Insurance... What Does It Cover and Do You Have Enough?

Insurance is something both we and the Association need, but sometimes we wonder why. How much does the Association need? Is it too much or is it too little? What can happen to you personally and/or to the Association if either of you are covered properly? It can be devastating to everyone either as a result of the actual loss or as a result of the special assessment that may be needed if the coverage is not sufficient to cover the loss.

So, let's start with some basics and see what the different types of insurance are for.

Property Insurance provides protection against most risks to property such as fire, theft and some weather damage such as lightning and wind, sinkholes and pipe bursts, etc., that damage the association owned portion of the buildings (excludes interior of owned units.) It also provides coverage for any ancillary structures (clubhouses, amenities, gates, walls, etc...). Most state statutes require the appropriate insuring of common areas, common elements and some privately-owned property. The replacement value of these properties should be determined by an independent property insurance appraisal* or an appraisal update performed once every 36 months.

Property Insurance includes some specialized forms of insurance, such as those noted above, but property is insured in two main ways - Open Perils and Named Perils. Open Perils cover all causes of loss not specifically excluded in the policy. Common exclusions on open peril policies include damage resulting from earthquakes, floods, nuclear incidents, acts of terrorism and war. Named Perils require the actual cause of loss to be listed in the policy for insurance to be provided. The more common named perils include such damage-causing events such as fire, lightning, explosion and theft. It is very important to note specifically any exclusions in your policy.

General Liability Coverage provides protection against a third party that brings suit against the Association for resulting Bodily Injury or Property Damage that occurs at the Association's negligence. Examples are slip and falls, assault and

batteries, gate damage to a vehicle, etc. Boards need to review the exclusions carefully.

Crime Coverage provides protection against a board member, employee or property manager stealing the Association funds. Different states have different requirements as to specifics regarding what and who needs to be covered. Your insurance agent can provide that information.

Directors and Officers Coverage. Members of an association's board of directors put their personal assets on the line when they make decisions on behalf of the Association. In order to protect the board member's assets, the Association should purchase D&O coverage. A good D&O policy will provide coverage to the directors and officers, committee members, employees and property managers for decisions they make that a third party sues the association for. However, D&O insurance will not cover a Board or its individual members if the decision made is found to be criminal in nature or made contrary to using the good business judgment rule.

Umbrella Coverage provides extra coverage to whatever policies are scheduled under the umbrella. Typically, on a property umbrella policy the general liability and directors & officer's policies will be provided excess coverage. In certain situations, auto liability and workers compensation can also be included. Typically umbrella coverage starts at $1M, however $5M is normal.

Boiler & Machinery or Equipment Breakdown Coverage provides added protection to the property for those that have elevators, cooling towers, pump stations, lift stations, etc.

Flood Coverage is typically only purchased for those associations that are in Flood Hazard Zones (determined by FEMA flood maps). However, it is noted that 33% of flood claims occur outside of these flood hazard zones so every association should weigh this coverage vs the costs. Flood coverage protects the Association against external water rising from rivers, lakes, oceans, streams or accumulating on normally dry land that floods into the buildings damaging the association. There is NO flood coverage included on a property policy.

There are three types of insurance coverage:

- Replacement cost pays the cost of replacing your property regardless of depreciation or appreciation.
- Extended replacement cost will pay of the coverage limit if the costs for construction have increased. This generally will not exceed 25% of the limit.
- Actual Cash Value provides replacement minus depreciation.

When you obtain an insurance policy, the coverage limit established is the maximum amount the insurance company will pay out in case of loss of property. This amount will fluctuate if homes in your neighborhood are rising in value; the amount needs to be in step with the actual value of your home.

This is a good time to ask, "Are you adequately covered?" Most commercial policies contain a coinsurance clause that may leave the Owner (you or your condominium or HOA) holding the ball if you miscalculated the insurance needs. The basic principle behind coinsurance is to make sure the Owner is insuring the property to an adequate value. If the Owner is found to be carrying inadequate levels of insurance, they will be required to bear a portion of the loss themselves. Coinsurance means that the policy is permitted to carry only a percentage, usually 80-90%, of the buildings full replacement value.

Coinsurance varies based on the amount of loss, the replacement value of the building at the time of the loss, and the amount of coverage purchased. The basic formula for determining adequacy of limits is:

"Actual amount of insurance (the amount you purchased) divided by Required amount of insurance (the amount you should have purchased) x the amount of loss = Amount Insurance will pay.

Let's assume you have a building appraised* at $250,000. Under an 80% coinsurance clause, you would be expected to insure 80% of this value or $200,000. Now let's consider the two scenarios, the amount of loss in each case is $50,000.

- In the first scenario, the owner only carried $150,000 in coverage on the building. $150,000 (bought) divided by $200,000 (should have bought) x $50,000 loss = $37,500 (Amount insurance company will pay). The out of

pocket required of the owner (Association) through "self-insurance" to fund the shortfall is $12.500.

- In the second scenario, the Owner carries the full $200,000 required under the Policy. $200,000 (bought) divided by $200,000 (should have bought) x $50,000 (Loss) = $50,000. The amount the Insurance Company will pay. In this example, the Owner would get a full recovery under their insurance policy for the loss incurred.

As you can see by these examples, coinsurance can have a major effect on what you can expect to be paid in the event of a claim.

*As noted earlier, one of the most important steps in determining value is to have an insurance appraisal done. The small amount spent for an appraisal, may save the Association thousands of dollars in out of pocket expenses and will provide the board with the advice of an expert on which they can rely when exercising their fiduciary responsibility to the members.

Please note: We would like to thank Insurance Office of America for the examples used to demonstrate the coinsurance coverage and losses.