Thus, if any of our suggestions may require an amendment and lender consent, or may cause an owner to walk away from a damaged unit, thereby dumping an expensive problem in a foreclosing lender's lap, it is wise to formulate an insurance solution that will provide a safety net to deter owners from walking away, or will prevent lenders from inheriting a significant liability to restore a unit to a habitable condition. For example, an association could adopt a deductible policy that provides that once a certain number of units are damaged, or if the total damage exceeds a certain dollar amount, the association will pay the deductible.

Many older documents require associations to obtain a "fire and extended coverage" policy. This is also called a "named perils" policy because it covers only specifically named causes of loss. Typically these are fire, lightning, wind, hail, aircraft, riot, vehicles, explosion, smoke, vandalism and malicious mischief. A named perils policy typically does not cover water damage. Thus, for an association that has high water damage claims that needs to gain control over those claims for a period of time to get coverage, it can purchase a named perils policy and eliminate all water damage claims. The downside risk is that no water damage claims are covered. Not only are water damage claims in owner units not covered, but water damage claims in association clubhouses and common areas of residential buildings won't be covered either. Unlike homeowners who can purchase a separate policy to insure against their individual water damage claims, the association will have to self-insure those claims. In our view, switching to a named perils policy should be reserved for an association with such high water damage claims that it cannot obtain any other policy at a reasonable price.

If the declaration requires obtaining "broad form" coverage, that is essentially a named perils policy which expands the list of named perils to include water damage claims, so obtaining a broad form policy will not eliminate water damage claims. If the declaration requires an "all-risk" policy, those policies provide coverage for "all risks" except those that are specifically excluded (such as earthquake, war, and many other specifically identified exclusions), but they do include coverage for water damage claims, so only a named perils policy is likely to exclude water damage claims.

Some association documents may require an all risk or broad form policy, but mandates it only if it is commercially available, or if it is available only at a reasonable price. An exemption like this can empower the board to purchase a named perils policy, if a more comprehensive policy cannot be obtained, or it may be language the association can adopt by amendment, if its water damage claims are out of control.