
WHO PAYS THE INSURANCE DEDUCTIBLE: IN SEARCH OF THE COOKIE CUTTER ANSWER

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Today's topic, my fellow CAI members, is, I am sorry to say, as dry as dust bowl dirt. I doff my hat to any professional who could make this subject fun. Now, with that said, stick with me as we plumb the depths of the post-casualty loss stumper: who pays the uninsured loss on an association master policy claim. Though your eyes may glaze over, yes even before we start, work with me through the basics and see what you think.

First, ask yourself, am I dealing with a condominium created prior to July 1, 1990? If the answer is yes, then The Horizontal Property Regimes Act (the "Old Act"), RCW 64.32.220, applies. The Old Act requires that a condominium association obtain insurance for the condominium property against loss or damage by fire and any other hazards required or requested by the Declaration, by a majority of owners, or by any mortgagee having a mortgage of record covering an apartment. The association's master insurance policy is required to cover the building and *all improvements and structures* on the land. The Old Act requires that the insurance be purchased *in trust for the benefit of the apartment owners*. The Old Act does not differentiate requirements for insurance on apartments as compared with common or limited common areas. Based on the language in the Old Act, it is important to look to the insurance requirements of the Declaration, and of the mortgage holders, in addition to the requirements outlined in the Old Act itself. We will get to that in a minute.

If you are dealing with a condominium created after July 1, 1990, the Washington Condominium Act (the "WCA") applies. The WCA, RCW 64.34.352, requires a condominium association to maintain property insurance on the condominium insuring against all risks of direct physical loss commonly insured against. How vague is that requirement? Your insurance agent will help answer "what are the risks of direct physical loss commonly insured against" at the time you are procuring your insurance. Now, back to the question at hand. Under the terms of the WCA, this insurance does *not* need to include equipment, improvements, and betterments *in a unit* installed by the declarant or the unit owners *unless the Declaration provides otherwise*. Before you become fixated on this differentiation between units and other improvements, we will soon see below, the Declaration often "provides otherwise".

Whether under the Old Act or the WCA, Declarations are almost always written to comply with the underwriting requirements of Fannie Mae, Freddie Mac, the VA and the FHA. With few exceptions, a reading of your Declaration will disclose a requirement that the Association obtain coverage to protect the apartments or units (collectively the "units") as well as the common areas or common elements (collectively the "common elements") and the limited common areas or limited common elements (collectively the "limited common elements") against casualty loss. These are what are known as either a "single entity" policy or an "all in" policy.

Many associations are anxious to make the individual unit owner responsible for damage when it occurs as a result of an owner's negligence or because of the failure by that owner to maintain a portion of the condominium for which the owner is responsible, for example, a hot water heater or the hoses on a washer. That is often not possible under existing circumstances. First, the association's insurance coverage under its master policy is purchased for the benefit of the individual unit owners and they have the right to have the association file a claim under it for any covered loss. Second, the association's policy is primary. That means that the association's coverage must be tapped before any other insurance policy which provides coverage for the same risks. This leaves the issue of who is responsible for paying the amount of the deductible under the master policy, especially when there has been damage caused by the fault of an owner. Where the declaration states, without qualification, that the association is responsible for insurance to the full replacement cost of the building, then that includes responsibility for the deductible.

In addition to containing insurance requirements, the condominium Declaration is required by the Old Act to contain a provision stating the percentage of votes by the unit owners which shall be determinative of whether to rebuild, repair, restore or sell the property in the event of damage or destruction to all or part of the property. "Property" is a term defined by the Old Act to include the apartments as well as the common and limited common areas. A careful reading of the damage and destruction provision in most Declarations discloses an almost universal formula. In the event of damage or destruction to all or a part of the property, unless the owners vote not to repair and to terminate the condominium, the association is responsible for repairing the damage or destruction, using the available insurance proceeds for this purpose, and assessing any repair costs in excess of the insurance proceeds to the owners as a *common expense* in accordance with their respective percentage interests in the common elements and facilities. Most Declarations recorded before July 1, 1990 do not contain any provision which allows the association to assess the costs of damages in excess of the insurance proceeds against the individual owner causing the damage.

Similarly, the WCA requires that any portion of the condominium, which the association is required to insure, that is damaged or destroyed must be repaired or replaced promptly by the association unless the condominium is terminated, the repair or replacement would be illegal, or eighty percent of the unit owners, including every owner of a unit or assigned limited common element which will not be rebuilt, vote not to rebuild. The WCA also provides that the cost of repair or replacement in excess of insurance proceeds and reserves is a *common expense*.

To sum up so far then, unless your association has adopted changes to its Declaration regarding insurance requirements and/or uninsured losses, it is highly likely that the association is responsible for paying the deductible amount on any master insurance policy claim as a common expense of the association. For those who favor making an individual unit owner responsible for the deductible, do not be so quick to judge this system. Leaving the system set up so that the association always pays an uninsured loss, including any deductible amount, as a common expense, has the benefit of simplicity and certainty. Granted, it does nothing to motivate good behavior or to dissuade or penalize neglectful behavior. In any cost/benefit analysis, however, simplicity and certainty have value.

For the association seeking to keep common expenses down and to motivate individual unit owners to invest in care and maintenance of the areas of the condominium for which they are responsible, what can be done? Jim Strichartz, Esq., recommends that associations adopt changes in their Declarations and in their insurance policies to accomplish two related goals. The first goal is to

reduce the number of claims an association must report on its master policy, for small incidents such as leaking hot water heaters or washer hoses. This protects the association against large premium increases or outright non-renewal/cancellation. The second goal is to reduce the amount of uninsured loss due to master policy deductibles that either the association or individual owners must pay out of their own pockets.

Most owners purchase individual insurance coverage on their condominium units, and if they do not, they should. These individual policies, typically referred to as HO-6 policies, protect individual unit owners against liability to third persons, as well as providing important coverage for casualty loss of personal property belonging to the owner. They also usually include coverage for additional living expenses or loss of rent in the event that the property is made uninhabitable by a casualty loss, and may include loss assessment coverage to help an owner pay a special assessment due to a covered cause of loss which exceeds the amount of coverage under the association's master policy.

One feature of these HO-6 policies, which is frequently overlooked, is what is called "Coverage A-Building Property" coverage. The coverage may also be referred to as "Coverage A-Dwelling" or "Coverage A-Building/Improvements". This coverage generally provides insurance against damage to those portions of the real property which pertain directly to the unit *and* which the individual owner is responsible for insuring under the association's governing documents. This building property coverage generally also includes coverage for an individual owner's share of the master policy deductible, *but* only when the deductible is not assessed against all of the unit owners. The amount of building property coverage automatically available is usually ten percent (10%) of the amount of the personal property/contents coverage purchased. Additional building property coverage is fairly inexpensive. One major writer of condominium insurance recently quoted additional coverage in the range of \$1.80 to \$2.00 per thousand dollars of additional coverage. The deductible under an individual condominium homeowner's insurance policy is typically much lower than the master policy deductible. Deductibles between \$150 and \$250 are typical.

The first key to taking advantage of the building property coverage afforded by each individual owner's insurance policy is to amend the association's governing documents to make each individual owner liable for the insurance deductible in certain cases. These include circumstances where the damage is limited to a single unit, circumstances where damage is caused by the fault of an owner or that owner's tenant or family members, and circumstances where the damage is caused by the failure of some portion of the condominium property which the owner is responsible for maintaining. In cases where damage affects more than one unit or a unit and the common elements, the Declaration amendment provides that responsibility for the uninsured damage is pro-rated among the affected parties, including the association.

The second key is to make sure that the master policy deductible is set at an appropriate level to eliminate claims for minor damage. Insurance professionals often recommend a master policy deductible of \$5,000 to \$10,000 to exclude "nuisance" claims. The third key is to make sure individual owners understand their options with regard to additional building property coverage, through the use of the HO-6 policies referenced above, and their obligations in the event of loss or damage. If an association has a \$5,000 deductible and an owner only has \$20,000 of contents coverage and \$2,000 of building property coverage, that owner should purchase an extra \$3,000 of building property coverage. This would certainly appear to be a good investment at a cost of approximately \$6.00 per year.

Another option to leverage the benefits of the individual HO-6 type coverage is to use a “no-fault” system. Amendment of the governing documents would again likely be required, due to reasons outlined earlier. However, in a “no-fault” system, the individual unit owner is responsible for the damage to his or her unit regardless of fault. If a leak or fire on floor three damages units on floor two and floor one, the unit owners on floor two and floor one would bear the cost of their respective repairs, regardless of the fault, if any, of the owner on floor three. If common elements were damaged, in this example, the association would participate on a pro-rata share for the damage to the common elements. This “no-fault” type system does nothing toward motivating responsible care and maintenance or toward dissuading negligence by individual owners, but does blend some of the elements of simplicity with the benefit of the low cost HO-6 coverage discussed above. Because of the likely pro-rata sharing of costs for repairs, it is not as simple to administer as bearing any uninsured loss exclusively as a common expense.

Clearly many factors will impact any association’s decision making regarding which system may be best for it; the size of the association, insurance claim history, anticipated level of participation in carrying additional HO-6 coverage, and personal philosophy of the owners being a few.