

Earthquake Casualty Insurance For Community Associations Insurance for “The Big One”

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Although California is known for its easy lifestyle and climate compared to the snow and flood regions of the country, the Golden State is not without its calamity risks. California is the land of wildfires and earthquakes. The specter of a catastrophic earthquake naturally leads to the question of whether community associations should purchase earthquake insurance. Given the notoriously high cost of the premiums, this is a big dilemma for many governing boards — especially for those communities along the major earthquake faults.

Must, may, or should an association buy earthquake insurance?

The purpose of this article is not to answer this ultimate question for all community associations. Whether and what insurance is appropriate is going to be different for each association. Instead, this article summarizes generally the law governing the question about an association’s rights and duties to obtain (or not obtain) earthquake coverage. We also propose questions boards may wish to direct to their insurance brokers to fully understand the various earthquake insurance products available. This article helps guide boards through the important process of deciding what to do about earthquake insurance – and, we are here to help you through it.

Check Your Governing Documents!

To understand whether an association must or may purchase earthquake insurance, the first place to look is the association’s governing documents. Most associations have comprehensive sections in their CC&Rs (less often in the Bylaws or Articles of Incorporation) specifying the type of insurance the association must purchase. If the governing documents specify that the association must purchase earthquake insurance (rare), then that arguably creates a duty for the board to buy that insurance and include the premiums as part of the association’s annual budget and assessment structure. The alternative would be to obtain membership approval to delete the requirement from the CC&Rs. However, most CC&Rs only require fire and casualty, liability, and “director’s and officer’s” coverage – either remaining silent about earthquake coverage or stating the association may purchase it. A careful review of the association’s governing documents is the first place to start.

What Does The Law Say?

The Davis Stirling Act (the “Act”) does not require community associations to purchase earthquake insurance. In fact, the Act merely encourages, without requiring, associations to

purchase other insurance and is completely silent about earthquake insurance. Under Civil Code section 5047.5(e) and 5800, the Davis Stirling Act incentivizes associations to buy liability insurance and directors and officers coverage by providing a qualified immunity to the directors for buying policies with limits of either \$500,000 or \$1,000,000, depending on the size of the association. Civil Code section 5806 requires an association to maintain fidelity bond coverage for its directors, officers, and employees. That's it for insurance under the Act! Earthquake insurance is not contemplated by any of these provisions.

However, just because earthquake insurance is not mandated by the association's governing documents or the Davis Stirling Act does not mean an association cannot, and arguably in some regions along the fault lines should, at least consider purchasing earthquake coverage. What is clear is that each year the association must disclose to its homeowners the full extent of its insurance portfolio, whatever it includes. Civil Code section 5300, subdivision (b)(9) requires disclosure of a summary of the association's property, general liability, earthquake, flood, and fidelity insurance policy as part of the association's annual report to members.

Overview of Available Earthquake Products and Questions for Insurance Broker

What earthquake insurance products should a board consider, and what questions should the board ask its broker? The main earthquake insurance products presently available fall into three basic categories:

Master Earthquake Policy: Purchased by the association to cover the entire project (with certain exclusions and exceptions).

Individual Owner Policy: California Earthquake Authority ("CEA"): Purchased by the individual owners through carriers approved by the CEA to cover the (sometimes large) deductible an association might have to pay through a special assessment and other gaps between the association's master policy limits and the cost to rebuild. Often, these policies include owner relocation costs during reconstruction.

MOTUS: Association "Mini" Master and Individual Owner Enrollments: This product is newer, and might require some additional homework. The association purchases a "mini" (limits of \$10,000.00) master policy, allowing the owners the opportunity to enroll individually to purchase coverage roughly equal to what a special assessment would be for an uninsured catastrophic earthquake loss. Some brokers describe the MOTUS as designed to be supplemental to a full Master policy – make sure your broker explains this!

The main questions to ask an insurance broker are:

- What are the premiums?
- What exactly does the "master" policy cover versus the individual CEA policy, and how does that compare to a MOTUS product with the association as insured under a "mini" (\$10,000 limit) master policy, with individual owner enrollments?
- What is the association's deductible (often a percentage of the loss)?
- What are the policy limits?

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- What is the estimated cost to rebuild the entire project in the event of a catastrophic loss?

The premium for a master policy is tied to the policy limits and the amount of a deductible the association chooses in the event of a catastrophic event. An important fact for boards to understand about their project, in evaluating the adequacy of a proposed master policy, is what is the actual estimated cost to rebuild the project? Understanding this is important to assessing how close to complete coverage the proposed policy would yield in the event of a total destruction of the building(s). The MOTUS model of insurance is an interesting concept, but it relies almost exclusively on individual owners to enroll and most brokers explain that even with 100% owner participation the MOTUS does not replace the value of a full coverage Master policy. Moreover, if only a few owners enroll in the MOTUS, the policy is not going to do much for the community in the event of the Big One. Another useful comparison is to consider what the total cumulative premium cost is for all owners to enroll in a MOTUS, and that compares to the total premium for a traditional association master earthquake policy? It may be less expensive overall, with better coverage, for the association to simply purchase a master policy with limits sufficient to cover the reconstruction, passing the premium on to the owners through the assessments. But a MOTUS is sometimes viewed by some as better than nothing, and it does provide the association an opportunity to educate owners on options which are available.

Membership Involvement in the Decision.

In most cases, the board makes all the arrangements and final decisions for the association's final insurance profile. However, when it comes to earthquake insurance there are many reasons why membership input (or vote) is either a good idea and in some cases required. If your association does not already have earthquake insurance built into its budget and assessment structure, the decision to purchase earthquake coverage might require membership approval as a practical matter because of the significant increase in revenue needed to cover the premium. It might require an increase in regular assessments beyond the discretionary increase the board may make each year without membership vote. If your governing documents require earthquake insurance, but the premium is deemed by the board cost prohibitive, an amendment to delete the requirement might help mitigate a breach of duty claim for failing to obtain the insurance. If your governing documents are silent or permissive on the question of earthquake insurance, and boards wish to confirm the membership has had an adequate opportunity to participate in this important decision, a vote to clarify the governing documents (to expressly state earthquake insurance is not required) might help protect boards against claims they did not meet a duty in the event an uninsured catastrophic loss occurs. All of these amendments would require membership vote, and that process is a useful one in which the pros and cons of earthquake insurance can be the subject of homeowner discourse and education. Short of a membership vote, an advisory "straw" poll of members as to whether they wish to pay the premiums through a master earthquake policy purchased by the association or face an uninsured catastrophic loss through an earthquake can also be a useful and informative process. Overall, getting membership input on these important issues can be extremely helpful in the overall education of the community and potentially to mitigate claims that the boards breached any duty by failing to get earthquake

insurance in the event of the Big One. Hindsight is often 20/20 in lawsuits, and the more board members can do to educate themselves and solicit, where appropriate, membership input, the better in defense of a breach of duty claim.