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Why can't co-ops cooperate when disaster hits?

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In those rural days of yesteryear, if a barn burned or blew down the neighbors would rally together to rebuild it. It wasn't required by law, unless you count the Golden Rule, nor was it in the declaration of Covenants, Conditions and Restrictions (CC&Rs) in the nonexistent homeowners association's bylaws. It was the charitable thing to do, but it also made good sense: Many hands make light work, and your barn might be next.

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Today, there's no expectation that neighbors will help each other rebuild after a catastrophic loss. But there are communal obligations and risks to cover through insurance for subdivisions, condominiums and cooperatives, as well as the risk of harm to others through liability coverage.

In these circumstances, insurance coverage becomes "curiouser and curiouser," to quote Lewis Carroll's "Alice's Adventures in Wonderland." While most single-family homes have the standard types of homeowners coverage, when does the homeowners association (HOA) have an insurable interest in private residences – who pays when catastrophic loss occurs? And are boards of directors of HOAs at risk? Should the HOA board of directors maintain insurance coverage?

The contract of sale or the recorded deed often govern these questions, as they may incorporate the CC&R rules, raising the question as to whether these documents, as well as the terms of the owners' and HOA's insurance are adequate to avoid gaps or duplications of coverage. Better to determine the answers before disaster hits.

Basics of insurance in an HOA

Buying property insurance for an HOA or its members is more complex than the personal coverage that geckos, emus and other brand icons promote on TV. State laws governing HOAs are not uniform, and CC&Rs often set forth the insurance coverage requirements. But CC&Rs are unique to each development and its HOA.

Consider the question of insurable interest. The purchaser of insurance must have an "insurable interest" in the matter being covered, whether it is life, liability or property insurance. A more familiar phrase, "skin in the game," expresses the same concept.

If someone buys insurance on another person's life with whom the buyer has no familial or contractual relationship, or on property in which the insurance buyer has no rights as an owner or lessee, and the policyholder suffers no loss when the death or property damage occurs, he or she is perversely the winner if the loss happens. To avoid this 'moral hazard' or the temptation to abet the loss and reap a windfall, insurance law has long required that the buyer have skin in the game.

California's Insurance Code section 280, for example, flatly states, "If the insured has no insurable interest, the contract is void." Several other states have similar standards, including but not limited to Arizona, Florida, Louisiana, Nevada, New York and Pennsylvania.

The usual model is that the HOA board buys a "blanket" property and liability policy to cover damage to the common areas and injuries occurring on those areas, and each homeowner buys a similar policy covering only his or her house and contents. The homeowner does not own the common areas, and so usually will not have an insurable interest in the shared clubhouse and cannot insure it.

In free-standing homes within a development, insuring property is usually each owner's responsibility under the terms of the contract of sale or the CC&R rules. CC&Rs often require the HOA itself to procure insurance on all the common areas of the properties. Here is an example of one such clause:

"The Association must obtain and maintain a master or blanket policy of fire and casualty insurance, for the full insurable value of all the Improvements within the Common Area and on any Common Facilities, excluding land, foundations, excavations and other items normally excluded from coverage. The insurance must be kept in full force and effect at all times and the full replacement value of the insured property must be redetermined on an annual basis.

The private areas — the residences — are not covered under a blanket policy of this type."

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The HOA may be required to maintain other types of coverage for the good of all. These include comprehensive public liability and property damage insurance for the association, members of the board of directors, any manager and the owners, but only as to liability arising from the ownership and use of the common areas and other association real or personal property. It does not provide liability insurance to the owners for events occurring on their property.

CC&Rs usually allow the HOA to purchase a directors and officers (D&O) liability insurance policy, protecting volunteer directors, officers and committee members against claims against them for the decisions they make in the course and scope of their duties. Most HOAs cannot function without such volunteers, and few would accept managerial roles without protection from claims and lawsuits.

There is a common interest among HOA members, as with the rural farmers who rebuilt the barn. In both cases the goal is to maintain the value and utility of property. In an HOA, the CC&Rs are generally aimed at preventing one owner from altering the size, uses or appearance of his/her property in ways that diminish the value of other properties. Such alterations might be adding a second story that blocks sunshine to a neighbor's solar panels or creating an eyesore by repainting a house in psychedelic paisley colors. When buying a house within an HOA one surrenders some rights to acquire communal advantages — tennis courts, clubhouses and private security services, for example. It's a trade-off.

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In condominium developments, especially high-rises, these considerations apply and can be intensified by the proximity of the units. An unreported plumbing leak occurring in unit 14C while the owners are away on a two-week trip might damage units 14B, 14D, and 13C. That's a routine example, easily fixed. But if a construction defect allows widespread water intrusion damage to nearly all the units as well as the common areas, the remedy and its insurance implications become curiouser and curiouser.

The issues are further tangled by another insurance concept: additional insureds. A bit of background: During construction of a housing development or condo there is typically a general contractor, who performs some of the work and selects subcontractors to perform specialized work, such as plumbing, carpeting and electrical installation.

The contracts between the general contractor (G.C.) and each subcontractor (sub) usually require that each sub indemnify the G.C. for any claims against the G.C. arising from the sub's work and require the sub to name the G.C. as an "additional insured" on the sub's liability insurance policy.

The sub's liability policy may contain a "blanket additional insured" clause, meaning that anyone to whom the sub owes indemnification under a contract is automatically considered insured under the sub's policy. That's not always the case. Without a blanket additional insured clause or an endorsement issued by the insurer, the sub's duty to indemnify the G.C. is not backed by insurance.

These are the generic concepts. This article does not address the unique laws and insurance programs for earthquakes, hurricanes and certain other catastrophic events.

Plenty of blame to pass around

Here is a fictitious but all-too-frequent fact pattern in a large-scale property damage case. Three years after a 150-unit home development governed by an HOA was completed, owners noticed that their driveways were cracking and splitting apart. The same was happening to concrete surrounding the common areas.

The HOA and its members filed suit against the G.C., the rebar assembly sub, the concrete sub, the grading sub, and the soils consultant who recommended the degree of soil compaction. The G.C. invoked its right to be indemnified under the subcontract agreements. However, the concrete sub's liability insurance policy did not have a blanket additional insured endorsement. Though the concrete sub's insurance broker issued a "certificate of insurance" stating that G.C. was an additional insured, the sub's insurer never issued an endorsement to that effect.

Incensed, the sub sued its insurance broker, alleging malpractice. One homeowner, Burton, sued the HOA and its board members, alleging that the concrete sub was owned by the G.C.'s son-in-law, a fact never disclosed to the owners.

The HOA had not procured a D&O policy. Though the CC&Rs required owners to name the HOA an additional insured under their homeowners policies, Burton's insurer refused to do so because, under applicable law, the HOA lacked an insurable interest in Burton's driveway.

There are enough contentions in this scenario to keep a squadron of law firms busy for three years, not an unusual estimate in such cases. Many construction cases never see a jury, thanks to court-appointed Special Masters or mediators who are skilled at resolving multi-party lawsuits.

The irony of this tragic tale is that all the parties should share two common interests: to replace the concrete, and to avoid the delay and expense that litigating the case would entail. By recognizing these interests early in the dispute and involving an experienced neutral to guide it to resolution, all parties can make the best of a bad situation.

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