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## **Self-Insurance**

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# Is Self-Insurance Right for Your Association?

by Kenneth S. Direktor, Esq. and Lance D. Clouse, Esq.

## **I**ntroduction

The concept of self-insurance has generated considerable interest in recent years due to increasing casualty insurance premiums. Frustrated by the current insurance market, many associations perceive obtaining traditional insurance coverage to be an exercise in futility, given that the repair costs resulting from recent storms did not exceed the deductible under the insurance policy.

Community associations are always under pressure from owners to keep costs down and casualty insurance premiums can be the largest line item in an association's operating budget, often exceeding 30 percent or more of the total operating budget. Naturally, an alternative such as



self-insurance appeals to any association if the association can significantly reduce the casualty insurance premiums. Although self-insurance is an alternative to traditional insurance, there are significant differences between traditional insurance and the self-insurance plans that we have reviewed.

**Although self-insurance has been available as an alternative to traditional insurance, when traditional insurance was more affordable, self-insurance was not a viable alternative for most associations. There were also legal questions as to whether self-insurance could meet the requirements for coverage under most condominium documents.**

Several questions should be asked when considering self-insurance for your community. This article attempts to ask the pertinent questions and address some of the differences between traditional insurance coverage and self-insurance.

#### **Legislative Changes**

The Florida legislature amended Chapter 718 (Condominiums), Chapter 719 (Cooperatives), Chapter 720 (Homeowners' associations) and Chapter 721 (Timeshare associations) to: (1) provide that participating in a qualifying self-insurance plan is "adequate windstorm insurance"

for an association's insurance obligation; and (2) include costs and contingent expenses required to participate in a self-insurance plan as proper common expenses. For many years, Section 718.111(a)2., Florida Statutes, has provided that "[a]n association or group of associations may self-insure against claims against the association, the

association property, and the condominium property required to be insured by an association, upon compliance with the applicable provisions of [Sections] 624.460–624.488[, Florida Statutes]." The 2007 amendment specifically states that self-insurance is adequate insurance under the Statute.

Although self-insurance has been available as an alternative to traditional insurance, when traditional insurance was more affordable, self-insurance was not a viable alternative for most associations. There were also legal questions as to whether self-insurance could meet the requirements for coverage under most condominium documents. The Florida legislature promulgated these amendments to try to respond to these legal issues in an attempt to give associations an alternative to traditional insurance.

#### **The Advantage of Self-Insurance**

We have seen only a few self-insurance plans. The proponents of these plans promise a twenty percent (20%) to forty percent (40%) savings in premiums over traditional windstorm policies, depending on the age and condition of the buildings being insured. The proponents of self-insurance plans also assert that the statistical probability of a major catastrophe or combination of major catastrophes to all participating members of a plan is so remote that the benefit derived from the savings in premiums greatly outweighs any of the risks. The savings in premiums are tempting, indeed, but what are the risks?

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### Amount of Deductible

An association must first determine whether the deductible offered in a particular self-insurance plan is the same as the deductible on your traditional policy. What if your current deductible is three percent, and the self-insurance plan has a deductible of five percent? If an association's total insured value of its buildings is \$40,000,000, the deductible under the current policy is \$1,200,000. Under the self-insurance plan, the deductible is \$2,000,000. This deductible increase exposes the association to an additional \$800,000 of direct risk on the front end of a casualty claim. All wind-storm policies will have a deductible. However, a fair comparison of the savings in premiums requires that the deductibles on the two policies be the same. If you stay with the current insurer and increase the deductible to five percent, the premium savings might not be as great.

### Assessments and Reinsurance for a Major Catastrophic Event

The greatest risk with self-insurance, however, lies in the event of a truly catastrophic casualty event because the real risk lies in claims that substantially exceed the deductible. In a traditional policy, claims in excess of the deductible are paid for by the insurer and the association is protected by the Florida Insurance Guaranty Association if the insurer becomes insolvent. As further described below, this is not the case with a self-insurance plan.

Some self-insurance plans provide for an assessable amount to cover the gap between the deductible and an attachment point of the reinsurance. This means the participants in the plan are assessed pro-rata for the damage claims that exceed the deductible. For an association building with a \$40,000,000 insured value, the assessable portion of a one-half percent assessment would be an additional \$200,000 over and above the \$2,000,000 deductible. Some plans, however, may offer reinsurance coverage for the gap between the deductible and the attachment point of the other reinsurance, thereby reducing the exposure for assessments at this level.

After the deductible and the assessable portion of the policy, if any, has been exceeded, all self-insurance plans must maintain reinsurance. The self-insurance plans reviewed offer reinsurance up to a certain level from the private sector and then provide coverage through the Florida Hurricane Catastrophe Fund ("FHCF"). Recourse to the Florida Hurricane Catastrophe Fund involves a ten percent co-pay obligation over and above the deductible and any assessable portion of the policy.

At this point, the principal risk of a self-insurance plan becomes apparent in the event of a truly catastrophic event. When considering a self-insurance plan, compare the total insured value of all the property for all of the associations participating in the self-insurance plan to the total insurance coverage available from reinsurance and the FHCF. The risk to the association increases exponentially the more the value of all the property covered exceeds the available coverage under the plan. If a self-insurance plan insures \$1.5 billion worth of property with available insurance (private reinsurance and FHCF) capped at \$94,000,000, this



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leaves \$1,406,000,000 worth of the total insured value essentially uninsured. This represents coverage for only about six percent of the total insured value of the property. This is a very important figure to consider because, although the prospects for a catastrophic event of this magnitude may be unlikely given Florida's history, this is the ultimate risk in self-insurance. In fact, unlike traditional insurance companies,

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which cannot come back later and ask for more money from the insured, a self-insurance plan is a "fully assessable policy," meaning that the participating associations will be required to contribute on a pro-rata earned premium basis any amounts necessary to meet any unfilled obligations. Furthermore, if a participating member cannot or will not meet its assessment obligations,

the other associations in the plan will be responsible for covering the shortfall, also on a pro-rata earned premium basis. This factor is especially important to note, given that, as opposed to traditional insurance companies authorized to do business in Florida, self-insurance plans currently have no protection from the Florida Insurance Guarantee Association in the event a plan becomes insolvent.

**Other Risks**

There are many other risks and issues associated with self-insurance. We will address two of them. Based on the amendments to Section 718.111(11), Florida Statutes, it would appear that every association is authorized to fulfill its insurance obligation by accepting a self-insurance plan. However, it may not be that simple. Constitutional challenges could be raised based upon an impairment to existing contracts. Most condominium documents require the association to buy casualty insurance for the full insurable replacement value of the improvements on the property. The self-insurance plans we have seen claim to provide for full replacement coverage, but provide for the overwhelming majority of coverage through assessments against its members, arguably making the full replacement coverage illusory.

You must also consider the impact of self-insurance in financing opportunities. Will your owners be able to get the same financing opportunities for their units with self-insurance? A lender to a unit owner has a considerably greater risk of loss to the collateral under these circumstances. What if the association wishes to finance a significant construction project? Again, the absence of traditional insurance creates a far greater risk to the bank.

**Other Factors to Consider**

Beyond the issues discussed above, an association should evaluate with whom they will be doing business. Some factors to consider include: the financial strength of the reinsurance carrier; whether all the association properties participating in the plan are within a relatively concentrated geographical area or from diverse locations around the state; and how selective the proponents of the plan were in determining eligibility (i.e. the age, condition, and location of the buildings). The association should also examine some of the operational issues relative to the plan, such as the availability of adjusters,

the selection and removal process for trustees, directors or officers, and the level of fidelity bonding for those individuals responsible for managing the plan's assets. If the association chooses to participate in a self-insurance plan, the association should also notify its owners to give them a chance to investigate and make any arrangements they wish to make to protect their interests.

**Conclusion**

This article is not intended as a comprehensive analysis of all of the legal issues impacting an association's decision to participate in a self-insurance plan in lieu of traditional insurance coverage. The decision to participate or not participate in a self-insurance plan is a business decision for each association after weighing the advantages, disadvantages, and potential risks. Accordingly, all board members should investigate and verify for themselves the protections the association has under its current insurance and the costs associated therewith, both in terms of premiums and potential recovery in the event of a casualty loss by windstorm, and compare those protections against the coverage, cost, and recovery under a proposed self-insurance plan.

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