10 Steps to a Well-Designed HO 6 Policy

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I originally wrote this article 6 years ago, but it is time to revisit the topic. In recent years, townhouse/condominium associations have been choosing higher deductibles on the master policy to keep costs down while simultaneously shifting responsibility for the entire master policy deductible to affected individual unit owners. The insurance industry has just responded with deductible assessment endorsements to the HO 6 policy intended to cover the unit owner's responsibility for the deductible. In some cases today, that assessment can be as high as $25,000 or even $50,000.

by Jack Hungelmann
Corporate 4 Insurance Agency, Inc.

Today, an owner of a condominium or townhouse is much more likely to have major insurance gaps in his or her property and liability insurance coverage than the purchaser of any other personal insurance policy is. There are several reasons for this.

First, the basic structural coverage of the standard unit owners policy (HO 6) is generally quite inadequate. For starters, the perils covered are the equivalent of a homeowners form 2—named perils on building and contents. Also, the structural coverage limits are usually grossly inadequate. Typically, the Coverage A structural coverage under the HO 6 policy is just $1,000. Most unit owners are legally responsible for insuring much more than that.

Additionally, coverage for loss assessments is inadequate in two ways. This can be loss assessments that are association-wide, such as those that arise when a lawsuit for serious injuries ends up in a judgment that exceeds the association's general liability coverage limit, and the excess is assessed to all unit owners. This also can include loss assessments made against specific unit owners when a loss is caused by the unit owner's negligence, such as a kitchen fire, and the entire association master policy property insurance deductible is assessed against that unit owner. An HO 6 policy usually comes with only $1,000 of loss assessment coverage. But, even if limits for loss assessment coverage are increased to, say, $25,000, in most cases, assessments for deductibles are still only covered for $1,000 under the increased loss assessment policy endorsement.

Broadening the Perils Covered

The unendorsed HO 6 policy provides named perils coverage only for both Coverage A structural claims and Coverage C personal property claims. (This is the unit owner equivalent of a homeowners form 2—a policy rarely sold today because of its limited coverage.) An agent for a townhouse or condo unit owner needs to change the perils covered to special perils at least for structural claims (i.e., HO 3) and probably for personal property claims as well (i.e., HO 5). This is especially important in an association because the unit owner cannot directly control the exterior maintenance. So, for example, if the older roof in need of replacing leaks all kinds of muddy water onto a unit's carpeting, hardwood floors, cabinets, furniture, piano, clothing, etc., causing major damage to these items, the unit owner will have no coverage at all unless his agent had upgraded the perils covered. ("Water damage from roof leaks" is not one of the "named perils," nor is it an excluded peril under the "special perils" form.)

Measuring the Interior Structural Risk

A second reason for the difficulty in setting up an HO 6 policy with adequate coverage is the difficulty of identifying and measuring the amount of structural insurance for which the unit owner is responsible. The home owners' association insures the majority of the structure of each unit. The unit owner is responsible for insuring just the part of the structural interior not covered by the master policy, as spelled out in association documents (typically the "Declaration" rather than the "Bylaws") and any pertinent state laws (see below). The most common language in a declaration document is that the unit owner is responsible for everything inside the bare walls and bare floor of the unit. This means that the unit owner is responsible for insuring all of the items shown in Table 1.

Table 1	
Unit Owner Structural Responsibility Items	**Sample. Replacement Cost Installed**
Carpeting, hardwood floors, ceramic tile, any other flooring	$25,000
Wall coverings	$5,000
Lighting fixtures	$2,000
Plumbing fixtures (e.g., toilets, tubs, etc.)	$8,000
Built-in appliances	$3,000
Kitchen cabinets	$15,000
Unit owner installed improvements (e.g., screened-in or four-season porch)	$20,000
Any other improvements made to the unit by all previous owners (usually very difficult to determine, especially for an older unit with several previous owners)	$20,000
Total Replacement Cost Installed	**$98,000**

The installed replacement cost of the items in this particular example is approximately $100,000. Clearly, the HO 6 basic coverage of $1,000 is grossly inadequate.

Discover All Pertinent State Laws

Some states have passed laws limiting how much of a condominium unit interior a unit owner can be held responsible to insure. In Minnesota, for example, under the Minnesota Common Interest Ownership Act—Statute 515B.3–113—an association can hold a unit owner responsible for no more than "ceiling or wall finishing materials, floor coverings, cabinetry, finished millwork, electrical fixtures, plumbing fixtures, built-in appliances, and all improvements and betterments to the unit, regardless of when installed." In Table 1, each responsibility is within the law. But, if there were other requirements, such as responsibility for interior non-load-bearing walls, wiring within the walls, etc., the law would supersede the added bylaw requirements, and the unit owner could ignore the value of those items when estimating his or her Coverage A exposure. [*Caution:* Some older townhouse associations are exempt from the law, so make sure the association is covered by the law before relying on its requirements.]

Measuring the Loss Assessment Exposure

Another shortcoming of the basic HO 6 policy is the minimal amount of coverage—usually $1,000—for assessments made against all unit owners for uninsured or underinsured property or liability claims. Three examples, assuming 100 units in the association, follow.

- The complex, insured for $5 million, is destroyed by a tornado and costs $8 million to rebuild. The $3 million shortfall would be assessed to the 100 unit owners—that is, $30,000 each.
- A drowning occurs at the complex swimming pool. A lawsuit ensues, resulting in a $4 million judgment. The association carries $2 million of liability coverage, resulting in each unit owner being assessed $20,000.
- Heavy rains lead to a massive sewer backup in the complex. Cleanup costs and repair costs total $75,000. The association board did not purchase sewer backup coverage, leading to an assessment of $750 to each of the unit owners.

Under the basic HO 6 policy, with $1,000 loss assessment and named perils coverage, our hypothetical unit owner will be personally out of pocket for $29,000 from the tornado assessment, $19,000 from the lawsuit assessment, and $750 from the sewer backup assessment (not a covered "named peril").

Because additional loss assessment coverage is so inexpensive, I recommend always including at least $25,000–$50,000 additional limits with each HO 6.

A fringe benefit of broadening the perils covered is broadening coverage for loss assessment. Loss assessment coverage applies to those loss assessments arising out of perils that are covered by the particular unit owner's HO 6 policy. When the coverage is broadened to special perils, the perils covered under the loss assessment optional coverage are also broadened. Coverage for sewer and water backup should be added as well, not only because the exposure otherwise isn't covered but also because, by adding that endorsement, sewer and water backup coverage is added to the loss assessment perils covered.

Note that if the unit is in an area exposed to the risk of earthquake, and earthquake coverage is purchased, most increased loss assessment endorsements will not include earthquake automatically. The best strategy to avoid this risk is for the unit owner to strongly lobby the association board to purchase earthquake coverage on all the structures and buy "earthquake loss assessment" coverage.

Covering a Unit Owner's Responsibility for the Master Policy Deductible

Yet another reason why the HO 6 policy is so difficult to set up correctly is that more and more associations have changed their rules so that the master policy deductibles are no longer always assessed association-wide against all unit owners but rather are assessed against an affected individual unit or units. With significantly rising insurance costs for association master policies in the past few years, more associations have gone to higher deductibles of typically $5,000 or $10,000, but in some cases even $50,000.

The problem with those higher deductibles for a specific unit owner is that if the loss is caused by the negligence of a unit owner, such as a bathtub that overflows or a kitchen grease fire, the association deductible can be the sole responsibility of the negligent unit owner. Unfortunately, in many cases, insurance companies have been slow to provide a way of covering that increased deductible assessment. Now, however, most companies have developed a specific endorsement that the unit owner can purchase to cover the full amount of the deductible assessment, or they have amended their loss assessment increased coverage endorsement to include deductible assessments against individual units.

Here are a few examples to illustrate how some insurers are currently handling the problem in Minnesota.

Table 2

Insurer	Solution
Western National	Separate deductible assessment coverage as part of the increased loss assessment endorsement with a $25,000 maximum for deductible assessments
Auto-Owners	Included in loss assessment coverage with a $50,000 maximum
Chubb	$10,000 for deductible assessments built into the basic homeowners contract with no additional coverage available
Cincinnati	Included in loss assessment coverage with a $25,000 maximum
Harleysville	Included in increased loss assessment coverage with a $25,000 maximum
Safeco	Included in loss assessment coverage with a $51,000 maximum
Disclaimer: These illustrations are intended to reflect the huge disparity in the way companies deal with this problem. Do not rely on this information as being currently accurate.	

Ensure Proper HO 6 Coverage

I recommend the following 10 steps to help agents set up the proper coverage for their clients, using the HO 6.

1. Request a copy of the association "Declaration" document. Make a list of building items not covered by the master policy (e.g., carpet, hardwood floors, tile floors, kitchen cabinets, plumbing and electrical fixtures, built-in appliances, unit owner improvements, etc.). (Be sure that the requirements are within your particular state law.)

2. Have your client estimate the replacement cost of each of the structural items that are his or her responsibility. I find it easier and more accurate to write out a list of each type of item and have the client estimate the replacement cost of each category (see the earlier table for an example of how to accomplish that). Total the values. (Don't forget the labor costs in your estimate.) To be safe, I add an additional 20 percent to the total to allow for estimating errors. That total should be the limit for Coverage A building coverage on your HO 6 policy.

3. Add "special perils" coverage to Coverage A, changing perils covered from "named perils" to "all risk" unless excluded. This is important for three reasons: it covers more losses (e.g., water damage to

walls and ceiling from roof leaks); it improves coverage for losses subject to the master policy deductible; and it changes the perils covered by loss assessment coverage from named to special.

4. Add special perils contents coverage (e.g., roof leaks, paint spills, etc.).
5. Increase the loss assessment coverage limits to $50,000.
6. Find out the current master policy deductible as well as the maximum deductible authorized in the declaration. Choose the higher (so that your client is protected when the association decides to raise the deductible to the next level). If the insurance company you are using does not offer that high of a deductible assessment coverage limit, change insurance companies.
7. Add sewer backup coverage to provide coverage for the direct damage to the unit or contents from sewer backup and sump pump failure and to broaden loss assessment coverage to include assessments for sewer backup (i.e., loss assessment coverage only covers assessments for perils covered by the HO 6 policy).
8. Assess the need for flood or earthquake coverage. If there is an exposure to earthquake, remember to add earthquake loss assessment coverage, which normally is not included in general assessment coverage.
9. Buy adequate and consistent liability coverage (i.e., $500,000) in limits equal to your client's other personal liability coverages, or in limits high enough to satisfy the umbrella underlying insurance requirements.
10. Buy an umbrella policy. Be sure it includes coverage for association volunteer activities including nonprofit directors and officers (D&O) liability coverage in case your client ever serves on the board. Caution: Because an umbrella policy only covers claims arising out of bodily injury, property damage, and personal injury, this umbrella coverage clearly doesn't replace the need for that board to carry D&O coverage.

Jack Hungelmann's book, *Insurance for Dummies*, contains much of this information and is available at your favorite bookstore or online. For more information on his risk management and insurance business, go to www.JackHungelmann.com, where you can check out sample newsletters, brochures, and other articles written on various issues. For background information, see Mr. Hungelmann's biography.

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