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Fall Forum: Planning for the Realities of Aging & Failing Piping Systems

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Water is the nemesis of condominium living. Water damage that occurs in stacked units and even townhouse-style condominium associations can result in expensive losses that affect multiple levels involving other units and common area, and while both old and new condominium associations experience water losses from similar sources (overflow of washing machines, icemaker supply line breaks, condensate line leaks, tub/sink/toilet overflow), older buildings are also challenged by aging infrastructures that if not addressed early can result in frequent and/or severe losses that can impact the loss history, the delicate balance of the Association's budget, and even the marketability of the Association.

The insurance portion of today's discussion will focus on what can happen to an Association's insurance program when repairs are delayed, deferred, or worse, ignored.

Everyone starts with a clean slate until…

For Associations with a clean loss history (typified by little or no claims activity over a five-year or longer period), insurance is a buyers' market. Strong reserves, a well-maintained, attractive building(s), and a relatively clean loss history can result in multiple offers of insurance from highly rated carriers, as well as stable renewal offers from incumbent carriers.

But what happens when the Association's history begins to experience claims, particularly from water? First, carriers are looking for frequency and severity. A single burst pipe claim of $25,000 against several years of little to no other claims activity and an adequate annual premium will usually have little impact on an insured's program, but an uptick of similar losses requires a carrier to take notice, and this can happen sooner with smaller associations since premiums are small to begin with; larger associations can absorb some losses with the "safety in numbers" philosophy.

What are carriers looking for? Initially, loss ratios: your premiums over a one- through five-year period are scrutinized annually. For example, an association that has paid approximately $25,000 annually for five years can stand to have a $25,000 claim or a smaller claim periodically. If that's the only loss, then the five-year loss ratio is only 20% of written premium. But take the same association with three claims of $20,000 in three years and then one very large claim of $80,000 in the fourth year and suddenly the loss ratio is more like 80 percent. That's when the insurance program is in jeopardy and very likely can see significant deductible and premium increases, or worse, cancellation.

Once the loss history is affected, any of the following can happen, from least severe to most severe:

1) The loss history makes the Association less attractive to insurers, which makes bidding insurance more difficult. Bids, generally speaking, are for healthy condominium and cooperative associations; they are not for associations running from increases in premiums and deductibles because of losses, particularly if they have not done anything to curb those losses.

2) The current carrier increases premium. Typical premium increases in the current market for healthy associations are anywhere from 1% to 6% and may include valuation changes to ensure proper insurance to value. Claims can result in increases above normal levels of 10% or more.

3) In addition to increasing the premium, the carrier may also apply a separate per-occurrence water damage deductible as a means of controlling loss. These can range from $10,000 to $50,000 in the standard market.

4) If losses have been severe enough, the carrier may even apply a $5,000 (or other amount) *per-unit* water damage deductible. For example, if six units are damaged in a single water event, the Association would pay a $30,000 deductible before any insurance is triggered. For Associations in the District of Columbia and Maryland, where deductible responsibility is statutory, per-unit deductibles are likely to be shouldered mostly by the Association as a common expense (Maryland limits responsibility to $5,000 to the owner where a loss originates; DC's law is similar, but allows deference to the bylaws; still, neither statute assigns responsibility to owners affected by a loss that originated in another unit); for those in Virginia, usually all of the deductible is shouldered by the Association as a common expense unless the bylaws provide otherwise.

5) If claims have been severe and/or frequent, the insurance program is ultimately canceled. Absent major completed repairs to address the cause of loss, once a program from a standard market carrier has been canceled, the likelihood of replacing the program with another standard carrier's program becomes slim. Carriers don't want to take on the problems of another carrier without solid evidence of repairs being made (and they may require a signed contract and repair updates to bind).

6) The insured finds the only carriers available are those in the non-standard market using non-admitted carriers. While non-admitted carriers (also referred to as "excess and surplus lines insurers") are typically still highly rated by insurance carrier rating agency AM Best (remember, unless options are unavailable, insurance agents still need to follow the provisions of the governing documents), non-admitted carriers are not regulated in the state and do not contribute to a state's guaranty fund, which protects policyholders from the bankruptcy of its insurance carrier. Excess and Surplus lines policies typically include policy fees, inspection fees, state tax, and offer no policy payment plans which then requires insureds to either pay premiums in full or finance and incur finance fees.

7) Once an Association finds itself in the Excess and Surplus (E&S) market, they may stay there for anywhere from three- to five years while the Association works to address the problems that lead to repetitive loss. Associations that are not able to get the work done because of financial constraints or an inability to secure project financing may linger in the E&S market indefinitely, and while the coverages from the E&S market may meet the basic requirements of the governing documents, coverages may have more exclusions, fewer enhancements, higher deductibles, and certainly the premiums can be twice as expensive.

But the loss started in a unit!

Very often I hear board members and community managers advise an owner who experiences a loss in their unit from a pipe or other unit component to file the claim with their own insurance carrier – particularly if the loss is confined to that unit. Please don't do that. While some bylaws may be unique, the vast majority of bylaws in Maryland, the District of Columbia, and Virginia are written such that the Master Policy is always primary and that insurance coverage carried by owners shall not be brought into contribution with the Master Policy at time of loss; DC and Maryland's Condominium Act provisions echo this premise. In some cases, bylaws may allow for some responsibility if there is true negligence, but for the purposes of this topic, it is unlikely a condominium owner could be found negligent of failing to maintain pipes that are behind a finished wall.

With some exceptions*, the bylaw insuring agreements for condominiums in Maryland, DC, and Virginia require the Master Policy to cover the units as they were originally conveyed, including original grade floor, ceiling, and walls coverings, counters, cabinets, appliances, fixtures, and equipment. The condominium unit owner's (HO-6) policy is written to respond, then, to an owner's improvements, betterments, alterations, and additions (made or acquired), their personal property/contents, personal liability (the Association's General Liability coverage does not reach inside the units), additional living expenses/loss of use (in the event they must live elsewhere during the period of restoration), loss of rental income (for investor owners), loss assessment, and content manipulation during repairs.

** The insuring provision in the Virginia Condominium Act is bylaw-dependent and defers to the condominium's instruments. Some older associations may not require coverage for the units at all or may require the entire unit to be covered including improvements and betterments; newer associations typically call for coverage of the units as originally built. We encourage you to review your individual bylaws with an insurance professional and general counsel to determine your specific insuring agreement.*

** Provided a building has horizontal boundaries, the insuring provision in the District of Columbia Condominium Act requires coverage of the units as originally conveyed absent improvements and betterments.*

But the board and management can't enter the units to make repairs…

This is a common refrain among board members and community managers. Unless there is an active loss taking place, boards of directors and managers often believe they have no right to enter a unit to affect repairs or make changes in order to avoid future loss; I hear this in particular when it comes to aging water heaters and leaking pipes, particularly polybutylene pipes. Maryland and District of Columbia law allow for a very broad right of entry, which we encourage Boards to utilize to force changes to reduce loss. Boards in Virginia should consult with their individual bylaws; it may be possible to create allowances for entry under certain circumstances and with proper advance notice.

It may also be helpful to review your own bylaws when attempting to make global repairs and replacements. We have been very successful in working with attorneys to force replacement of polybutylene pipes when the bylaws include such language as "No unit owner shall permit anything to be done or kept in the unit or on the common elements which will result in the cancellation of insurance on the building or contents thereof or which would be in violation of any public law, ordinance or regulation." In past experience, the existence of polybutylene pipes has qualified as keeping something in the unit that would result in cancellation of the insurance policy.

Deductible Responsibility

Both Maryland (as of June 2009) and the District of Columbia (as of June 2014) allow for a shift of the Master Policy's deductible to the owner in whose unit a loss originates or from a component (including a pipe) that services only that unit. In Maryland, this responsibility is limited to $5,000 (even if the Master Policy's deductible exceeds $5,000). The statute in the DC also is limited to $5,000 unless the bylaws provide otherwise (i.e., if an Association's governing documents provide for greater deductible responsibility, the bylaws prevail). Most condominium unit owners' (HO-6) policies can be written to pay the Association's deductible less the HO-6 policy's deductible.

Virginia presently has no statutory deductible provision, but Associations may be able to shift this responsibility via a bylaw amendment; Virginia associations should consult with general counsel to see if this is possible.

Community Responsibility

Before insurance claims can negatively impact the budget, condominium fees, owners' own policies, and potential buyers, examining the types of losses that are occurring in your community's building(s) is imperative. Insurance carriers do not want insureds to think of the insurance policy as a maintenance contract. They are looking for you to prevent the preventable loss. If pinhole leaks and burst pipe losses are becoming problematic, an association's Board is encouraged to act sooner rather than later. While reserve studies may indicate full or partial pipe

replacement in the future, current claims activity should dictate whether these repairs should be scheduled sooner. Consider the cost of replacing pipes now (while losses are still infrequent or perhaps below the Master Policy's property damage deductible) vs. the additional premiums and deductibles that will be incurred if losses are allowed to become more frequent and/or severe leading to cancellation of a good insurance program. Insurance agents don't enjoy watching Associations spend money on insurance. We prefer that you spend your money on your infrastructure. Stable associations, too, are able to get reduced financing rates for capital improvement loans, whereas associations with troubled loss histories, high premiums and deductibles, and challenged balance sheets may not qualify for lower loan rates.

Failure to proactively address infrastructure problems such as aging pipes may also lead boards of directors open to suits from owners who view the board as failing to protect their investment. While owners may not be happy with increased condominium fees or special assessments, loss of market value because of neglect is a common cause of lawsuits against boards of directors even when the Association's documents include a limitation of liability provision. While board members are elected volunteers, they still have a fiduciary responsibility to make certain that the association remains sound. Seeing potential issues before they become problems and addressing those issues to avoid damage truly is what can set your community apart from others that have not heeded similar advice.

Note for District of Columbia Cooperative Associations:

It is recommended that Cooperative associations review their Articles of Incorporation, Lease Agreement, and House Rules for specific insurance provisions. In addition, the deductible law that passed in June 2014 making owners where a loss originates responsible for the Master Policy's Property damage deductible (not to exceed $5,000 unless the bylaws provide otherwise) does not apply to cooperative associations.

Note for Maryland Condominiums:

The Maryland Legislative Action Committee (MD-LAC) will be seeking during the 2018 legislative session a possible increase of the deductible responsibility limit from $5,000 to $10,000. A second bill may also be introduced requiring owners in condominiums to carry a condominium unit owner's (HO-6) policy. Updates will be made available by the Washington Metropolitan Chapter of CAI, through the MD-LAC, and through my office.

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