



INSURANCE ESSENTIALS: PREPARE FOR THE FUTURE

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The Board of Directors of a community association is charged with operating the association in a manner that preserves, protects, and enhances the property values. A necessary component of that charge is obtaining and maintaining proper insurance. The fundamentals of insurance are discussed in articles available at www.wncwlaw.com. This article will discuss the seven coverage issues that are overlooked that often result in larger payments by associations.

VALUATION – FULL REPLACEMENT COST

Replacement Cost -Is defined as the cost to replace a structure with materials of like kind and quality without deduction for depreciation. This method determines the cost to rebuild a structure which may be more or less than the value a person would pay to buy the property. Replacement cost is limited to the dollar value of property insurance purchased.

Extended Replacement Cost –typically reads similar to the following: If the limit of Insurance (building value) is inadequate to pay the full amount of building loss, under this coverage extension:

- (a) we will pay that part of the otherwise covered building loss that exceeds the applicable Building limit.
- (b) The most we will pay under this coverage extension is 25% (this may vary from company to company and is worth knowing) of the applicable Building limit shown in the Declarations.

Guaranteed Replacement Cost – Is defined as the cost to replace a structure with materials of like kind and quality without deduction for depreciation, and without a dollar limitation. If you purchased \$10,000,000 of property insurance and at the time of loss it costs you \$19,000,000 to rebuild you would get the full \$19,000,000.

As you can see, the concept of “Replacement Cost” is simple – re-build damaged property with materials of like kind and quality without deduction for depreciation. The tough issue is how the replacement cost of a structure is determined and who is responsible for making that determination.

Proper valuation of properties may be the single most important coverage for an association to evaluate prior to a loss. But, according to Marshall & Swift, an expert in building costs, almost 59 percent of all houses in the United States are not valued properly when it comes to insurance coverage -- by a whopping 22 percent, on average! So, who determines valuations?

If you ask a Board member or a manager, they will tell you that they rely on the agent to determine the replacement cost. They feel the amount of coverage the agent recommends is a representation of the replacement cost of all of the insurable property. That seems logical that if the Act or documents require replacement cost coverage and an agent places a value on the building(s), that value must be the replacement cost. Well, that is not correct. I have discussed this issue with insurance agents from all across the United States and everyone of them has stated that the amount of insurance they recommend be purchased is not a certification that the amount

is the replacement cost. Rather, it is their recommendation on how much insurance the association should carry. It is usually calculated using generic numbers and industry software, which varies from company to company, and if you look at a proposal, you will see that it disclaims being a certified valuation. In fact, some companies require a Board member to sign a statement of values. A statement of values will require a signature of a Board member, the result of which is that Board member is now the “professional appraiser” that agrees with the values of the property.

Consequently, it is incumbent on every Board to obtain a certified valuation. Once that is done, it will serve as the benchmark for future years. It can be updated at nominal expense. Without a certified appraisal, a Board cannot know the replacement cost value of the property and will be at risk of underinsuring the property. Because of the position of trust in which the Board is placed, failure of a Board to adequately insure the property will be considered a breach of each Board member’s fiduciary duty.

Determining “Replacement Cost” value is particularly challenging at this time due to the increased costs of construction materials. The weighted average of the wholesale prices of materials used in residential construction has increased to the order of 10%. But, that is an average of all building materials. Plywood has increased by 50%, steel 12%, drywall 20%, asphalt 25%.

Once the “Replacement Value” has been estimated, there are several provisions of policies or coverages that must be reviewed to avoid a reduction in the amount paid for a loss.

CO-INSURANCE

It is rare, other than instances of catastrophic loss, that a building is a total loss. Recognizing that, insurance companies offer to write coverage with a “co-insurance” premium. As the name indicates, an association is “co”-insuring the building. The benefit to an association is a lower premium, the detriment is short-fall between the amount of the loss and the amount paid by an insurer if the amount of co-insurance is not maintained.

The most typical co-insurance provision is 90%. It means the insurer will pay up to 90% of the total value of the property for a covered claim so long as the amount of insurance in effect is 90% of the value of the building at the time of the loss. If the value of the building has increased and the amount of coverage has not also increased to maintain the 90% value to insurance ratio, the amount an insurer will pay is the percentage of insurance in effect compared to the current value of the property. The difference between the amount paid and the actual cost of repair becomes an additional amount of the “co”-insurance paid by an association.

If a building is worth \$1,000,000, a 90% co-insurance provision would require an association to only purchase \$900,000 of coverage and then “co”-insure the remaining \$100,000. If a building is a total loss, the insurer will pay \$900,000 and the association will be responsible for the remaining \$100,000. If the amount of the loss is less than the amount of insurance in effect, the insurance will pay the amount of the claim, subject to any deductible. If the association has \$900,000 of coverage and a building sustains \$150,000 of covered damages, the

association will be reimbursed \$150,000 subject to any deductible. If, however, the building increases in worth to \$1,200,000 at the time of loss and the coverage is still only \$900,000, the insurance in effect is only 75% of the building's value, rather than 90%. The insurer will only pay \$112,500, 75% of the \$150,000 loss. The \$37,500 shortfall will be the responsibility of the association. It will have to be paid from reserves or, if the association does not have sufficient reserves, by a special assessment. With increased costs of materials, an association with a co-insurance provision is playing Russian Roulette. It is all but a certainty that an association will not have maintained the co-insurance requirements of the policy.

SPECIFIED BUILDING COVERAGE (a/k/a Scheduled Building Value)

This is probably the least favorable way to insure your property if it consists of more than 1 building. What it provides is what its name suggests – a specific building value for each and every building in the association. If an association has 15 buildings, you will typically find 15 different valuations by building number as many associations have buildings of different sizes shapes and possibly construction. It is possible that in total the buildings could have the proper amount of insurance and yet a problem still exists. If for example one or two buildings are overstated in values because the board believes the square footage to be one thing and then it turns out to something different, you could be facing an unintentional financial loss.

Example – Association has 10 buildings totaling 87,000 square feet of similar shaped buildings and carries \$10,000,000 in building coverage which approximates to \$115 per square foot replacement cost. They have a scheduled building limit of \$1,000,000 per building and then suffer a loss. At the time of loss they realize the building that just burned down was actually 10,200 square feet as opposed to the assumed 8,700 square feet and the \$115 per square foot was the right number to replace the building - **is there a financial impact?**

There is a **\$173,000 under-insured loss!** Just by being off by 1,500 square feet! When the board gave the square footage to their agent they forgot that building 1 had 1,500 square feet more than building 3. Instead of having 10 buildings of equal size they had two that were slightly different and 8 of equal size. As Murphy's Law goes, the one that burned down was the oversized and under insured building. The \$10,000,000 they carried was enough in its total, but fell short in its parts.

Blanket building coverage provides the entire limit of building insurance for each and every covered loss regardless of the number of buildings effected. In the previous example, if the association carried a "blanket" limit of \$10,000,000 in building coverage, the insurance company would pay the additional \$173,000 or the actual replacement cost of the building.

This is the most favorable way to insure your association. The main problem with *Blanket Building Coverage* is a tendency for an association to get "lax" in determining the proper valuation of the buildings. The general consensus can become, if we only insure our association to \$8,000,000 as opposed to \$10,000,000 (the true replacement cost) we can save money. After all what are the chances of a total disaster wiping out all of the buildings? To bank the financial stability of your association on never having a natural disaster is foolhardy at best.

AGE OF BUILDINGS

Property insurance pays to rebuild a structure to the condition that existed at the time of the loss. Buildings must be constructed in accordance with the building code in effect at the time the work is performed. If a building code at the time of a loss is different than the building code at the time of the initial construction, the insurer will only pay the cost to rebuild the structure to the original specifications. The increased cost of construction will be the responsibility of the association. An association can avoid this by purchasing Ordinance or Law Coverage. Ordinance or Law Coverage is comprised of three parts:

1. **Undamaged Portion of building** – this basically states that the insurance company agrees to pay for the loss of value of buildings as a consequence of enforcement of an ordinance or law that requires demolition of an undamaged building.

Remember an insurance contract states they will pay for direct physical loss of or damage to a covered building caused by a “covered peril”. Without this coverage if 40% of a building worth \$1,000,000 is damaged and the governing authority requires you to tear down the rest of the building, you would receive \$400,000 for the covered damage and be out of pocket the additional \$600,000 of building value, plus the additional cost to tear down the undamaged building. With this endorsement you would receive the \$1,000,000 it costs to replace the building, you would still be out of pocket the cost to demolish the undamaged portion of the building (s) unless you also had coverage for demolition costs.

2. **Demolition Cost Coverage** – We will pay the cost to demolish and clear the site (debris removal) of *undamaged portions* of building that results as a consequence of law or ordinance that requires you to demolish the undamaged building.
3. **Increased Cost of Construction** – We will pay the increased cost to:
 - Repair or reconstruct damaged portions of the same building; and/or
 - Reconstruct the undamaged portions of the same building whether or not demolition is required.

This coverage is one of the most overlooked and least understood coverages that every association needs.

DEDUCTIBLES

All insurance policies have a deductible – an amount of damage that is not reimbursed by an insurance company. In 1984, the average deductible was \$250 per occurrence. Since then, the average deductible has risen to \$2,500 per occurrence and there are also separate deductibles for water damage of as much as \$10,000 per unit, per occurrence.

In a homeowners association, the authority to impose a deductible on a unit and any limitation will depend entirely on the provision of each declaration. If your declaration does not authorize the Board to impose a deductible on an owner, the declaration will need to be amended to authorize that action.

Section 94 of the Georgia Condominium Act authorizes an association, to the extent provided in the declaration, to allocate equitably the payment of a reasonable deductible between the association and the unit owners affected by a casualty required to be insured by the Act. Effective July 1, 2004, the amount increased from \$1,000 to \$2,500. Whether an association can charge the increased amount will depend on if the deductible provision of a declaration is worded to automatically adopt a change in the Act. If not, an association will not be able to impose a \$2,500 deductible without amending the Declaration.

Section 94 authorizes and limits the imposition of a deductible that can be imposed on a unit owner for casualties required to be insured by Section 107. Water damage is not included in fire and extended coverage. Consequently, there is no limit on the amount of the deductible for water damage claims and the policies can impose a per unit, per occurrence deductible for water damage claims. The payment of those deductibles is the sole responsibility of the owner of the damaged unit. So, if a pipe bursts and causes \$9,500 of damage to a unit, if there is a \$10,000 water damage deductible, the association policy will not pay anything and the owner of the damaged unit will have to pay the \$9,500 to repair the unit . . . a real shock to a unit owner who assumed the association's insurance policy would pay the cost to repair or replace the damages.

An association is responsible for the payment of any deductible assigned to damage to the common property, as well as the amount of any deductible in excess of the amount that can be assigned to an owner.

If a water pipe in a high-rise building ruptures and causes \$100,000 of water damage to the elevators, floor lobbies, and main lobby, if the policy has a \$25,000 water deductible, the association will be paid \$75,000 and be responsible for the remaining \$25,000 costs of repair. Rather than water damage, assume a fire causes \$100,000 damage to a unit. If the general deductible is \$10,000, the insurer will pay \$90,000, the association will pay \$7,500, and the unit owner will pay \$2,500, assuming the documents permit the \$2,500 deductible to be assessed to an owner.

DIRECTORS AND OFFICERS INSURANCE COVERS MANAGER

Virtually all management company contracts require the association to indemnify the company and its managers for all claims that arise out of providing services under the contract. Indemnity means the association will pay all costs of defense and any damages that may be awarded. Without insurance, the association will pay both of those expenses out of pocket. Some D&O policies add the management company and its managers as named insureds. The coverage extends to actions either taken pursuant to the contract or at the direction of the Board. It will cover the cost of defense and damages that are not otherwise excluded by the policy.

Similarly, an association should also obtain coverage that includes a manager and management company for theft of association funds. It should also cover the directors and officers. That coverage is found in a property policy under employee dishonesty coverage. Policies are written that consider the directors and officers as employees solely for the purpose of that coverage and adds a manager and management company as additional insureds. Naming the manager and management company as additional insureds allows the association to make a first party claim, rather than filing a claim with the management company's insurer.

D&O POLICY COVERS COST OF DEFENSE OF FAIR HOUSING ACT CLAIMS

Many D&O policies do not cover any claims for violation of any civil rights law. No cost of defense and no damages. The Fair Housing Amendments Act of 1988 added familial status and handicap as protected classes. That has resulted in claims against associations for restricting children from using the common properties and failure to accommodate a modification to allow a handicap person the full use and enjoyment of the property. Nearly all such claims are without merit. Nevertheless, they must be defended. If a policy does not cover costs of defense, it will come out of the association's funds.

These seven coverages are essential to a well-developed community association program. Failing to cover even one of these coverages can cause a severe financial loss for an Association.