INSURANCE:
HOW COMMUNITY ASSOCIATIONS PROTECT THEMSELVES

A Guide for Association Practitioners

By Clifford J. Treese, CPCU, ARM
&
Katharine Rosenberry

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Insurance: How Community Associations Protect Themselves

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Authors
Clifford J. Treese, CPCU, ARM
Katharine Rosenberry

Editor
Debra H. Lewin

Art Director
Cori Canady

Reviewers
Mark Blasch
H. Joseph Coughlin, Jr.
John Hebden
Michael Packard, PCAM, CPM
Doug Kleine, CAE, PCAM
Albert LeQuang
Gary Hobbs
Mark Polivka

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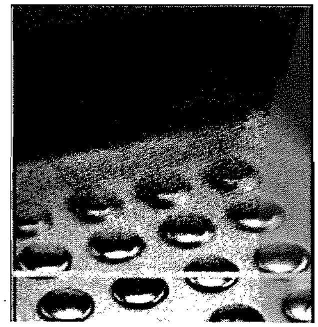
INTRODUCTION:
BACKGROUND AND KEY POINTS



RISK MANAGEMENT IS THE PROCESS OF MAKING AND CARRYING OUT decisions that minimize the adverse effects of accidental losses on the community association. An exposure to loss is the possibility of financial loss that the association may incur because of the occurrence of some event, activity, or peril. Risk management is a five-step decision-making process that:

- Identifies exposures to loss.
- Examines treatment techniques (control and financing).
- Selects the best techniques.
- Implements the techniques.
- Monitors the techniques.

Carrying out these steps involves planning, leading, organizing, and controlling community association activities. (See the companion guide *Risk Management: How Community Associations Protect Themselves.*) Purchasing commercial insurance transfers some of the risk of loss to another party—the insurer. Insurance helps offset property, liability, net income, and personnel exposures to loss that all community associations face.

Commercial insurance is one of the most important components of a community association's risk management program. To help managers and boards fully understand insurance issues, this guide will explore three key areas:

- Insurance terminology, in terms of coverages, policies, and practices.
- Association exposures to loss and insurance coverages.
- Risk management and the association insurance industry.

The following four topics are an integral part of each of these areas:

- Insurance industry and insurance.
- Community association industry.

- Types of community association insurance.
- Related community association insurance issues.

When confronted with decisions concerning their commercial insurance program, association boards sometimes simply repurchase the old program. This guide will provide boards with the critical knowledge necessary to fulfill their legal requirements and fiduciary obligations by providing information to make informed decisions without merely repurchasing what's in place.

KEY POINTS

- Property and liability insurance can be divided into commercial and personal insurance. A community association purchases commercial insurance; a unit owner or homeowner in an association purchases personal insurance.
- The insurance industry is highly regulated at the state level in terms of rates, policy forms, financial standards, and business practices.
- Insurers, operating primarily through agents and brokers, offer a variety of property and liability coverages. Most are standardized, but some are designed for community associations.
- Condominiums, cooperatives, and planned communities each function as a business, government, and community. Each function can lead to property, liability, net income, and personnel exposures to loss.
- Legal obligations to develop a commercial insurance program flow from the association's governing documents and the need to comply with various statutes, agency mandates, and prudent business practices.
- Developing an association's property insurance program depends on determining values and defining the interface between individual units and common areas and the responsibilities of each.
- Insurance professionals can tailor coverages for most of the four primary loss exposures.

CHAPTER ONE

THE INSURANCE INDUSTRY

INSURANCE EVOLVED FROM MEETING THE MARINE RISKS ASSOCIATED with the worldwide exploration and shipping that began in the late 1600s. Fire, life, and accident insurance were slower to develop, but by the last half of the 19th century, their benefits were widely accepted. The 20th century was one of generally increasing economic growth and the insurance industry both facilitated and shared in this expansion.

In the United States, insurance is divided into two broad categories: the first is accident, life, and health. The second is property and liability insurance. The United States has more than 6,000 insurers. Nearly 4,000 of these sell property and liability insurance; however, most property and liability insurance is written by 900 insurers who are licensed in many states. Property and liability insurance can be divided into commercial and personal insurance. A community association purchases commercial insurance; a unit owner or homeowner in an association purchases personal insurance. The community association is the insured and the insurance company is the insurer.

Insurance contracts are written to provide financial protection for exposures to loss. A large number of exposure units—exposures to loss—ensures sound rate projections. For example, if an insurance company's number of exposure units equals the number of insured condominium units, the company must insure thousands of similar units to make sound rates.

TYPES OF INSURERS

Insurance contracts or policies are offered through the private sector and government agencies. Most private insurance is voluntary for individuals, although some types are required by law. For instance, numerous states require workers compensation coverage and automobile liability insurance, which can be purchased from the private market. Most governmental insurance, however, is involuntary.

Some insurers only specialize in one line of insurance; others are authorized to sell many different kinds. If an insurer sells property and liability insurance, it is called a multiple-lines company. Multiple-lines insurers are usually prohibited from selling accident, life, and health insurance.

Private Insurers

Private insurers are often classified according to their ownership arrangement. The four most common private insurers are stock companies, mutual companies, reciprocals, and Lloyds types of associations. Two other private insurance providers are risk retention groups and purchasing groups.

Stock companies. A stock insurance company is a private for-profit corporation that is organized to sell insurance. Stock companies must meet capital and surplus requirements of state law and they must participate in state guarantee funds. As in any stock corporation, the stockholders are expected to bear losses and to benefit through dividends.

Stock companies usually conduct the sale of their insurance products through the American Agency System (or the Independent Agency System). They often work through private insurance organizations to establish rates and policy forms that are then filed and/or approved by the state insurance commissioner through which they are licensed to do business.

Mutual companies. Mutual companies are organized under state insurance codes as nonprofit corporations owned by their policyholders. Mutual companies do not earn profits because excess income is returned to the policyholders as dividends or reduced premiums, or is retained for future growth. (Stock companies provide this benefit by issuing more shares of stock.) Some mutual companies may assess their policyholders if they run short of revenue.

Mutuals often work with private insurance organizations to establish rates and policy forms. Mutuals tend to market their insurance products through their own employees (or agents)—not through the independent agency system.

Reciprocal insurance exchanges. A reciprocal—or inter-insurance exchange—is designed to provide "at-cost" insurance. Unlike a mutual, however, a reciprocal is an unincorporated association whose members are termed subscribers. While reciprocals only write a small percentage of property and liability premiums, the community association field is host to some large reciprocals companies.

Lloyds types of associations. Lloyds of London is an organization of individual members who have joined to insure risks on a cooperative basis through entities termed syndicates. Lloyds operates in this country through excess and surplus-lines markets. Lloyds insures risks that domestic or conventional markets will not insure. Each member (or name) of Lloyds is personally liable to the full extent of his or her financial resources to the syndicate and the risks insured.

American Lloyds organizations and insurance exchanges function very much like Lloyds of London. These providers do not participate in state guarantee funds with respect to insurer solvency. They do, however, meet the insurance needs of community associations that have unique property risks—ski hills, equestrian centers, shooting ranges, and similar risks that conventional markets will not insure.

Risk retention groups and purchasing groups. Risk retention groups (that are actually owned by the individual policyholders) and purchasing groups (that act through conventional insurers) are two vehicles that provide hard-to-place liability coverages. Risk retention groups, to date, have not been used in the community association field. Purchasing groups, however, have been used. They are backed by conventional companies to provide specialized liability coverages, such as directors and officers liability and professional liability.

Government Insurers

The federal and state governments have developed insurance programs for certain types of risks, such as floods.

Federal insurance programs. The federal government offers numerous insurance programs, but two are commonly used by community associations: the first is the National Flood Insurance Program, a federal program that enables community associations to purchase flood insurance. It is administered by the Federal Insurance Administration, which is a part of the Federal Emergency Management Agency. The second commonly used program is Social Security.

State insurance programs. The most important state programs for community associations are in the areas of workers compensation, automobile insurance, property insurance, and various windstorm pools.

All states have established benefits levels for workers compensation claims. Some states have workers compensation programs that compete with the private market. A few states have monopolistic funds that offer the only coverage. Most states have a residual market mechanism, often referred to as an assigned risk pool that assigns workers compensation coverage to itself or a private insurer if the private market will not voluntarily insure the risk.

Residual market mechanisms also exist for automobile coverages and property insurance. The latter programs are referred to as FAIR plans (Fair Access to Insurance Requirements).

Some coastal states require their insurers to form pools to write windstorm and other coverages that the conventional market will not voluntarily insure. Some pools use a syndicate of insurers while others use a single insurer. Usually, insurers participate according to their state-wide property insurance premium volume. These pools often limit associations in coastal states to windstorm coverage.

FINANCIAL PERFORMANCE OF INSURERS

The *Audit Guide for Common Interest Realty Associations* published by the American Institute of Certified Public Accountants established principles to control the form and substance of reports concerning association financial operations. These principles are based on generally accepted accounting principles that are designed to test whether an association will survive as a business entity. The financial operations of insurance companies are measured not only according to these principles, but also according to statutory (or state) accounting requirements established by various state insurance regulators. These statutory principles emphasize liquidation measures. For instance, if the insurer goes out of business, it must pay the claims, refund the unearned premiums of its policyholders, and satisfy the demands of other third-party claimants.

Profitability

Property and liability insurers derive their primary income from premiums. Interest from investments and interest from unearned premium reserves and claim reserves are secondary sources of company income. Because of statutory accounting requirements, however, insurers state their assets conservatively.

Assets. Even though the insured must pay an entire insurance premium at the beginning of the policy period, the insurer only earns the premium on a daily basis. This way, if the insured cancels the policy before it expires, the insurer can return the unused premium.

To discourage community associations and others from canceling early, insurers charge a short-rate penalty of approximately 10 percent of the unearned premium. In some policies, the insurer charges a higher penalty for early cancellation.

Liabilities. An insurer's liabilities include general expenses, such as commissions paid to insurance agents, as well as the unearned premium reserve. The other major liability component is for claims (or loss) reserves for both paid and incurred losses.

Loss reserves are funds set aside to pay claims and claims expenses.

Incurred losses are estimates of what must be paid on a claim when all the bills are finally submitted. Property claims are usually paid quickly so these reserves are often small. Liability claims, however, take longer to pay out and these reserves are usually larger. Insurers list loss reserves on the loss run, and associations should request a copy of the loss run from their insurer each policy year. The loss run shows the association how much has been paid and how much is estimated for claims against the association's insurance policy.

Policyholders' surplus. When the insurer's liabilities are subtracted from its assets, the remaining amount is termed policyholders' surplus. The surplus is the equivalent of the association's fund balance or an individual's saving account. It is what the insurer would use to pay for claims from catastrophic losses or liquidation.

Capacity. The ratio of written premiums to policyholders' surplus is a measure of the insurer's capacity to write or insure new business. A ratio that is greater than three to one warns insurance regulators that the insurer may be headed for financial trouble.

Combined ratio. The combined ratio is a combination of an insurer's loss ratio and its expense ratio. The loss ratio is the ratio of claims and claims expenses to earned premiums. The expense ratio is the ratio of underwriting expenses to written premiums. Currently, the combined ratio exceeds 110 for most of the property and liability industry. It means that for every premium dollar received, $1.10 was paid out. The extra dime was gained from investment income and the sale of assets. Historically, when the combined ratio has reached 115–117, the insurance market hardens meaning rates increase dramatically.

INSURANCE REGULATION

Insurers are regulated to ensure they meet their obligations to policyholders and other third-party claimants. States—not the federal government—regulate insurers. Each state has an insurance commissioner who regulates insurance companies within his or her jurisdiction. State commissioners have often proven to be powerful allies for community associations with insurance problems. The National Association of Insurance Commissioners (NAIC)—an organization for state commissioners—can also provide community associations with useful information.

Rate Regulation

States regulate rates to ensure that they are adequate, reasonably priced, and fair. The degree to which a state becomes involved with property and liability rates varies widely.

Solvency Regulation

In addition to regulating rates, states monitor the financial solvency of insurers.

State surveillance. The states monitor property and liability insurers by examining (or auditing) their annual statements. States also use the Insurance Regulatory Information System (IRIS) that was developed by NAIC. An association can request IRIS information from NAIC or its state's insurance commissioner. NAIC is exploring risk-based capital criteria used to measure the risk of insurer insolvency.

State guarantee funds. Most states have guarantee funds or insolvency funds as nonprofit quasi-governmental agencies. Insurers fund their state agency by paying assessments. If an insurer becomes insolvent and is liquidated, these funds pay policy holders' and other third-party claims. These funds only cover certain types or lines of insurance and have statutory limits per claimant. Many community associations have learned in the aftermath of a catastrophe that these funds provide modest help in recouping losses caused by insolvent insurers.

Private monitoring organizations. Several private organizations monitor the solvency of property and liability insurers. The most prominent include A.M. Best, Standard and Poor, Moody's Investors Service, and Duff and Phelps. Each of these companies uses a variety of criteria to rate property and liability insurers. The rates are distinguished with a letter and/or letter-number (such as A++ or Aa1). In addition to these letter ratings, some private monitoring organizations also use a roman numeral to denote financial size in terms of policyholders' surplus.

Every community association should determine whether its insurer is on NAIC's IRIS watch list and what type of rating the insurer has received. The association's insurance agent can help interpret the significance of the rating.

Consumer Protection

State insurance commissioners endeavor to protect consumers in a number of ways in addition to regulating solvency and rates.

Licensing. Before an insurer can write business in a state, it must be licensed (or admitted) to sell certain lines (or types) of insurance in that state. The primary requirement for obtaining a license is financial strength. Once licensed, the insurer must conform to state requirements for financial operations, reporting, policy forms, rates, and it must participate in the guarantee fund.

Unlicensed insurers can still provide insurance in a state, but they must do so through licensed excess-and-surplus-lines insurance brokers. These brokers can usually only go to the unlicensed insurers if licensed insurers will not write the insurance. The unlicensed market is for hard-to-place coverages and operates free of the rate and policy form requirements placed on licensed insurers. States do not regulate the unlicensed market, and its insureds are not eligible to participate in the state guarantee fund.

Policy forms. Most states require licensed insurers to file policy forms with the insurance commissioner in the same way they file rates. Property and liability forms are either standard or nonstandard. They are standard if the insurer has subscribed to the forms promulgated by a private insurance organization. The most prominent in the property and liability insurance field is the Insurance Services Office. These forms are sometimes called bureau forms. The Insurance Services Office copyright can be seen at the bottom of the property and liability policy pages.

Other important private organizations include the Surety Association of America (crime and fidelity forms), the National Flood Insurance Program (flood insurance forms), and the National Council on Compensation Insurance (workers compensation and employers liability forms).

Insurance Services Office rates and/or loss-costs promulgated by the Insurance Services Office are called bureau rates. However, many insurers—especially in the community association field—have developed their own nonstandard or special forms and rates.

To facilitate electronic communication with their agents, numerous insurers use various ACORD application forms, depending on the class of insurance involved. While these applications are not as closely regulated by state insurance commissioners as policy forms and rates, they are used extensively in the property and liability field.

Market conduct. Insurance commissioners regulate insurers by monitoring their sales operations, underwriting practices, and claims adjustment. Most states have unfair trade practices statutes and unfair claims practices statutes. Insurers who violate these statutes can be subject to fines, penalties, and license revocation or suspension. Insurance companies also monitor their conduct through a consumers' complaint department.

INSURER OPERATIONS

Three aspects of insurer operations directly affect a community association's insurance program: establishing rates, underwriting, and marketing. A fourth aspect, reinsurance, is less direct, but still important.

Establishing Rates

To establish insurance rates, insurance companies determine the loss potential of the insured and select a rate of insurance for the insured's exposure units so the resulting premium is sufficient to pay claims, expenses, and to generate a profit. An exposure unit is a measure of loss potential. (See Figure 1.) Given the rates per exposure unit established in Figure 1, the premiums for each coverage would be those listed in Figure 2.

Manual rating. Manual rating, sometimes called class rating, is used when rates are published in rating manuals. Manual rates can also have individual components.

Bureau rating. Bureau rating refers to rates that are developed by private insurance organizations to which the insurer subscribes or is a member. Typically, it refers to Insurance Service Office (ISO) rates. Bureau ratings emphasize development of loss costs, rather than rates. Some insurers develop their own company or special rates.

Merit rating. Merit rating modifies manual rating to account for certain characteristics of the insured. For instance, a community association with substantial fire protection and life-safety devices would receive premium discounts from the manual rates. Manual rates can also be tightly focused on a given class of business. For instance, some insurers will separate their habitational class into apartments and community associations.

Experience rating. Experience rating evaluates the insured's loss history. The more favorable the history (fewer losses), the more favorable the rate. For example, workers' compensation and employers' liability insurance are very loss sensitive. Experience rating can measure frequency (the number of claims) or severity (the dollar magnitude) of claims, or both.

Debits and credits. Each of these rating systems will give scheduled credits and/or debits depending on the size of the deductible, loss experience, life-safety equipment, and other factors.

Underwriting

The term underwriting, which refers to evaluating and pricing risk, derives from a practice first begun at Edward Lloyd's coffee house in London in the 17th century. Ship owners came to Lloyd's to seek financial protection for their cargos and vessels during transatlantic crossings. The individuals who gave their personal financial guarantees in the indemnity contract (or insurance contract) wrote their names along with the percent they would insure under the shipping contract. Because their personal fortunes were at stake, these early underwriters were very careful in the selection of risks they would insure.

Selecting risk. Today's underwriter performs many of the same functions as the early Lloyds' underwriters. A modern underwriter, however, works for the insurer and

FIGURE 1. INSURANCE EXPOSURE UNITS

Type of Insurance	Exposure Unit
Property	Frame construction: 10 cents per $100 of building valuation
Liability	$15 per residential unit
Workers' Compensation	$7 per $100 of payroll for a maintenance employee

FIGURE 2. HOW TO DETERMINE PREMIUMS

Property	**$360,000 Frame Building** $360,000 ÷ $100 = 3,600 exposure units x 10-cent rate = $360 premium
Liability	**A 75-Unit Community Association** 75 exposure units x a $15 rate per unit = $1,125 premium
Workers' Compensation	**Maintenance Payroll of $50,000** $50,000 ÷ $100 = 500 exposure units x $7 rate = $3,500 premium

is no longer personally liable for the risk. The underwriter's tasks involve selecting the desirable risks from all of the applications for insurance, pricing the coverage, establishing policy terms and conditions, and monitoring underwriting decisions.

Insurance agents often negotiate with underwriters about the nature of previous losses, the property's physical condition, and the association's financial characteristics. If problems develop, the association should not hesitate to meet directly with the underwriter. The underwriter may need to learn about community association insurance and risk management.

Underwriters function in a specific geographic market. The insurer may advertise that it insures community associations, but the underwriter may not wish to select these risks.

Capacity. Capacity is the ratio of premiums written to policyholder's surplus. It directly affects the amount of new business that an insurer can write. Heavy business in geographic areas that are susceptible to catastrophic losses can lead to insolvency. Associations that are located in such areas should examine whether their insurer can handle severe losses.

Delegating underwriting. Large underwriting firms often delegate tasks to individuals with various areas of expertise and levels of authority. Underwriting may also be delegated to the insurance agent who submits the application to the insurer. The insurer may grant extensive underwriting authority to specialists.

Marketing

The most important task of marketing is to sell insurance. Insurers accomplish this through different techniques that usually involve a compensated salesperson whose behavior is governed by common-law principles, insurer rules, and state regulations.

Agents and brokers. The insurance salesperson is known by various terms such as agent, broker, producer, and sales representative. In insurance, the term agent—when paired with the term broker—has carried other meanings. Historically, the agent represented the insurer and the broker represented the insured. These distinctions are not necessarily valid any longer. The community association should inquire as to whether the agent or broker can bind the insurer.

Marketing systems. Property and liability insurance are marketed through four primary methods.

1. The independent agent. This agent belongs to the American Agency System and often has agency contracts with several different insurers and offers insurance through several companies.
2. The exclusive agency system. The independent agent represents one insurer or primarily one insurer for a given class of business. Usually, this agent is a specialist and the insurer benefits from the agent's expertise.
3. The direct writing system. The agent is actually an insurer employee or an independent contractor who only offers insurance through that insurer.
4. Direct-response or direct-mail solicitation. Insurers that employ this system do not rely on an intermediary.

The most prominent distribution systems in community association insurance are the independent agency, direct writer, and exclusive agency. The association should examine the quality of coverage, the expertise and service of the agent, and the premium cost when choosing an insurer.

Agent compensation. The insurer pays its agents by offering sales commissions that are a percentage of the premium for a line of insurance. In most states, the agent may only share the commission with another insurance agent. Rebating—sharing a commission with the insured—is usually illegal.

At times, the agent may also charge a fee for the placement of insurance. Most states, however, have regulations that control fees if commissions are also paid. Fees are often charged when the placement of the insurance is time consuming and technical.

Agent regulation. State statutes regulate the market conduct of agents. Every state licenses insurance agents. The insurer with whom the agent has a contract or is employed also monitors the agent's performance. A community association can appeal to both the state and the insurer if difficulties arise with their insurance agent.

Many insurance professionals who specialize in community association insurance join CAI. CAI provides educational and certification programs and materials.

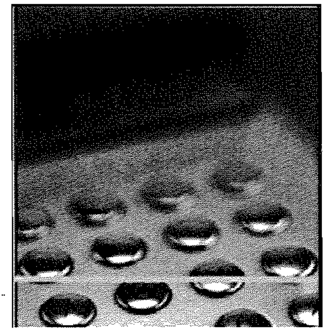
Reinsurance

Reinsurers buy portions of insurance policies from insurers. Insurers use reinsurance to bolster their capacity, gain expertise, and for other reasons. Reinsurers are not licensed or regulated by the states, so the financial stability of a reinsurer can be important, especially if the association is located in a potential catastrophe area or has a large concentration of values.

In most cases, the insured only deals with the insurer. In some instances, however, it may be desirable to obtain a pass through or cut through endorsement that usually allows the insured association to directly contact the reinsurer in case a solvency problem develops with the primary insurer. This direct access is used when very large values are at risk. For associations with values in excess of $100 million, this technique may have merit. An agent can recommend whether such an endorsement is desirable.

CHAPTER TWO:

INSURANCE CONTRACTS AND POLICIES



INSURANCE POLICIES ARE SPECIAL CONTRACTS BETWEEN THE INSURER and the insured, and they are an integral part of a community association's risk management program.

Contracts are legally enforceable promises. Every contract must have certain features to be valid and enforceable, including: an agreement, competent parties, consideration, form required by law, legal purpose, and no defense to formation or enforcement. If an element is missing, the contract may be voidable. Insurance contracts comprise six special features.

1. **Conditional.** Whether the insurer has to pay a claim depends on whether a loss occurs and whether other conditions are met. For instance, if the community association fails to notify the insurer of a claim within the required time period, the association may lose its right to enforce the claim.

Coinsurance is also a condition of the contract that the insurer uses to obtain insurance-to-value. If the association fails to carry a requisite amount of property insurance, it must pay a portion of the loss beyond the deductible. It will become a "coinsurer" with the insurance company. These and various other conditions affect the contract's enforceability.

2. **Aleatory.** The premium amount will probably only be a fraction of a possible claim. It is this exchange of unequal amounts of money that makes the conditional nature of the insurance contract a fair trade.

3. **Utmost good faith.** As an aleatory contract based on a promise to pay, insurance requires the utmost good faith of both the insurer and the insured. Good faith can be violated by concealment, misrepresentation, or breach of warranty by the association. The existence of any of these could void the contract. Concealment is the failure to

FIGURE 3. PROPERTY INSURANCE INDEMNITY TERMS

Actual Cash Value	Replacement cost, less depreciation. This is the basic approach of property insurance.
Replacement Cost Value	Replacement cash value usually must be added by endorsement to supersede the actual cash value indemnity concept.

disclose material facts. Misrepresentation is the false statement of a material fact. A breach of warranty occurs when a statement that is deemed to be true is violated. These three actions are most likely committed by the insured during the application process. The insurer can violate its good faith agreement by unfair claims settlement practices. This is called bad faith.

4. Adhesion. The insurance company writes the contract and uses preprinted forms for most insureds. The insurer presents the contract on a take-it-or-leave-it basis. Because the insured must adhere to the contract, the courts interpret any ambiguity in favor of the insured; therefore, insurers benefit from clear policy language.

5. Indemnity. The amount paid by the insurer depends on the amount lost by the insured. This is why most property policies are written on an actual cash value (ACV) basis and not a replacement cost basis (RCV). (See Figure 3.) If the insured suffers a loss of an old item, then the insured should be indemnified on a depreciated basis. A community association is much better off with replacement cost protection. This usually needs to be endorsed or specifically provided because of the indemnity concept.

6. Insurable Interest. In property insurance, an insured party must be in a position to suffer a financial loss at the time of the insured claim. Absent an insurable interest, recovery may be voided or voidable. For a community association, insurable interest problems develop in at least two areas.

First, a planned community that insures itself on a blanket basis (as though it is a condominium or cooperative), must have an insurable interest in the individual homes. This can usually be accomplished by covenants that allow the board to purchase blanket coverage or require the association to maintain private home exteriors.

Second, some community associations participate in master or group insurance programs that are written in the name of a community association management company or other entity. There may be no insurable interest, however, between the community association and the entity itself. This is often referred to as a fictitious fleet in state insurance statutes. These master programs can have several potentially adverse consequences:

- There may be no insurable interest, which may void the coverages.
- The first-named insured is not the community association. Therefore, important policyholder rights are lost and regulatory oversights are compromised.
- Because the association is not the first-named insured, the coverages probably do not conform to governing document requirements.
- Because the association is not the first-named insured, any insurance certificate might be rejected by a lender because its borrower is not completely protected.
- The adverse experience of one community within the group program could affect all of the associations' loss experience.
- The closer associations are located to each other in a group program, the more a catastrophic event could affect the policyholder's surplus.
- The property insurance component of these groups is usually layered, which makes policy administration and claims management more difficult.
- The property policy limits are usually based on the concept of probable maximum loss for each association in the group program. These limits may cause an association to be underinsured if a catastrophic loss occurs or if the association is not insured for full replacement costs.
- The liability insurance component usually does not have limits dedicated to each individual association so that low premiums mask shared limits.

Associations should carefully evaluate master or group programs.

Most policies follow a certain common format:

Name of the insurer and insured. This is usually presented on the first page or the declaration page.

Policy period. This also is on the declaration page.

Consideration. This premium may appear at different locations.

Definitions. Contemporary property and liability policies usually have glossaries that define words printed in bold. It is necessary to understand these definitions to understand the insurance. Sometimes they are different from common usage. For instance, in everyday usage, the term personal injury usually includes the idea of bodily injury, whereas a liability insurance contract makes a clear distinction between the two.

Insuring agreement(s) and exclusions. While there are sections with these exact titles, insurance coverages, limitations, extensions of coverages, and exclusions are typically found throughout the policy. The entire contract must be read.

Limits and valuation provisions. These provisions define how much will be paid and how that amount is determined.

Duties of the insurer and insured. These provisions relate to the conditional nature of an insurance contract, especially regarding claims.

Dispute resolution. These provisions detail how disputes over claims and coverages will be resolved.

Most property and liability policies follow a standardized policy structure. Nonstandardized forms contain special coverage features or manuscript endorsements. Endorsements expand, contract, or clarify coverage. Manuscript endorsements are specifically designed for a particular policyholder. Community associations cannot rely on these features. Each contract of insurance must be read and understood on its own.

COMMUNITY ASSOCIATION INSURANCE POLICIES

Community association insurance contracts usually are written on standard forms. Some insurers and their agents, however, have developed special nonstandard forms and endorsements.

Even insurers using standard forms, however, have developed specialized conditions for condominium policies. No similar standard policy conditions, however, exist for cooperatives and planned communities.

Standard Policies

These policies follow the forms and endorsements developed by the Insurance Services Office.

Commercial package policy. The commercial package policy (CPP) is written in a modular format and usually is referred to as a package policy. This policy contains property and liability coverages and it may contain other coverages, including boiler and machinery insurance, blanket employee dishonesty (fidelity), and directors and officers liability insurance. Modifications to these package policies are accomplished by adding either standard or manuscript endorsements.

The package policies usually have more favorable ratings than a stand-alone or monoline policies. For example, commercial property insurance written by itself (stand-alone) would have a higher premium rate than if it was combined with commercial general liability and both were written in a commercial package policy. This favorable rating is generated by administrative and actuarial savings.

In addition to rate advantages, package policies usually contain numerous coverages extensions for valuable papers and records, property of others, and similar exposures.

A planned community with nominal property exposures should keep rate advantage and coverage extensions in mind when evaluating a package policy.

Even the most basic planned community will have some type of common area property. Trees, shrubs, entrance signs, fencing, and light poles can be used to justify the property insurance component of a commercial package policy.

Business owners policy. The business owners' policy is a special type of package policy that has been developed by the ISO and combines certain coverages with corresponding coverage and rating benefits. If a business owners' policy is used, however, special endorsements must be added to the contract. Only condominium associations are eligible for this package program.

Special or nonstandard policy. Certain insurers, usually with the assistance of an exclusive agent or an agent specializing in association insurance, have developed unique policy forms to insure community associations. These nonstandard policies vary greatly, but their coverage benefits can be substantial. The association should carefully explore the coverage differences between nonstandard and standard forms.

Special Policy Conditions

Among condominiums, certain special policy conditions have become standard. These policy conditions were developed in response to governing document requirements to more equitably meet association, unit owner, and developer insurance needs.

These special conditions usually are contained in the condominium endorsement. There are no corresponding standard endorsements for cooperatives and planned communities, so these two types of associations must request special conditions. Most condominium association commercial package policies include the following special conditions:

1. Although the association is the named insured on the declaration page, unit owners also are defined as insureds except for the portion of the property that they own or control.

2. The insurer waives its right to require the association to transfer recovery rights to the insurer regarding unit owners. This was formerly termed a waiver of subrogation. In other words, if a unit owner, as an insured, accidentally causes insurable damage to the common areas, the insurance company waives its right to sue the unit owner for recovery of claim proceeds that were paid to the association.

3. The developer, if a unit owner, is recognized as an insured under the policy.

4. The insurer will recognize the appointment of an insurance trustee to receive the payment of claim proceeds if required in the governing documents.

5. A severability-of-interest clause protects innocent insureds if any given insured jeopardizes coverage.

6. A no-control clause preserves coverage for loss caused by an insured acting outside of the control of the association.

7. Cross liability is included that permits one insured to bring a claim against another insured.

8. The association's commercial package policy is treated as primary when the unit owner and the association carry insurance over the same property. This helps speed claims adjustment when both the unit and the adjacent common elements are damaged by the same covered cause of loss.

9. A unit owner mortgagee is protected by a mortgagee interest certificate and governing document requirements that the association use insurance proceeds to reconstruct the property. Only the association, as the first-named insured, is entitled to receive payment of claims.

In a cooperative with an underlying blanket mortgage, however, the standard mortgage clause would be used. The same also would be true for a condominium or planned community if the association owned real property encumbered by a mortgage.

Remember that condominiums using a business owners' policy form and cooperatives and planned communities using a standard commercial package policy form should work with their agent to obtain these special conditions.

BIDDING AND EVALUATING CONTRACTS

In addition to understanding the nature of insurance contracts as discussed above, boards and managers need to understand how to go about bidding, evaluating, and maintaining those contract as part of their risk management responsibilities.

Agents (and insurers) who demonstrate a commitment to community associations and to a given association account—absent a legal requirement—should *not* be subjected to annual bidding.

Associations need to balance detailed bidding specifications with bare outline specifications. That balance centers on the degree of responsibility or liability that the person who prepared the bid specifications is willing to incur.

The following items should be in a bid packet that can be used to solicit bids:

- The specifications dealing with the four loss exposure areas: property, liability, net income, and personnel.
- Three years of loss runs.
- Governing documents and pertinent resolutions.

- Insurable replacement cost appraisal.
- Annual financial reports or audit.
- Site plan, map, or other graphic property description.
- Annual report or annual meeting minutes.

Bid Calendar

Typically, associations renew their insurance policies on an annual basis. Different policies, however, have different annual policy periods. Therefore, it is important to maintain a chronological schedule of coverage inception dates. Allow at least 90 days lead time for the bidding and evaluating process and provide bidders with a complete bid packet.

Market Allocation

If more than one agent wants to use the same insurer, that insurer will only provide a premium quote to one of the agents. The assignment of the insurance market to a single insurance agent is known as market allocation. It is accomplished by having the association send an Agent of Record letter to the insurer appointing a specific agent to receive the quote.

Evaluating Insurers

Associations can evaluate insurers by using Best's ratings or ratings of comparable organizations. Associations should base their evaluation on the insurer's commitment to community associations. The National Association of Insurance Commissioners and state insurance commissioners also can provide useful information.

Evaluating Agents

Agents or brokers should be evaluated according to their experience, expertise in association insurance, participation with CAI, and professional standing. Three important designations in the insurance field are:

- CPCU—Chartered Property and Casualty Underwriter.
- ARM—Associate in Risk Management.
- CIC—Certified Insurance Counselor.

Agents may also demonstrate commitment to their field by participation in insurance organizations. All of this information should be revealed in their biographical material. Associations that rely purely on an insurer's reputation miss a fundamental part of the risk management assessment—the agent's degree of expertise.

The agent or broker and other industry professionals should demonstrate an understanding of the six-tiered analytical format. The agent also must review the association's governing documents. It is virtually impossible to prepare an effective insurance program without reviewing those documents.

The agent can also demonstrate commitment to community associations through CAI membership. CAI offers comprehensive publications and programs that deal with community association insurance and risk management.

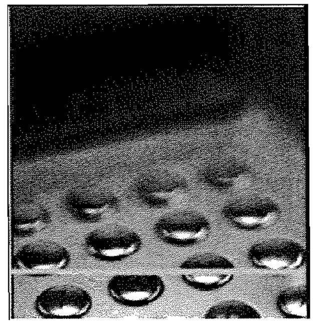
Evaluating Insurance Programs

Spread sheet comparisons of limits and premiums fail to consider the quality of the coverages, much less agent and insurer qualifications. They are of dubious value in the risk management decision process when used as the primary basis for making the selection of the insurance program. In a very direct sense, the association is purchasing coverages, expertise, service, and premium—in that order.

An individual, committee, employee, or consultant must bid and review the insurance program. Encourage long-term involvement in this function. Insurance issues are usually examined once a year. Short-term employees and volunteers examine insurance issues too infrequently to retain a command of the basic concepts.

CHAPTER THREE:

ANALYZING INSURANCE REQUIREMENTS



THERE ARE THREE TYPES OF COMMUNITY ASSOCIATIONS: CONDOMINIUMS, cooperatives, and planned communities. In a condominium, a person owns an individual unit and has tenant-in-common ownership in the common elements. In a cooperative, a corporation holds title to the units and common areas and a special lease gives a person exclusive right of occupancy of a unit. In a planned community, a person owns an individual unit and a corporation has title to the common areas. These three types of associations also can exist as part of master-planned communities or mixed-use associations.

ASSOCIATIONS' THREE CORE ACTIVITIES

All associations engage in three core activities—business, government, and community—that make purchasing commercial insurance essential to the overall risk management program.

Business Activities

The association's primary business activities involve protecting assets, which can be either tangible or intangible. The association either owns tangible assets or is responsible for their insurance, maintenance, and replacement through the governing documents. Examples of physical assets range from personal property, such as common area furniture and maintenance equipment, to real property, such as a maintenance building.

Although a condominium association does not own the individual units or the common elements, its governing documents usually require it to insure and maintain those units, as well as the common elements. Similarly, a planned community's governing documents require the association to maintain the exterior features of the homes.

The association's intangible assets are more difficult to measure. In a for-profit business, intangible assets are represented by goodwill, copyrights, patents, and trademarks. In a nonprofit community association, they are probably best measured through the resale values of individually-owned units.

Tangible assets are susceptible to direct and indirect loss exposure. Direct damage can come from fire, lighting, windstorm, and similar causes of loss. Indirect damage can arise from a peril that is not the immediate cause of loss. For example, a fire may directly damage a clubhouse and indirectly damage the revenue generated by that clubhouse.

The community association has several options for protecting its business activities. It could reserve all the funds that may be needed, it could pay for losses as they happen, it could levy special assessments on its owners, and it could borrow the funds. For a variety of reasons, the purchase of commercial insurance is usually not only required, but is also the most effective type of protection.

Government Activities

An association's primary governmental activities involve interpreting and enforcing governing documents and related rules, regulations, and resolutions. Depending on the type of association, these governing documents perform similar functions, although with different names. (See Figure 4.) These activities can create liability under tort, contract, and corporate law.

FIGURE 4. COMMUNITY ASSOCIATION DOCUMENTS

Type of Association	Name of Governing Documents	Other important documents
Planned Community	Declaration of covenants, conditions & restrictions (CC&Rs), bylaws, and articles of incorporation	Rules, regulations, resolutions
Condominium	Declaration, master deed, bylaws, and articles of incorporation	Rules, regulations, resolutions
Cooperative	Proprietary lease or occupancy agreement or membership agreement	Rules, regulations, resolutions

If a legal claim is filed against the association, then the resulting liability exposure to loss can create legal defense costs and damages. Once again, the association can fund these exposures to loss in a number of ways. The purchase of commercial insurance, however, is probably the best method.

Community Activities

The association's primary community activities involve maintaining enhancing social harmony by resolving disputes, communicating openly with residents, and educating residents about association living.

At another level, harmony is preserved and enhanced when all three core activities accomplish their goals and objectives. Poor business practices and harsh governmental behavior almost certainly cause turmoil and, perhaps, bring legal grief. When community harmony is shaken, the board's stewardship is called into question. Allegations that the board has breached its fiduciary duty can result in serious lawsuits. These types of legal conflict can be funded internally, but are usually best transferred to a liability insurer.

ANALYZING LEGAL REQUIREMENTS

Undertaking the core activities can expose associations to significant loss; therefore, purchasing insurance should be a risk management priority. The association can use the following steps to analyze its legal requirements for purchasing insurance.

Step 1. Carefully examine association governing documents. Though the governing documents generally require the board to purchase association insurance, the documents may stipulate other requirements as well. For example, in a planned community, the board may insure the common areas and the units on a blanket basis—as though the property was a condominium or cooperative. The governing documents will define the nature and extent of the common elements or common areas. In general, condominium and cooperative documents require the board to purchase insurance that covers the units and the common elements, while planned community documents only require insurance for the common areas.

Governing documents are binding because they are recorded in the land records. At times, however, the board will adopt resolutions that clarify insurance obligations. These resolutions, even if they are not recorded, may be as binding as the governing documents. Associations often use resolutions to allocate deductibles.

Step 2. Examine the enabling statute that created the community association. Condominiums are created by enabling statutes in every state. Cooperatives and planned communities, however, usually are created by conventional real estate transactions.

Step 3. Determine if related statutes at the local, state, and federal levels have direct and indirect insurance implications.

At the local level, the most important insurance-related laws center on building codes and zoning. If the building codes change, they can have a significant effect on the association's insurance program. The operation of building laws is excluded in most commercial package policies. Similarly, zoning that prohibits rebuilding in a given area may trigger an actual cash value settlement, as opposed to replacement cost, from an insurer. Other locally-driven insurance obligations vary. Some flow out of canopy-bond requirements for association property that extend over public rights of way.

At the state level, omitting the enabling statute, the most typical insurance requirements relate to workers' compensation and unemployment insurance. Nonprofit corporation acts allow nonprofit associations to purchase insurance indemnifying their directors and officers. The state also may have passed tort immunity for volunteers who serve on the boards of nonprofit corporations. These immunity statutes are designed to protect volunteers from lawsuits. With few exceptions, however, these tort immunity statutes flow according to the federal tax standing of the corporation.

At the federal level, there are few laws that directly effect community association insurance. Two notable exceptions to this generalization involve Social Security and the National Flood Insurance Program, which is mandatory for associations in designated flood areas. The federal level also deals with deposit insurance on association bank accounts.

Step 4. Carefully review the requirement of lenders, agencies, and professional organizations. At the lender level, the two secondary mortgage market agencies, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation indirectly affect association insurance. Before these agencies will purchase a mortgage, the lender must prove the association's insurance program meets their requirements.

The Federal National Mortgage Association has detailed association insurance requirements in virtually every loss exposure area. It emphasizes property, building ordinance, liability, flood, mechanical equipment, and insurer solvency standards. Review these requirements and update any outdated governing documents accordingly.

At the agency level, the Federal Housing Administration (FHA) and the Department of Veterans Administration (VA) play an important role in providing affordable

FIGURE 5. HOW TO ANALYZE COMMUNITY ASSOCIATION INSURANCE REQUIREMENTS

1. Examine the governing documents and related rules, regulations, and resolutions.
2. Examine the state enabling statute, if any, that created the association.
3. Determine if any local, state, or federal laws apply.
4. Determine if the association needs to comply with FNMA, FHLMC, FHA, or VA requirements.
5. Determine if the association has assumed any insurance or indemnity obligations under a contract with a vendor, contractor, or other service provider.
6. Use good business judgment and read the insurance contracts.

housing. FHA insures mortgages and VA guarantees mortgages. Through their insurance requirements, these agencies indirectly influence association insurance. A prospective purchaser seeking FHA mortgage insurance or VA mortgage guarantee will pressure the association to obtain required coverages. FHA, through a regulatory agreement, may directly affect the insurance program of a cooperative with an FHA insured blanket mortgage.

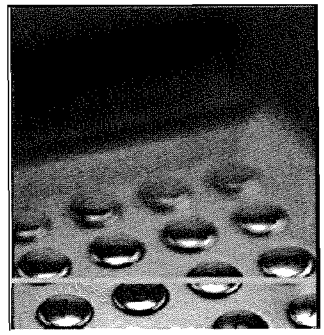
At the level of professional organizations, the accounting industry—through the American Institute of Certified Public Accountants and the Financial Accounting Standards Board—monitors association insurance through audit standards that require coverage stipulations.

Step 5. Review all vendor, contractor, and other service provider contracts to determine if they contain insurance or indemnity obligations. For instance, the association may be required to insure contractor damage or indemnify that contractor if he or she is sued while working for the association.

Step 6. Exercise prudent business judgment under common law. Boards that read all insurance policies carefully and develop the association insurance and risk management program with the help of professionals are prudent and exercising good business judgment.

CHAPTER FOUR:

PROPERTY ISSUES AND PROPERTY INSURANCE



BEFORE THE BOARD CAN DEVELOP THE ASSOCIATION'S PROPERTY insurance program, it must consider certain related issues. First it must determine values and identify the interface between individual units and common elements.

Placing a dollar value on the association's real and personal property is critical to quantify loss exposures, obtain insurance-to-value, and avoid coinsurance penalties. The American Institute of Real Estate Appraisers lists several different types of value: market value, use value, investment value, going-concern value, insurable value, and assessed value.

The association is concerned with insurable value—defined by the Appraisal Institute as "that portion of the value of an asset or asset group that is acknowledged or recognized under the provisions of an applicable loss insurance policy." Insurable value, as found in a commercial property policy regarding property exposures, eliminates certain items such as land and paved surfaces and limits others such as trees and glass. Further, insurable value, from an insurance contract view, comes in two forms:

- Actual cash value is the replacement cost of an asset less accrued depreciation.
- Replacement cost value is the estimated cost to construct—at current prices—a building using modern materials and standards, design, and layout. The replacement cost value is determined at the time of loss, without deduction for depreciation. Actual recovery is always subject to policy limits.

The most widely-used standard in association governing documents is replacement cost. Replacement cost, without the qualifying term insurable, includes items that are typically not insurable, such as land, certain portions of the foundations, paving, curbing, bulkheads, piers, dams, etc.

The insurable replacement cost of real property also includes the value of heating, ventilating, air conditioning, and other related equipment. The inclusion of equipment and machinery values in total property values does not mean that these items are insured for all causes of loss.

- Actual cash value is the most widely-used valuation concept in commercial property insurance because of the principle of indemnity. In other words, most property insurance contracts need to be endorsed to obtain insurable replacement cost coverage.
- Guaranteed replacement is an available option with respect to commercial property valuation. This concept, borrowed from personal lines, insures the property without any limit. The property limit of insurance purchased is only for determining premiums and does not act as a limitation of any loss payments.
- Appraisals. The most effective way to determine insurable replacement cost is to purchase an insurable replacement cost appraisal. The insured is responsible for determining value in a property contract of insurance—the insurer will only perform a replacement cost estimate. At times, the insurer may require the association to stipulate the property values being insured by signing a statement of values. The board should not sign such a statement without an insurable replacement cost appraisal.

Planned communities should consider obtaining a package rather than a standalone (or monoline) commercial general liability policy. In a very simple planned community, however, with virtually no common property two problems may arise: appraisals are impractical, and the type of property included in the commercial property part of the package may be uninsurable.

OWNER INSURANCE AND THE INTERFACE BETWEEN UNITS AND COMMON ELEMENTS

Condominiums, cooperatives, and planned communities that insure on a blanket basis (as though they were a condominium or cooperative) are usually required to insure the common elements and the units. Driven by interest allocation, this requirement produces an overlap or interface problem. Where do the common elements and the units begin and end?

In cooperatives, this interface has largely been resolved through leasehold interest solutions that were developed for rental and commercial properties where the legal structures were similar: a single title holder with a real property interest and a user's (renter's) personal property interest.

In condominiums, however, this problem became more convoluted because of the owner's real property interest in the unit and the association's interest in the common elements.

Most of the debate centers around improvements and betterments and who is responsible for insuring them—the association or the unit owner. Historically, improvements and betterments were additions made to the premises by a tenant that became part of the realty and reverted to the owner at the termination of the lease. With the exception of certain types of housing cooperatives, this is not the case for most associations.

There is no single correct way to handle this interface problem except by using the six-step analytical framework outlined earlier. Once insurance responsibility has been determined and allocated, it needs to be firmly spelled out in the package policy by endorsement (preprinted or manuscript) and communicated to all owners by means of newsletters, mailings, or meetings. It is important to remember that though the owner may have maintenance responsibilities, the association may have insurance responsibilities. (See Figure 6.)

Adjusting too many losses within the boundaries of a unit may lead to endless problems for the association. If the single entity or all-in approach is used, the package policy deductible can be used to help reduce claim frequency. Once again, the solution must become part of the formal association governance and must be communicated to the owners. Cooperatives may be required to insure all improvements and betterments and appliances whether they are built in or not.

FIGURE 6. THE INTERFACE BETWEEN COMMON ELEMENTS AND UNITS

Bare Walls	Treats the unit and common elements as entirely separate. Therefore, the owner would have to insure not only personal property, but also partitions, paint, cabinets, etc.
Single Entity	Treats the unit and common elements as one. The package policy insures paint, partitions, cabinets, fixtures and similar real property that was part of the original unit. Personal property is excluded.
All-in	Extends the single-entity concept to insure a variety of improvements and betterments within the unit at the time of a loss.

Owner Insurance

The individual owner's personal insurance program is important not only for the individual, but also for the association. At one level, both are interconnected because of the interface between common elements and individual units. At another level, they are interconnected because the board may be charged in the governing documents with monitoring the existence and quality of the individuals' policies.

Insurance programs for community associations and the owners come into close contact in several areas, although the consequences often vary. If the master commercial package policy is primary and the common area/unit interface is carefully evaluated and communicated, it should make little difference if the association is insured through one company and the unit owner through another.

In a planned community, the association must worry about whether the individual owner is adequately insured. Unless the planned community insures on a blanket basis, it has no way to control the effects of an owner's underinsurance or lack of insurance.

Relying on the mortgagee to require the owner to carry adequate insurance begs two questions. First, the owner may own the home free of debt. Second, the mortgage limit may be very low compared to insurable replacement cost. The mortgage company will usually only require insurance for the debt limit. The association can try to be named as an additional insured on the owner's policy, but some insurers balk at this.

Also, planned communities that do not insure on a blanket basis are more susceptible to insurance pricing cycles because insurers traditionally prefer predictable property exposures. When the insurance market hardens and rates increase, liability-driven insurance programs usually feel the price increases first. If the market significantly hardens, then coverage availability becomes a problem.

There are no easy answers to these problems. Experienced association insurance professionals can provide useful advice. The most effective answer, however, is for the planned community to insure itself as though it was a condominium or cooperative.

Insurance Services Office Homeowners & Unit Owners Program

All of the coverages listed below are referred to as the "homeowners' insurance program" by the Insurance Services Office. Forms HO-1, 2, 3, and 8 apply to homes, form HO-4 is for renters, and form HO-6 is for a condominium or cooperative unit owner. The numbering system of the homeowners' insurance program has 10 digits with the last four referring to the edition date: HO 00 01 2006. Insurance Services Office provides six main coverages:

1. Coverage A (dwelling) insures the housing unit and construction supplies. In an HO 00 06, it means:

- Additions, alterations to the "residence premises."
- Items of real property that pertain exclusively to the residence premises.
- Property that is the individual's insurance responsibility under the governing documents
- Structures owned solely by the owner located at the residence premises.

2. Coverage B (other structures) insures other structures located on the premises, but not connected to the dwelling. In an HO 00 06, there is no Coverage B. It is included in Coverage A.

3. Coverage C (personal property) provides contents coverage and applies to property owned or used by the individual owner (insured).

4. Coverage D (loss of use) involves additional living expenses, fair rental value, and prohibited use.

5. Coverage E (personal liability) covers legal liability arising from bodily injury and property damage claims. It does not include personal injury—libel, slander, defamation, etc.

6. Coverage F (medical payments to others) provides accident coverage for third parties injured on the premises.

Insureds should remember that most personal property coverage is written on an actual cash value basis. If insureds want replacement cash value coverage, they must purchase it by endorsement.

Association Loss Assessment Coverage

All of the homeowner forms, except the HO 00 04, contain within Coverages A and E an additional coverage entitled loss assessment. In both cases, the limit of liability is $1,000 although this limit can be increased by endorsement to as much as $50,000. In some cases, the coverage is only triggered if the assessment is made against all unit owners.

- Coverage A pays that part of a loss assessment charged to the owner by the association because of a peril. The assessment must occur during the policy period, but the cause of loss may occur earlier. The commercial package policy deductible for the common area policy, if it is charged back to the individual, can be paid for out of this coverage. It is subject to the homeowner policy deductible and a possible sub-limit that is usually $2,500.
- Coverage E pays that part of a loss assessment charged to the owner by the asso-

ciation because of property damage or bodily injury or because the liability for the act of a director or officer is charged to the owner. The assessment must occur during the policy period, even though the event that caused it may have occurred earlier.

Owners in a community association can add certain endorsements to their homeowner's policy that will provide broader protection.

Communicating the Insurance Program

In any type of community association, it is vital that the association's insurance agent communicate to the owners the type of coverage in place for the association, how that coverage may or may not benefit them, and what they should consider insuring. This can be done through meetings, newsletters, or direct mailings.

OTHER PROPERTY ISSUES AND INTERESTS

Personal property is usually defined as everything that is not real property. Personal property is not typically appraised unless it has unique value. The valuation of personal property can usually be obtained by reviewing acquisition records and inventories.

- Unique property. Large-scale master planned communities often have unique and special property issues. For example, they may have ski hills, dams, retaining walls, docks, piers, stables, and golf courses.

Associations must correctly value these exposures and read the policy to determine if unique property exposures fall within the definition of insured property. If they do not, the board should develop endorsements.

Association property involves many legal interests, including present-ownership interests, future-ownership interests, present-use interests, and future-use interests. Besides the association (present-ownership interests), the most frequently encountered interests are:

- Secured creditors. Secured creditors include mortgagees, loss payees, those secured with UCC filings.
- Sellers and buyers. The terms of sale usually stipulate when title passes and when insurance obligations shift.
- Bailee interests. Bailments are created when the bailee (i.e., the association) receives the property of another—the bailor—in a condition of trust for a specific purpose. For example, a bailment is created when a valet parks a car in the association garage or when an on-site management office receives resident packages.

- Tenant interest. Any tenant has a property interest, known as a leasehold interest, in the rented property. This interest may involve improvements and betterments.

CAUSES OF ASSOCIATION PROPERTY LOSS

The causes of property loss fall into three broad categories: natural perils (fire, windstorm, flood, disease), human perils (thefts, homicides, negligence, pollution), and economic perils (strikes, new technology, stock market fluctuations). Typically, insurance contracts deal only with natural and human perils. In insurance contract language, certain perils may become covered causes of loss.

Covered Causes of Loss

In commercial property insurance, causes of loss are insured in the following forms or insuring agreements: basic form (fire, lightning, windstorm, etc.), broad form (everything in basic form, plus breaking glass, falling objects, weight of snow, ice, or sleet, water damage), and the special form (covers direct physical loss, except the exclusions).

Standard Policy Exclusions

The board will gain a better appreciation of its property insurance needs if it understands what is not insured. Everything but exclusions are insured. All three of the forms listed above, including the special form, have several important exclusions:

1. Building ordinance or law. This relates to a building code (or ordinance) that may require the association to tear down an undamaged portion of a building because a certain percentage of the total structure has been destroyed. There are three aspects to this exclusion.

- Contingent liability. This is the value of the undamaged portion of the buildings.
- Demolition. The commercial property policy contains demolition coverage for the part of the building that has been damaged by a covered cause of loss. Demolition in building ordinance coverage, however, is for the undamaged portion of the building.
- Increased cost of construction. Once the undamaged part has been demolished and reconstruction begins, the cost of this new construction may be increased because of changes in building code requirements.

2. Earth movement. Any earth movement (other than sinkhole collapse), such as earthquake, erosion, and mud slide.

3. Governmental action. Seizure or destruction of property by order of governmental authority is excluded unless the destruction helps prevent the spread of a fire.

4. Power failure. This excludes damage caused by off-premises power or utility services failure. Coverage can be obtained for this exposure.

5. War and military action. Losses caused by such perils are usually so catastrophic that they are not insurable.

6. Nuclear hazard. The potential losses are too catastrophic for conventional commercial insurance. Coverage can be purchased, if necessary.

7. Water damage. The water damage that is insured pertains to damage caused by leaking roofs, plumbing, and similar causes. Water damage caused by the following, however, is usually excluded:

- Leakage and seepage, whether continuous or not.
- Back-up of sewers and drains.
- Surface and subsurface water.
- Flood.
- Wind-driven rain without prior damage to the building. In other words, if the wind blows a window open and water enters and causes damage, the ensuing water damage is insured.

8. Glass damage. Coverage is often provided on a limited basis, such as $100 per pane and $500 per occurrence for specific causes of loss, such as vandalism.

9. Maintenance exclusions. Damage caused by wear and tear, rust, corrosion, etc. is excluded unless loss or damage is caused by a specified cause of loss.

10. Mechanical breakdown and electric arcing. If mechanical equipment, such as pumps, fans, and electric switch gear accidentally breaks down, damage is excluded.

11. Pollutant cleanup. By the mid-1980s, insurers were refusing to grant any liability protection for pollution. Insureds then began to make pollution claims under the debris removal section of their property insurance. In turn, insurers eliminated virtually all direct damage property coverage for pollution cleanup, except for $10,000 as an aggregate limit.

STANDARD CONDITIONS AND LIMITATIONS

Coinsurance

This is a condition of a commercial property policy that the insurer uses to obtain insurance-to-value. Broadly speaking, coinsurance allows an insurer to value the property twice: once at the inception of coverage and again at the time of a loss. If the property insurance limits are insufficient at the time of loss, the insurer can contractually demand the insured to share in the loss. Most commercial package policies have several examples of the application of coinsurance.

Special Policy Conditions

Condominiums are usually granted special policy conditions. However, cooperatives and planned communities need to ask for them.

Property Limitations

All property policies have techniques for modifying their coverage:

Curtailed limits. Trees and landscaping, glass, valuable papers and records, accounts receivable, property of others, and other coverage extensions have defined limits that may be insufficient to meet the association's loss exposures.

Actual cash value. Despite granting replacement cost coverage for the buildings, certain items, such as common element carpeting and appliances may still only be insured at actual cash value.

Types of property. Fences, antennas, swimming pools, docks, architectural glass, retaining walls, etc. may be excluded. They may not be defined as a building.

PROPERTY INSURANCE COVERAGES

The policies and coverages listed below are available in the community association marketplace.

Commercial Package Policy

The commercial property part of the commercial package policy provides coverage for most of the association's property exposures to loss. Four areas of concern involve valuation, deductibles, covered causes of loss, and contents.

1. Valuation of real and personal property. It is important to obtain insurance-to-value by means of an insurable replacement cost valuation (for real property) and to obtain replacement cost endorsement because most commercial property insurance is written on an actual cash value basis.

2. Property policy deductibles. These should apply on a blanket basis to all buildings. The deductible should not apply per location. If it does, multiple deductibles could apply for any given occurrence.

- Property policy deductibles should be as high as possible to ensure adequate premium savings and to deter the use of the insurance contract as a maintenance policy.
- Deductibles can be split in dollar amount between real and personal property. They can also be allocated in differing amounts among the various covered causes of loss.

- The allocation of part or all of the package policy property deductible back to the unit owner depends on several factors that can be evaluated and analyzed according to the framework presented earlier. This allocation should be clarified before any loss occurs.
- In property insurance, the deductible will apply for each occurrence of a covered cause of loss. What constitutes an occurrence, however, may be open to question. Some occurrences are clearly defined—an earthquake and subsequent tremors that occur within 72 hours are viewed as a single event. On the other hand, a pipe that leaks over several months and causes damage with each leak presents a problem. How many occurrences took place? The association's agent should clarify how such an occurrence would be treated.

3. Causes of loss and other endorsements. Of the three forms of property insurance discussed earlier, the most comprehensive coverage is the special form covered cause of loss. The special form, however, may need to be supplemented by other insurance coverages and endorsements.

- Replacement cost and/or guaranteed endorsement.
- Agreed amount endorsement that deletes coinsurance.
- Inflation guard endorsement that adjusts the amount of property insurance by a certain percentage on a periodic basis during the policy year.
- Other covered cause of loss endorsements depend on the type of cause of loss (such as sewer backup) for which the association seeks coverage.
- Some or all of the special association policy conditions mentioned earlier.

4. Contents coverage. Most contents exposures can be insured through the commercial package policy. The agreed amount endorsement should apply to both the building and the contents. Certain items that appear to be contents, such as building maintenance equipment, are usually included in the definition of a building. Read the property insurance contract.

Boiler and Machinery Insurance

The name boiler and machinery often deters associations from examining their exposure to loss in this area. Usually, the board assumes that if it does not have a boiler, it does not need this type of insurance. Therefore, some insurers now use the term machinery and equipment. Because mechanical breakdown and electric arcing are excluded in the causes of loss forms of commercial property insurance, however, every association must consider this type of insurance. Every association has some type of mechanical and electrical equipment that is subject to breakdown. Other reasons for considering boiler and machinery insurance include:

- The insurer will often perform an inspection of the mechanical equipment. This type of engineering can be invaluable in risk management.
- Evidence of boiler and machinery insurance, in some jurisdictions, is the equivalent of a municipal or state inspection because the boiler insurer's loss-control personnel are licensed deputy inspectors for the municipality or state.
- The consequential damage from a steam boiler explosion may be excluded in the commercial package policy. Damage to the building from such an explosion, therefore, must be insured through the boiler and machinery form. Some boiler contracts have very high policy limits because both the mechanical objects and the building(s) are insured.

Boiler and machinery insurance applies to an accident and to an object. The accident must be sudden and manifest itself by physical damage to the object. A deductible will be applied to each loss. The object insured may be all classes of blanket group coverage for all fired pressure vessels. The object may also be insured on a comprehensive basis. All objects are covered, except exclusions. Valuation is provided on an actual cash value or replacement cash value basis. The association must ask which is being offered.

Building ordinance and business income (interruption) coverage can be added to the boiler and machinery policy. If the association has an exposure to loss in these two areas and only endorses its commercial package policy for these two coverages, but the ordinance or income loss results from a mechanical breakdown, the package policy will not cover the breakdown because of the exclusion. Business income usually carries a 24-hour waiting period deductible.

Associations should obtain a joint-loss deductible. A joint loss occurs when boiler and machinery insurance is provided by one insurer, but the commercial property insurance is provided by a different insurer. A joint-loss deductible prevents problems that could arise when a loss triggers both policies.

Building Ordinance or Law Coverage

This is added to the commercial package policy by endorsement. The coverage has three components: contingent liability, demolition, and increased cost of construction. Commercial Risk Services, a division of the Insurance Services Office, has developed a system called building code effectiveness grading that may allow associations to reduce the cost of their insurance if their property meets building code effectiveness grading code standards.

Commercial Automobile Coverage

This is for association-owned vehicles that must be licensed for highway use, and coverage will include physical damage (property damage), as well as legal liability protection. Commercial automobile insurance is written on a business auto policy form. This form refers to covered autos that are insured for particular coverages according to certain symbols. The association must review with the agent the schedule of covered autos and those symbols.

Difference in Conditions Coverage

This is a type of Inland Marine coverage that is written on nonstandard forms and is designed to broaden property coverage, particularly in the areas of flood and earthquake, or for any other cause of loss (peril) that is excluded in the commercial property coverage.

Difference in conditions coverage can be customized to the needs of the association. Certain government-sponsored enterprises, such as the Federal Home Loan Mortgage Corporation, are requiring earthquake insurance if a property is located in certain earthquake-prone areas.

Flood Insurance

Federal law requires owners of property that is located in a special flood hazard area and that is funded with a mortgage from a federally-insured lender to obtain flood insurance. To avoid the imposition of a coinsurance penalty, the association should purchase the maximum amount of coverage available under the federal program or 80 percent of the insured building's replacement cost.

Garage Keepers Legal Liability

This coverage combines elements of property and liability insurance—not only is physical damage to a vehicle insured, but so is the cost of any legal defense that may be engendered by such damage. This coverage is used for bailee's exposures. Damage to an association vehicle should be protected by commercial auto insurance.

Glass Insurance

Broad form and special form causes of loss provide protection for broken glass. This coverage, however, is usually subject to dollar limitations for certain causes of loss, such as vandalism. Glass insurance picks up a broad range of loss exposures, including flood, earthquake, and building ordinance.

Landscaping

The commercial package policy often contains coverage for trees, shrubs, and lawns that are subject to limitations for vandalism and windstorm damage. There may be other limitations related to mortality. Most landscaping exposures to loss are funded in normal financial operations through the annual or reserve budget.

Inland Marine Coverage

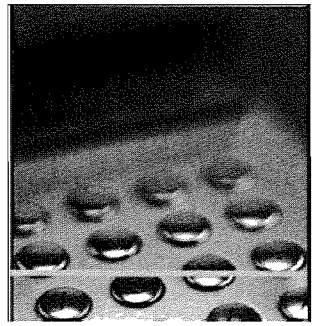
This coverage evolved out of ocean marine insurance. Inland marine insurance now provides coverage for methods of transportation, merchandise in transit, property in the custody of bailees, a variety of floating property, and other types of special property exposures.

- **Electronic data processing.** This type of insurance covers both hardware and software. It is usually written on an all-risk and replacement-cost basis. It can provide additional coverage for accounts receivable, extra expense, and business interruption.
- **Bailees customers insurance.** There are numerous policies in this area. However, they all protect association interests because of potential liability for loss to another person's property and the customer's interest in the property.
- **Contractors' equipment floaters.** This provides coverage for the largest class of inland marine insurance. Contractors' equipment floaters insure everything from hand tools used by the maintenance staff to tractors, portable offices, and scaffolding.
- **Instrumentalities of transportation.** Coverages are wide ranging—bridges, power transmission lines, television and radio towers, transmission equipment, and satellite receiving dishes.
- **Accounts receivable insurance.** This will be discussed under income exposures to loss.
- **Valuable papers and records coverage.** The importance of this coverage lies not in the paper destroyed, but in the reproduction of the information contained on that paper. In other words, the coverage pays for the labor costs to reconstruct the damaged information.
- **Fine arts floaters.** This coverage works in the same manner as the corresponding coverage a unit owner may purchase for his or her items of unique value.
- **Package policy extensions.** Most commercial package policies contain certain amounts of inland marine insurance as part of property coverage extensions.

The association must determine if these additional coverage extensions provide sufficient limits. The association must also determine if these inland marine extensions provide as much coverage as an actual inland marine policy.

CHAPTER FIVE:

LIABILITY ISSUES



LIABILITY EXPOSURES ARE FIRMLY ROOTED IN VARIOUS ASPECTS OF legal liability that may result from any of the association's activities as a business, government, and community.

Liability exposures differ in a number of respects. (See Figure 7, page 42.) Generally, the damages a judge or jury may award a plaintiff (the injured party) against the defendant (association) are unlimited. The liability for negligence, on which most liability insurance is based, requires the plaintiff to prove actual damages. The damages must be defined in monetary terms.

CAUSES OF ASSOCIATION LIABILITY LOSS

An association incurs a liability loss when a legal claim is brought against it for breaching a legal duty, allegedly causing harm, or being required by contract to pay for a loss that another entity has suffered.

Civil Liability

Civil liability arises from a breach of duty that the association owes to another person or entity. The duties may be imposed by common law, prescribed by statute, or voluntarily assumed by contract; however, regardless of the origin of the legal duty, the injured party may initiate a civil suit against the association. These legal actions may be an action at law for money damages or a suit in equity for one of many forms of equitable relief (e.g., an injunction to prohibit the collection of a special assessment). Most liability insurance policies will not cover lawsuits involving anything other than monetary damages.

Tort Liability

Most liability claims against community associations arise from tort law. (See Figure 8.)

FIGURE 7. FIVE FEATURES OF LIABILITY EXPOSURES TO LOSS

1. Third party in insured claims is involved.
2. Difficult to measure loss potential.
3. Tort rules and other related laws change.
4. The "long-tail" aspect of liability exposures results in claims that may be filed after the triggering event.
5. Contractual transfers, such as indemnification and old harmless agreements, used widely.

FIGURE 8. TORT LAW DAMAGES

1. **Compensatory.** Special damages are compensatory damages of a specific nature and can include:

- Medical expenses.
- Direct damage to property.
- Indirect damage from loss of use of damaged property.
- Loss of earnings for personal services.
- Value of lost future earnings.

General damages are compensatory damages that can be inferred from special damages, such as mental anguish and suffering.

2. **Punitive.** Damages imposed to punish the defendant, teach a lesson, and deter others. Punitive damages are usually not awarded in ordinary negligence cases.

A tort is a wrongful act or omission; the law remedies this through an action for damages. There are three categories of torts:

1. **Intentional torts.** The act or omission must have been voluntary. Intentional torts include: defamation (libel and slander), malicious prosecution, wrongful eviction, false arrest and wrongful detention, invasion of the right of privacy, assault and battery, nuisance, and bad faith.

2. **Negligence.** The failure of a natural person to exercise the degree of care that a reasonably prudent person would have exercised under similar circumstances to avoid harming another.

3. **Strict liability.** A generic class of torts that does not involve intent or negligence.

Fault is not an issue because the legislature has determined that public policy requires an individual to be liable without fault. Defined very broadly, these strict liability torts include:

- Workers compensation statutes that establish strict liability for work-related injuries.
- Dram shop acts that restrict the commercial production, sale, or distribution of intoxicating beverages.

Vicarious Liability

Vicarious liability is the liability of one party for the tortious act or omission of another. Since a community association must act through a person, the tort liability of a corporation is always vicarious. Vicarious liability is a relationship between an agent and a principal. The principal has vicarious liability for an agent's acts because the agent's negligence is given to the principal. Agency relationships can arise in employer/employee situations, possible independent contractor situations, and manager/board situations.

Unique Community Association Liability

The association functions as a business, government, and community. For example, the association performs business functions when it hires employees to maintain the common areas or operate a clubhouse. It performs governmental functions when it enforces covenants, rules, and regulations, and it performs community functions when it sponsors social events.

Each of these areas can create liability. For example, if the board—as part of its business function—hires a guard it knows is dangerous, it could be vicariously liable if the guard hurts someone. If the board—in performing governmental functions—enforces age-restrictive covenants, it may violate the Fair Housing Act. And, if the board—in performing community functions—sponsors an unsupervised social event, it may be liable if someone is injured. Many of these liability exposures to loss are insurable. (See Figure 9, page 44.)

STANDARD POLICY EXCLUSIONS

Associations obtain most of their liability insurance protection from the commercial general liability policy. The CGL provides broad coverage for bodily injury, property damage, personal and advertising injury claims. The commercial general liability is best understood by focusing on its exclusions. Everything is insured except what is excluded. Significant exclusions include:

1. Intentional injury. Payment for bodily injury or property damage that is either expected or intended by the insured is excluded. Intention can be separated from the act, but may be united with the result.

2. Contractual liability. Commercial general liability provides coverage for liability for bodily injury and property damage assumed in certain insured contracts.

3. Liquor liability. Liability for serving liquor is excluded if it is imposed by law (dram shop statutes) or if the insured is in the business of "selling, serving, or furnishing alcoholic beverages." Conversely, host liquor liability is insured because it is part of the commercial general liability and not excluded.

FIGURE 9. HOW A COMMUNITY ASSOCIATION'S CORE ACTIVITIES CAN LEAD TO LEGAL LIABILITIES

	Business	Government	Community
Contractual obligations	Canceling annual landscape contract prematurely	Failing to hold board meetings as required in the documents	Agreeing to sponsor social or recreational events
Intentional torts	Entering the wrong unit to correct a problem (trespass)	Publicly disclosing unit-owner violations (invasion of privacy)	Publishing derogatory comments about owners (defamation)
Negligence	Failing to maintain the common areas leads to bodily injury	Failing to enforce election rules leads to invalid results	Failing to supervise an event leads to damage
Strict liability	Having staff who are protected by compensation statutes	Ordering the removal of environmentally banned materials	Regularly selling alcoholic beverages at all community events
Vicarious liability	Employee improperly installs a shut-off valve causing damage	Management arbitrarily enforces no-parking rule for vans	Fireworks are canceled because association staff fails to get permits.

4. Workers compensation and similar statutes. If the association is liable for bodily injury to someone under an applicable workers compensation statute, there is no coverage under commercial general liability. This exclusion and the others mentioned below are designed to emphasize the need for workers compensation and employers liability insurance.

- No protection is afforded by commercial general liability for claims by spouses and families; nor is any coverage available under dual-capacity doctrines.
- Third-party-over actions are excluded. A third-party-over action results when an injured employee sues and recovers from a negligent third party. The third party, in turn, sues the employer (association) for recovery based on some theory of contributory negligence of the employer.

5. Pollution. The insurance industry is extremely sensitive in this area and the pollution (and asbestos) exclusion is detailed. The commercial property coverage part of the commercial package policy allocates $10,000 for pollutant cleanup. Although some insurers will provide protection for pesticides, herbicides, and pool chemicals under certain conditions, commercial general liability usually does not provide pollution coverage.

6. Aircraft, autos, and watercraft. This exclusion is designed to eliminate the overlap that would exist with other available commercial insurance policies that cover these risks. The auto exclusion relates to vehicles licensed for travel on public roads. Therefore, other mobile equipment is insured.

7. The products-completed operations hazard. Products and completed operations are subject to an aggregate limit—even though they are not handled in a separate insuring agreement. The products hazard uses the term *your product.* The completed operations hazard uses the term *your work.* Exclusions relating to these hazards are extensive. Associations that make and/or sell products such as crafts, food and beverages, that have an in-unit maintenance service program, or that perform work for others, should review this coverage.

8. General property damage. This exclusion is extensive, but its basic purpose is to avoid paying for damage to the association's property that should be insured in the commercial property coverage.

9. Fire legal liability. Commercial general liability provides coverage for an association that negligently causes fire damage to property for which it is legally responsible.

10. Professional liability. This excludes indemnification of an architect, engineer, or surveyor for damage arising out of work any of them may do for the association if that is the primary cause of the injury or damage.

LIABILITY INSURANCE COVERAGES

The availability of the coverages listed below depends on the willingness of the association insurance market to provide them on an affordable basis.

Commercial Package Policy

The commercial general liability coverage part of the commercial package policy provides most of the legal-liability protection a common interest community requires.

Coverage Trigger. A trigger is the basis on which commercial general liability coverage is activated. An occurrence can trigger coverage or making a claim can trigger coverage. Most triggers are based on an occurrence. However, director's and officers' liability is always a claims-made contract.

A commercial general liability occurrence trigger activates the policy in force at the time the damage or injury occurred—not when the claim is made. A claims-made trigger activates the policy in force when the claim is first made—not when the damage or injury occurred.

Duty to defend. The insurer has a duty to defend the insured, even if the legal claim is groundless, false, or fraudulent. Because the duty to defend takes precedence over the duty to indemnify, the insurer must defend—even if only one element of the claim is insurable. In turn, the insurer retains the right to settle.

Pay on behalf. The insurer will not require the association to pay first.

Legal liability. The insurer will pay sums on behalf of the insured that are insurable under commercial general liability, including civil liability, contract liability, intentional torts, negligence, strict liability, and vicarious liability claims.

Damages. Commercial general liability pays the insured's damages.

Supplementary payments. Commercial general liability contains a number of supplementary payments in addition to the policy limits. Most notably are the legal costs connected with defending a claim. This is an important coverage benefit—in a directors' and officers' liability policy, defense costs usually are inside the policy limits.

Even though commercial general liability can be written as a stand-alone policy, it is usually more desirable to write this coverage on a commercial package policy basis. This is nearly always an issue for planned communities that do not insure on a blanket basis.

Commercial General Liability Forms

Commercial general liability forms are divided into several sections.

Section 1—Coverages.

Coverage A—bodily injury and property damage liability. This coverage is for operations liability exposures both on and off premises that lead to bodily injury or property damage claims.

Coverage B—personal injury and advertising injury liability coverage. This covers claims involving libel, slander, false arrest, malicious prosecution, and certain advertising activities. Some definitions of personal injury leave out terms such as mental anguish and humiliation.

Coverage C—medical payments. This coverage applies to medical expenses for bodily injury to third parties on or away from the premises. It does not depend on negligence. Not all insurers cover unit owners.

Section 2—Who is an insured? Both the owners and the association must be insured.

Section 3—Limit of insurance. The term occurrence is often confusing in this section. Earlier, occurrence referred to an event that triggered coverage. In terms of limits, however, occurrence means the amount of insurance that is available per claim. There may also be an aggregate limit.

Section 4—Commercial general liability conditions. The insurer and the insured must abide by general liability conditions.

Section 5—Definitions. All commercial general liability insurance contracts contain glossaries. Associations should read these sections because definitions may vary.

Commercial Automobile Liability

Vehicles owned by the association should be covered under a commercial auto policy. The association should maintain current motor vehicle records on everyone who uses association vehicles. The schedule and symbols used in the business auto policy should be checked and deductibles should be evaluated. The association should determine if self-funding of physical damage is appropriate.

Hired and Non-owned Automobile Liability

This covers vehicles that are not owned by the association. It is excess over other valid and collectible insurance.

Commercial Liability Umbrella Coverage and Commercial Liability Excess Coverage

These coverages are used to increase the basic limits of liability protection provided by the association's commercial general liability policy. They provide increased protection, however, in two different ways. Typically, the excess policy only increases the commercial general liability limits. The umbrella policy increases the limits of all other scheduled liability policies. Because both policies usually have an occurrence-coverage trigger, there may be trigger coordination problems if they are scheduled over underlying claims-made liability policies.

Police/Security Guard Liability Insurance

This coverage is identical to a commercial general liability policy. The intentional-injury exclusion is modified, however, to provide assault and battery and other coverages.

Employee Benefits Liability

This coverage applies to errors and omissions that may occur in the administration of the association's employee benefits program, such as in a 401(k) retirement program.

Pollution Liability Insurance

Associations must learn about the absolute pollution exclusion and understand how almost anything can be construed as a pollutant if it is a "solid, liquid, gaseous, thermal irritant, or contaminant." Some insurers cover the application of pesticides, herbicides, and pool chemicals.

Several cost-effective pollution insurance programs are available for associations, including: petroleum tank liability insurance and first- and third-party pollution liability. Pollution protection also can be structured in related association insurance programs: commercial automobile liability and boiler and machinery insurance.

Contractors and environmental professionals who work with associations on pollution abatement need their own pollution policies, including contractors' pollution liability, professional errors and omissions with pollution and asbestos liability, and other coverages.

Employment Practices Liability Insurance

This type of insurance (often called EPLI) provides defense and indemnity protection for claims of wrongful discharge, work-place harassment, and similar employment related allegations.

Directors' and Officers' Liability Insurance

D&O coverage has three important functions. First, it can fund the governing document provisions that require the association to indemnify the board. Second, it may cover liability claims that are excluded in other association liability policies. Third, it assures association leaders and employees that they are not jeopardizing their personal assets.

D&O insurance often covers claims that do not lead to bodily injury, property damage, personal injury, or advertising injury because they are insured in the commercial general liability policy. Instead, D&O policies should cover wrongful acts that allege mismanagement of association affairs, failure to maintain adequate reserves, failure to maintain books and records, failure to enforce rules, regulations, and covenants, and breach of contract.

The structure of the D&O policy can lead to certain problems:

- The claims-made coverage trigger may require the board to include an extended reporting period.
- The association may need to increase limits because defense costs are often inside the policy limits.
- The D&O insurer may not have a duty to defend.
- A split-insuring agreement may be included and the association may not actually be insured.
- A retroactive date may be included that narrows coverage.
- A narrow-named insured may be used that fails to protect committee members, volunteers, and employees.

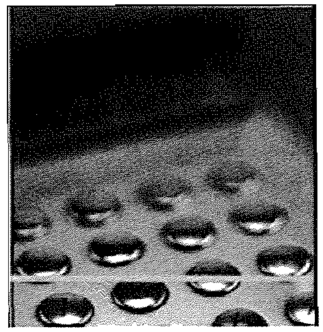
The board should be aware of the following significant exclusions:

- There may be no coverage for claims involving the wrongful purchase of the association's insurance program in form, content, amount, or deductibles.
- Defense and indemnity for nonmonetary damages that form the bulk of association liability claims may not be provided.
- Contractual liability, such as tortious interference and breach of contract, may not be covered.
- Discrimination and civil rights claims for either defense or indemnity may be excluded.
- Developer board members may not be insured.

Some innovative insurers have D&O policies that eliminate many problem policy conditions and most of the restrictive exclusions. They also extend coverage to community managers, thereby funding, at least partially, the indemnity requirement found in most management contracts.

CHAPTER SIX:

INCOME ISSUES



THE ASSOCIATION'S INCOME EXPOSURES TO LOSS INCLUDE ALL THE revenue items that appear in its statement of revenue and expenses. It also includes its expenses because an expense increase can cause a revenue decrease. It is impossible to evaluate these exposures without examining the association's financial reports.

DETERMINING VALUES

Technically, the income values exposed to loss are net income values—revenue minus expenses during a given time interval or accounting period. Causes of loss can expose the association to (net) income losses through either decreases in revenues or increases in expenses, or both.

Decreases in revenue can be classified as: business interruption, contingent business interruption, losses of anticipated profits on finished goods, reduced rental income, decreased collection of accounts receivable. The loss of anticipated profits classification is seldom an association net income loss exposure. This category becomes viable, however, if it is rephrased as "loss of anticipated profits from non-assessment revenue sources."

Expense increases can be grouped in the following categories: increased operating expenses, increased rental expenses, and increased expediting costs. Expediting expenses are those costs incurred in the process of speeding up the repairs after a covered cause of loss, such as having parts specially delivered.

Definitions

- Business interruption results from a reduction in profits (or revenue) because of an insured cause of loss at the association's premises.
- Contingent business interruption results when the cause of loss occurs away from the association's premises.

- Decreased rental income occurs because of damage to real or personal property rented by the association to others when the damage excuses the lessee from paying rent.
- Decreased collections of accounts receivable occurs when the association's records of accounts receivable are damaged to the extent that the association cannot collect accounts.
- Increased operating expenses may be necessary when the association decides to resume operations at another location rather than close down an income-producing facility or its on-site office because of a loss.

CAUSES OF ASSOCIATION INCOME LOSS

The causes of association income loss fall into three broad categories:

- Direct causes of loss include everything from fire and windstorm to flood and earthquake. They include both covered and uncovered causes of loss.
- Consequential causes of loss are best represented by the accounts receivable exposure. Some vendors will not pay until they have proof of their debt.
- Contingent causes of loss can occur when the covered cause of loss occurs off premises. For example, a damaged supplier can no longer furnish a needed product or service, or a customer no longer can make purchases.

ASSOCIATION INCOME INSURANCE COVERAGES

For most associations, the loss of business income is only a nominal exposure. This is not always the case, however, and care must be taken to examine appropriate insurance coverages, such as the following:

1. **Business income insurance.** This coverage is based on the net income concept and is written on an actual loss sustained basis.

2. **Rental income insurance.** This coverage applies to the loss of rents. Some insurers place this coverage under the business income coverage format. Cooperative assessments should be insured with this coverage.

3. **Extra expense coverage.** This protection is found in most commercial package policies. It pays for business costs if a covered cause of loss interrupts business. Extra expenses range from temporary telephones to off-site storage.

4. **Expediting expense.** This coverage is usually a component of the extra expense or the business income coverage. The limits provided, however, may not be suitable and should be reviewed.

5. **Accounts receivable insurance.** This coverage is triggered by a covered cause of

loss affecting the association's ability to collect monies.

6. Assessment fees receivable insurance. This coverage is included in some commercial package policies for condominiums. It is triggered when associations unsuccessfully attempt to collect assessments because of a covered cause of loss. There is no comparable coverage for planned communities. Cooperatives are protected by rental insurance.

PERSONNEL AND INCOME ISSUES

In the broadest sense, personnel exposures to loss result from the death, disability, retirement, resignation, or unemployment of association employees and key volunteers. These are typically accident, life, and health insurance issues and are regarded as employee benefit problems. The focus of personnel exposures in this guide, however, is from a property and liability insurance perspective.

Personnel exposures will be examined as workers compensation and employers liability insurance and as fidelity or blanket employee dishonesty insurance issues.

Workers compensation. When an association employee sustains a job-related injury, the association can have legal responsibility imposed by the state workers compensation statute. The values exposed to loss usually are set by statute and can involve temporary or permanent disabilities that are either partial or total in nature.

The causes of personnel losses from a workers compensation perspective are fairly straightforward. Fault does not need to be established for this exposure to occur. The injury, however, must have certain characteristics.

- It must be accidental—without foresight or intention.
- It must arise out of the work the injured person was employed to do.
- It must be in the course of such work.

Coverage issues the board should consider include whether to cover individuals who are not employed by the association. These individuals often include directors, officers, volunteers, employees, and contractors.

Depending on the state statute in question, these individuals may not be covered in a workers compensation and employers liability policy. If they can be covered, they may need to elect coverage. If they elect coverage, they will be charged according to an imputed salary—even if they are nonsalaried.

Association volunteers, if they desire coverage, must be assigned a job classification and charged an appropriate premium.

Determining the difference between the employer and the contractor can be difficult. Each situation is determined by specific facts. The answer generally depends on the intention of the parties, the association's right to control work hours, work methods, and the means of accomplishment.

Fidelity insurance. Crime exposures are usually regarded in terms of fidelity insurance or blanket employee dishonesty. Often, it is referred to as fidelity bonding. Bonding language—often seen in governing documents and state statutes—carries a surety notion. In fact, the association typically purchases insurance—not a surety bond.

The values exposed to loss in the fidelity exposure are subject to some misunderstanding. Historically, fidelity coverages often excluded protection for money in the care, custody, and control of the insured (association). Today, most fidelity coverages provide protection for the association's funds and funds for which the association is legally responsible.

Personnel exposures from a fidelity perspective occur primarily because an association employee, association member (director, officer, or volunteer), or association manager (who is not an employee) steals money. Coverage issues include:

Most fidelity insurance policies cover employee—someone who receives a regular salary and wage—theft of funds. Nonsalaried board members and volunteers do not meet this definition. Without an endorsement covering nonsalaried individuals, this coverage may be useless.

If an employee has caused fidelity coverage to be terminated in a prior job and that coverage was not reinstated, that employee will not be covered in his or her new job under new fidelity insurance.

If an employee steals from the association, sets up a repayment plan, and steals again, that employee will not be covered from the time of the first theft.

Personnel Insurance Coverages

Associations may use two forms of personnel insurance coverages—worker's compensation or fidelity insurance/blanket employee dishonesty. Workers' compensation is governed entirely by statute and is designed to pay whatever benefits are prescribed by the applicable statute. Employers' liability coverage protects employers from suits brought by injured employees to recover money damages separate and distinct from claims for workers' compensation benefits.

Workers compensation coverage premiums are determined by the occupational class of the employees involved. Each class has a rate established by the state and, sometimes, the National Commission on Compensation Insurance. Associations with no employees who obtain this coverage usually purchase a policy rated on an "if any" employee basis.

Unfortunately, the class codes used for community association employees are often inequitable and confusing. Generally, most association and association management company employees should be in two class codes: 8810 for clerical staff and managers, and 9015 for maintenance staff. Some insurers will use 8742—outside sales to code managers while other insurers use 9013—condominiums and cooperatives. Associations should avoid code 9013 because it arbitrarily lumps clerical, managerial, and maintenance staff together in a high-cost category.

Fidelity insurance/blanket employee dishonesty coverage is a subset of commercial crime coverage and, as such, can be written on a monoline or stand-alone basis or as part of a commercial package policy. Fifteen crime coverage forms are available. Form A, employee dishonesty, comes in two types: blanket and scheduled. Blanket covers all employees. Scheduled covers only those listed by either name or position.

In addition to the limitations mentioned earlier, several exclusions and conditions in fidelity insurance can affect recovery of a loss. First, the acts of the named insured or partners are excluded. This means that if the association relies on the management firm's fidelity for indemnity and the principal of the management company stole association funds, the association will not recover funds from the manager's fidelity insurance. The management company's fidelity coverage does not benefit third parties.

The association might need to file a legal claim against the management company. In turn, the company would fund repayment of the stolen funds through its own fidelity insurance unless the cause of that theft was excluded.

Management Company Fidelity Issues

Because association funds are often in the custody of an association management company, simple maintenance of fidelity insurance does not benefit the association if the manager leaves with the funds. Certain alternatives are available:

- Ensure the manager carries sufficient fidelity insurance in his or her own name and that the principal-partner exclusion will not hurt the association.
- Find out what risk management procedures the company uses to protect association funds.
- Obtain an endorsement for the association's fidelity insurance that names the association manager or management company as an employee of the association. This allows a direct claim on the association's fidelity policy for a theft that is really a management company fidelity loss.
- Obtain a joint payable or similar endorsement on the management company's

fidelity policy that names the association and the company as recipients of any payout on the management company's fidelity.

- The best protection from association management company fidelity loss is effective risk management. Management companies must segregate their records and accounts because, if a loss occurs, it will usually involve multiple associations. Therefore, it will be difficult for any one association to establish the magnitude of its loss.