 AAIS PERSPECTIVE

| By Joseph S. Harrington, CPCU |

CONDOMINIUM DEDUCTIBLE COVERAGE

A tug-of-war between personal and commercial lines

Few people other than condominium insurance specialists are aware of it, and some of them may not recognize it as such, but there is a tug-of-war under way in residential condominium insurance.

For years, there have been often-uncoordinated efforts to shift exposures between commercial policies covering condominium associations and unit owners policies covering individual residences. This tug-of-war may have intensified in recent years as the market has hardened for condominium association "master" policies.

Master policies provide coverage for the collectively owned property of condominium associations and, in many cases, permanent fixtures in individually owned units. Master policies also generally provide liability and fidelity coverage for the association and its board members.

Premiums for master policies have reportedly skyrocketed in recent years. In response, condominium associations have accepted substantially higher deductibles. Master policy deductibles are commonly set at $5,000 to $10,000. Deductibles up to $50,000 are not uncommon, however, and shoreline properties have been reported to have deductibles as high as $250,000.

The cost of these deductibles is frequently passed along to individual unit owners, but the manner in which they are passed along, as well as other insurance obligations of condominium residents, can vary greatly from community to community, depending on the bylaws, declarations, and practices of each condominium association.

Given the variation in policies and practices by insurers and condominium associations, there are unresolved questions as to whether or not and how a unit owners policy should respond to losses arising from master policy deductibles.

Virginia action

The state of Virginia in 2003 enacted a law making a condominium unit owner responsible for a master policy deductible related to any loss arising from the owner's unit, whether or not the owner's actions or negligence caused the loss.

In response to that statute, the American Association of Insurance Services (AAIS) developed an endorsement for adding "association deductible coverage" onto a homeowners or mobile homeowners policy.

Although developed with condominiums in mind, the AAIS endorsement can be used for any type of one- to four-family residence that has insurance obligations as part of a homeowners association.

The association deductible endorsement was filed in Virginia at the request of the Virginia Bureau of Insurance and was made available throughout the rest of the country on an advisory basis only. The Virginia law was subsequently repealed, but the endorsement remains on file there.

In the meantime, AAIS is reviewing the issue of association deductible coverage as it prepares a comprehensive revision of its Homeowners Program.

Single entity shift

Throughout the prolonged soft market for residential insurance, there was a steady progression from "bare walls" to "single entity" coverage for residential condominium buildings. This shift was, in effect, a shift in coverage of real property pertaining to a household from personal lines policies to commercial ones.

Under a bare walls master policy, the condominium association insures only the structure of the condominium building(s), plus the structure, fixtures, and furnishings of collectively owned areas, as well as the personal property of the association. Under a bare walls approach, owners of individual units are on their own to insure building property of units they own and use exclusively, such as sinks, cabinets, and flooring, in addition to their personal property.

Over time, bare walls master policies were supplanted by single entity condominium association policies that cover virtually all building property in a residential condominium structure, including fixtures in individually owned units.

In turn, single entity master policies evolved from providing "original specs" coverage, which insured only the original fixtures in condominium units, to "all-in" coverage that insures all permanent fixtures, including those added or substituted by residents. It is unclear what percentages of single entity master policies offer original specs or all-in coverage.

Under the standard language of unit owners policies, their building property coverage becomes excess over any other insurance covering the insured property, such as a commercial master policy providing single entity coverage. (Note: The AAIS Homeowners Program provides a Form 6, which is analogous to the HO-6 developed by the Insurance Services Office.)

Claims handling varies

Faced with increased losses and hard market conditions, insurers of condominium association master policies have instituted higher deductibles to eliminate small claims. There is little evidence, however, that they are backing away from offering single entity coverage.

Insurance companies differ in how they respond to claims under unit owners coverage arising from master policy deductibles.

Standard unit owners forms provide a supplemental coverage for loss assessments by condominium associations, but this coverage applies only to assessments for losses to collectively owned property, and it cannot be raised beyond the limit written into the form ($1,500 in the AAIS Form 6) for assessments that result from a deductible in a master policy.

Some companies take the position that the excess coverage provided in a unit owners policy applies to any amount not recovered from other insurance for eligible property.

To illustrate how this approach would work with a master policy deductible, suppose that a unit suffers a $15,000 loss to individually owned building property that is insured by a master policy with a $2 million limit and a $5,000 deductible. Also, suppose that the owner-occupant of the damaged unit has a standard unit owners policy with a $25,000 building property limit and a $250 deductible.

Some homeowners carriers would pay the amount assessed against the homeowner, up to $4,750, the amount above the unit owners policy deductible and below the master policy deductible.

Under this line of reasoning, that amount would be in excess of the $10,000 that would be recovered from the master policy ($15,000 loss minus the $5,000 deductible) and thus would be covered by the unit owners form.

Different approaches

Other companies take a different approach, reasoning that the excess coverage provided by a unit owners policy only provides coverage above the terms, conditions, and limits of the other insurance.

Some insurance professionals object when condominium associations take on a higher deductible with the presumption that the added exposure will be picked up by the unit owners form.

"Note how they glibly seem to pass the insurance responsibility to the [unit owners policy]," wrote one agent to an AAIS affiliate, commenting on a letter from a condominium association telling its members to make sure they had sufficient coverage under their unit owners policies to cover an added deductible.

As the agent's comment suggests, the question whether a unit owner's policy should pay a master policy deductible is related to the question whether a personal insurance policy should pick up an exposure created by conditions in commercial coverage.

AAIS was cognizant of the unresolved questions surrounding association deductible coverage when it developed its endorsement for providing association deductible coverage in Virginia.

Under the AAIS endorsement, the association deductible coverage applies when a master policy deductible is charged against an insured during the policy period and results from a direct loss to property under certain conditions:

- The damaged property is covered by the association's master policy. Deductible coverage is not intended to create "all-in" coverage under a bare walls policy.
- The damaged property would have been eligible for coverage under the homeowners or mobile homeowners policy if it were owned by the insured or were an insured's insurance responsibility.
- The loss is caused by a peril insured against, other than earthquake, which is covered by the homeowners or mobile homeowners policy. (A separate endorsement is available to provide association deductible coverage for earthquake, and yet another is available for providing association deductible coverage for premises other than the insured location.)

Along with the added coverage for association deductibles, the AAIS endorsement amends the supplemental property coverage for loss assessment to exclude coverage for assessments arising from a deductible under insurance held by a condominium or homeowners association. This is to preclude the possibility of a unit owner collecting under two coverages for one loss.

Unlike standard loss assessment coverage, however, the AAIS association deductible coverage allows companies and policyholders to increase the amount of the coverage and provides loss cost rating information to support higher limits.

As stated above, AAIS is reviewing the issue of association deductible coverage as it prepares a comprehensive revision of its Homeowners and Mobile Homeowners Programs. Persons wishing to comment can do so by sending an e-mail to info@AAISonline.com. Put "condominium deductible" in the message line. ■

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