WHAT'S MY LINE:

WILL THE REAL COMMUNITY ASSOCIATION RISK MANAGER PLEASE STAND UP?

COMMUNITY ASSOCIATION RISK MANAGEMENT

Presented By:
Joel W. Meskin, Esq., CIRMS

As my father used to say: "*Why is there never time or money to do something right the first time, but there is always time and money to fix it?*" This old adage seems to apply far too often to many community associations we have seen around the country.

At the core, a community association whether it be a condominium, single family homeowners association, cooperative, timeshare, or commercial association, the structure is substantially the same.

A Separate Individual Interest in real property

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Common Interest shared with others

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Formation of a legal entity

Art. of Incorp./Condo Statute - Legal Status

By-Laws - Association Operating Manual

Covenants, Conditions, & Restrictions

= An Operational Association with Association Members

If the community association is properly formed, it can then manage its risk, which is the "shared common interest of the association members." It can make enforceable rules; it can enforce those rules; it can enter into contracts; it can obtain a reserve study; it can set forth a policy to fund reserves; and, it can purchase insurance.

So, who is the community association risk manager? The board of directors is the Risk Manager. A typical provision of a community association declaration provides:

"*Not withstanding any management agreement entered into by the Association through its Board, the Board shall always retain and be responsible for the enforcement of each and every provision contained within this Declaration and the By-Laws, and shall not assign these responsibilities.*"

What is the Community Association Risk?

The two assets for which the Risk Manager must protect is the community association are the "lifestyle" of the association as set forth in the governing documents and rules developed by the members of the association over time. The second involves the physical assets of the community association common interest. The physical assets impacts both the property value of the association members real property interest and the lifestyle of the community as people give up certain control of their castle in exchange for the association guarantee that the physical elements will be maintained.

Wear & Tear

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Unexpected Perils

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Risk

What is the role of the Community Association Risk Manager?

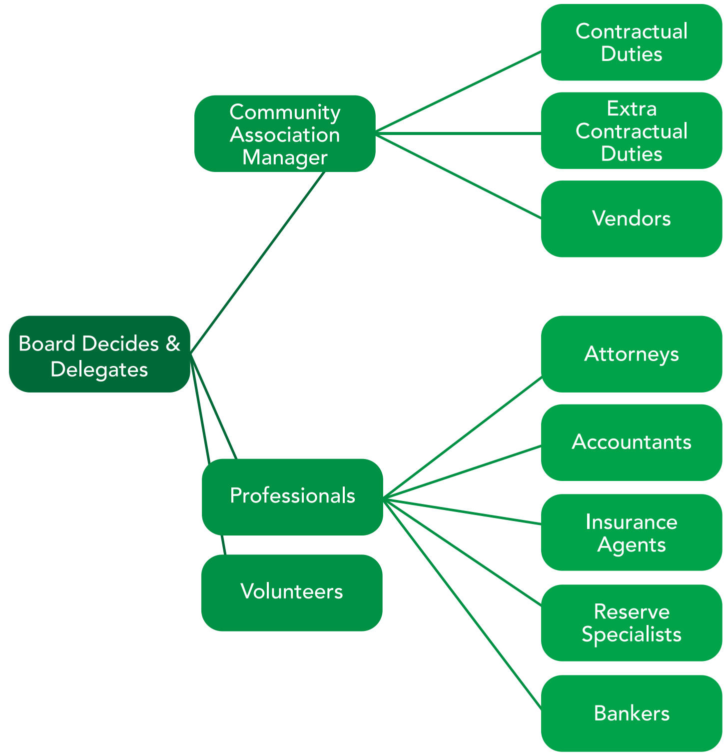
Many people throw around the term "fiduciary duty" or "duty of good faith and ordinary care" in the exercise of their duties. At the end of the day, the board of directors is judged pursuant to a "business judgment rule" to carry out their duties to manage the association, their duties as the "ultimate" risk manager. In this role, the board has the duty to manage and they are authorized to delegate the details of the management and to retain professionals when the management issue or task at hand is beyond their area of general competence.

One issue that boards need to be cognizant of is that many board members are themselves professionals which degrees and licenses such as attorneys, insurance professionals, engineers, accountants, architects and even community association managers. These "board" members may be the top in their field and may know more than other professionals in the community. However, what the board needs to keep in mind are a couple of important factors. First, these board members are covered in their capacity as a board member and not in their "professional services." Accordingly, in the slight chance that the board member is wrong in providing professional services, the association will be self insured which is taking on a liability exposure for the association it was elected to protect, putting the association and its members' assets at risk. If the board member who is giving professional advice accepts any competition, he or she is no longer a volunteer and therefore may not be covered by the association and indemnification provision and may also have canceled any volunteer immunity protection.

A second issue which is similar involves the community association manager hired by the association. It is very common and highly recommended for a community association to retain an independent management company to carry out the decisions and policies of the risk management board of directors. However, like the other professionals sitting an association members on the volunteer board, the community manager is covered for its community management services pursuant to a management agreement with the association, or at the direction of the association board. However, if they pursue professional services for which they are not licensed, they will not be covered by the D&O policy where they are covered. More importantly, the community association manager will not be covered under its own errors and omissions policy, because the other professional services are not within the definition of their community management professional services. The problem here is even bigger, because the community association may have an indemnification requirement under the terms and conditions of the management agreement to defend, indemnify and/or hold harmless the manager when it conducts business at the direction of the board.

The theme of most associations is to be as "lean and mean" as possible, and try to push as much into the lap of the manager as it possibly can. Although this may seem expedient for all involved, the unintended consequences can be huge and could be a clear breach of the risk management board's duty. This very often involves gray areas, but as an ultra conservative risk manager, attorney and insurance professional, I always recommend that the association with the fiduciary duty or duty of ordinary care err on the side of caution. If the question arises, the professional should be hired.

The community association risk management team in our opinion looks as follows:



As most governing documents provide, the community association board is ultimately responsible for all community association decisions. The role of the board is to make decisions, make policy, and make rules in order to protect the community association assets and to delegate the necessary tasks or jobs to make those decisions and policies get accomplished. In the normal course, the majority of the activities that are required to be accomplished on a day to day basis are covered in the management agreement and fall within the category of "contractual duties." As with most contracts, not everything can be anticipated. Accordingly, there are extra-contractual duties delegated to the manager and these should be documented as amendments to the management agreement, especially where most director and officer liability policies may only provide coverage pursuant to a written management agreement. Finally, most management agreement provide for the manager to have certain authority up to certain monetary limits to enter into contracts with vendors on behalf of the association.

The board also needs to retain "professionals" for certain decisions. Again, the key reason for this is because the licensed professionals have their own professional liability coverage. This should be an absolute requirement before engaging a professional. The goal is to hire the best, but even the best make mistakes and they should have their own professional liability to stand behind their work. This is rarely a concern, but it is part of the board risk manager due diligence and it is critical to get this in writing.

The final piece of the risk management team is volunteers. I contend that the board only functions as a "body" at a properly noticed board meeting. The board members very rarely have any duties outside of the board meeting other than those directly given to them by the board as a whole during the properly notice board meeting. After the task is delegated to the board meeting, when he or she leaves the board meeting, he or she is acting as a "volunteer." The pain and suffering of many board members and their boards is when they forget this concept and entertain issues of association members outside the board meeting and try to resolve those issues, for which the really do not have the authority to do. Most association member issues should be directed to the managers for handling and if it is an issue that is not within its authority, the manager should bring it to the board in the normal course of business. If there is an emergency, the unity owner should call 911. When the board member exits the board meeting, he or she should remove their board hat.

How is the Community Association Risk Management Program funded?

The board risk manager has the two key exposures to protect in addition to the lifestyle issues. The lifestyle issues are protected by enforcement of the governing documents. The other two categories are "Wear & Tear" and "unexpected perils."

Wear & Tear

The keystone to the "Wear & Tear" exposure is the Properly Completed Reserve Study. In a perfect world, this was originally done by the Developer, or the "Transition Team" at the time that control of the association was turned over to the control of the association. There are some developers who have the mission that they do not want to sell you "a house," but they want to sell you "all of your houses." Accordingly, it is in their best interest to have a transition study done. I recommend that they should commission an independent reserve/transition study on behalf of the association. If there are any issues, knowing them as soon as possible is better. The older we get, the clearer it becomes that the sooner we know of an issue, the easier and cheaper it is to fix.

The reserve study, when done properly, is the blueprint of the wear and tear portion of the risk management program. This is also key for the insurance professional so he or she is able to use it to put together the insurance program and to use it as a check and balance against a property walk through, a review of the existing insurance program, its review of the governing documents and the corresponding insurance requirements and its discussions with the Board Risk Manager, and in most cases the community manager.

Having handled the thousands of director and officer claims that we have over the years, we can often see their genesis from the absence of a properly completed, updated, and funded reserves study. In our opinion, it is worth its weight in gold.

The reserve study is the key to setting an associations "budget." This should present the basis of what is necessary to properly operate the association on a daily basis and the anticipated cost of taking care of "wear and tear." We can have lengthy debates regarding whether it is better to fund a reserve study as close to 100% as possible or whether we should leave it to the owners at the time things need to be fixed. They key to community association risk management is "certainty" and the ability to avoid as many surprises as possible. The goal, contrary to belief of many is not to keep assessments as low as possible. Rather, the board risk manager is obligated to protect the assets of the association and place the association interests above his or her own interests. We have never seen any governing documents that indicated that low cost is a goal. Rather, the goal is protect the assets.

Unexpected Perils

Unexpected perils happen!

Many perils are insurable, and there are some that are not. In addition, some items that are insurable have a heavy price tag. California has a big earthquake exposure. Florida and Texas, as well as some others, have a hurricane exposure. In our humble opinion, community associations must obtain this coverage, notwithstanding price, based on the duty to protect the association interests. In reality, this does not always happen.

The duty of the board risk manager is to obtain the best coverage available. As a board risk manager, the board needs to use a community association insurance professional to do the evaluation and to make a proposal. In our opinion, "shopping insurance" does not mean looking for the best policies available (which for many translates to the cheapest), but to shop for the appropriate community association insurance professional. If they are truly a professional in this industry, they will know the best markets available. If you have many insurance brokers going to the market, you may very well get a proposal from various insurance professionals that is not the best, but is the best that that individual insurance professional could get, because another insurance agent you are allowing to "bid" has blocked the first one from a market. If you do not like what the insurance professional has done, if you do not like the service prior and after the insurance is obtained, fire him or her and interview another. Here is what the board risk manager should do.

Select a Community Association Insurance Specialist to Develop the Insurance Portion of the Community Association Risk Management Program

- Shop for the Coummnity Association Insurance Specialist (licensed insurance agent), not the product
- How long has the insurance professional been involved with community associations?
- How many associations does the professional handle, including ones like yours?
- Obtain references to contact at neighboring associations handled by the specialist

- Ask what they need to analyze your program (if they do not ask for your governing documents, if they do not ask to review your existing policy, or if they do not ask if you have a reserve study, say thank you and interview your next candidate)
- Ask how many management companies they work with at this time
- Ask if they have any community association or relevant insurance designations
- Ask if they participate in any industry organizations such as the Community Association Institute
- Ask what roll they will play in the event of a loss
- The professional must present to the board in person—end of story!
- Ask what the community association insurance specialist will do once the program is put together, i.e. explain the requirements of each policy in the event of a loss, and provide education

The big issue we come across with the board risk manager is that they try to delegate their insurance responsibility. Their authority is to make the decision. The decision if they believe it is beyond their level of understanding, they can seek assistance from a community association insurance professional. Once the board sits with the community association, the mystery and complexity of insurance is often overcome. If not, they probably need a different professional. Again, many managers can put insurance professionals to shame with their knowledge and experience, but do they have the errors and omissions coverage to back up their advice?

When the board risk manager is obtaining proposals from multiple insurance professionals, if the board chooses to go with that strategy, they should request the proposals without the pricing. Accordingly, the board can go through the multiple proposals, determine which is appropriate to protect the association assets. After they have determined which best protects the community association's assets, they can then consider the pricing and make the cost benefit analysis as to whether it is in the best interest of the association to be self-insured for certain perils and roll the dice that no claim will happen and they will dodge a bullet.

Conclusion

The board is the community association risk manager. The board's duty is to place the interest of the association above its own in order to protect the assets of the association. The Board makes the decisions and delegates to its risk management team to effectuate the risk management plan. The community association is a business and the job as a board member should not be accepted lightly or with the idea that you are just rubber stamping the work done by someone else.