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Recovering the Whole Enchilada:
Matching Expectations and Contract Provisions with Property Insurance Policies

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Recovering the Whole Enchilada:
Matching Expectations and Contract Provisions with Property Insurance Policies

Landlords, Tenants, and their mortgagees need to be sure that when a tornado, fire, storm, flood, or other event damages the leased property and its contents, they can recover quickly for their loss of property and business income and resume business without losing tenants or customers. The coverage that will reimburse the Named Insured (the "Named Insured" is the party maintaining the coverage and its family of related entities) for the damage to or loss of its property and its loss of business/loss of rents is called "property insurance." Don't use the term "casualty insurance" to require insurance for loss of or damage to the improvements – insurance professionals use that term to mean liability insurance. Where the property is under construction, a different form of property insurance (Builders Risk) may be needed in lieu of or in addition to the permanent property insurance covering completed structures.

In these materials, we will reference the provisions of published, standard insurance forms developed by the Insurance Services Office, Inc. ("ISO"). ISO is an entity that reflects the views of insurance companies and provides the forms that most insurers consider "standard" forms. These forms are identified by their number and edition date. For example, the most common ISO Causes of Loss – Special Form currently bears the designation CP 10 30 10 12: (i) CP 10 30 means it's the form making the policy a special causes of loss property policy, and (ii) the 10 12 at the end of the designation indicate the edition's date, which in this case is October 2012. Lawyers should try to keep up with the changes in each edition – they generally add limitations that benefit the insurer. Of course, insurance companies may customize the ISO forms to suit their own objectives. In addition, a large insured party may require a "manuscript," or specially worded, policy. However, the coverages and exclusions in these customized or manuscript policies are often based on the most recent ISO forms.

I. Property Insurance Basics.

A. The Two Base Forms Necessary for Property Coverage.

The ISO form property insurance policy is comprised of multiple forms. Typically there is a "Declarations Page" that identifies the forms comprising the policy and the properties insured, as well as the limits of coverage under the policy and other important information. The ISO form is called the "Commercial Property Coverage Part Declarations Page" (CP DS 00 10 00). In order to have property insurance coverage, two separate ISO base forms are combined to describe the property that is covered and the losses that are covered.

1. First: The Form That Stipulates the Property That Is Covered (the "Covered Property").

The ISO Building and Personal Property Coverage Form, currently CP 00 10 10 12, describes the categories of property that the insurer will pay to restore or replace (the "Covered Property"). Generally, the

Covered Property under this form includes (1) the real property and related items, including the building, fixtures (including outdoor fixtures), permanently installed machinery and equipment, and the materials and equipment used to maintain or service the real property, and (2) the "Business Personal Property." This Business Personal Property includes the insured's furniture and fixtures, machinery and equipment, "stock," and other personal property used in its business located on the real property or to a limited extent, on the property of others (including leasehold improvements owned by the Tenant and located on leased property if the Tenant has the obligation to insure this leased property).

A Tenant's Business Personal Property includes its use interest in fixtures, alterations, installations, and additions made as part of a building or structure that the Tenant occupies but does not own, as well as those that the Tenant acquires or makes at its expense but cannot legally remove. Covered Property also includes property in the Tenant's care, custody or control. This Business Personal Property must be located in or on the insured real property or within 100 feet of it (this means if the insured is a Tenant in a shopping center, the Business Personal Property can be within 100 feet of the shopping center).

There are a great many exclusions to the property covered under the ISO Building and Personal Property Coverage form, including money and evidences of debt, animals (other than those owned by others and boarded with the insured and if owned by the insured, only as "stock" while inside a building), roadways and other paved surfaces, foundations below the lowest basement floor or the surface of the ground if there is no basement, land, growing crops, lawns (other than as part of a vegetated roof), bulkheads, pilings, piers, wharves, docks, property specifically described as covered by another policy (other than for the excess of the amount due under that policy), retaining walls that are not part of a building, and underground pipes, flues, or drains. Also excluded are electronic data except to the extent specifically described as covered, the cost of replacing or restoring the information on valuable papers and records, vehicles or self-propelled machines that are licensed for use on a public road or operated principally away from the premises (with exclusions for certain inventory items other than autos and other than some detached trailers), fences, antennas and satellite dishes, and trees, shrubs, or plants (unless covered by the extended coverage).

2. Second: The Form That Describes (and Limits) the Events Causing Loss That Will Be Covered.

This separate "Causes of Loss" form provides sets out the events that will trigger the insurer's obligation to pay for the insured property. There are three basic types of ISO commercial property "Causes of Loss" form policies:

> Basic Form which covers only listed risks, including fire, lightning, vehicles, aircraft, and civil commotion (generally ISO form CP 10 10 10 12).

> Broad Form which provides Basic Form coverage as well as coverage for additional listed perils, such as structural collapse, sprinkler leakage, and losses caused by ice, sleet, or snow weight (generally ISO form CP 10 20 10 12).

> Special Form which adds some listed perils and also covers "risks of direct physical loss" (this corresponds to the policy formerly called an "All Risk" policy) except those perils that are specifically excluded (generally ISO form CP 10 30 10 12).

A Causes of Loss – Special Form policy covers the most types of loss events. For that reason, it is the type of property policy that Landlords and Tenants should maintain for their own property. If the Landlord is allowing the Tenant to insure the Landlord's building, it is particularly important that the Lease require the Tenant to carry this insurance under a Special Causes of Loss policy.

The specific exclusions to the Special Form Causes of Loss policy (and the Basic Form and Broad Form policies) include ordinance or law, earth movement (earthquake, landslide, and earth sinking other than sinkhole collapse), governmental action, nuclear hazard, utility services, war and military action, water (flood and other water-related occurrences), fungus (mold), wet rot, dry rot, and bacteria, as well as boiler explosions, and defective design, construction, materials, or maintenance. However, if earthquake, landslide, mine subsidence, and earth sinking (other than sinkhole collapse) result in fire or explosion, the insurer will pay for the damage caused by the fire or explosion. Also excluded from coverage under the Special Form Causes of Loss policy are volcanic eruption, blasts, dust, and lava. *See* ISO CP 10 30 10 12 (Causes of Loss—Special Form). But an owner can obtain coverage for some of these risks by an Earthquake and Volcanic Eruption Endorsement, such as the ISO CP 10 40 10 12 (no Sub-Limits) or CP 10 45 10 12 (Sub-Limit Form).

B. The Insured Amount.

The next piece essential to an ISO form property policy is the policy's Declarations Page, which sets out the insurer's liability limits. These limits are the most that an insurer will pay on account of any single occurrence – they cap the insurer's liability at the lesser of the policy limits or the replacement cost or actual cash value, depending on which option was selected by the insured.

What's the difference between replacement cost and actual cash value?

a. Replacement Cost: The cost of repairing or replacing the damaged property with property of comparable material and quality, used for the same purpose, and at the same location (though once this amount is determined, the proceeds can be used to reconstruct at a different location).

b. Actual Cash Value: Replacement Cost minus physical depreciation. Each component of the improvement may be subject to its own depreciation schedule, depending on the nature of the component, the degree to which it was maintained, and whether it was replaced recently (*e.g.*, a 50-year old building with a 2-year old roof).

The insured should include demolition and disposition costs (as a common example, $20 per square foot of improvements) when setting the Replacement Cost limits of its coverage because it needs limits that are high enough to cover these costs, with no coinsurance penalty for underinsuring. For example, when an insured purchases $10,000,000 coverage on a building, the insured expects to be able to reconstruct that building with those proceeds. In reality, a significant portion of that amount may have to be used for these additional costs.

Replacement Cost is the coverage most often required by lenders. In addition, if a Tenant is insuring a building owned by the Landlord, the Landlord should require that the Tenant insure for the full Replacement Cost of this property. Otherwise, the Landlord is at risk for the possibility there will not be sufficient proceeds to rebuild, and will have to rely either on the Tenant (if required under the Lease) or its own pocket to pay the difference.

Even with Replacement Cost coverage, if the property is not actually repaired or replaced, the insurer will pay only the Actual Cash Value, and during the restoration work, the insurance company will generally pay the Actual Cash Value until the restoration is complete. Only when the restoration is complete will the insurance company will pay the additional amount that is required to cover the Replacement Cost. And of course, the insurer will not be required to pay more than the specified coverage limits. There may also be sub-limits for different types of covered causes of loss. If these sub-limits are too low, the actual total cost to restore will not be covered.

C. The Coinsurance Penalty for Underinsurance, and How to Avoid It.

Coinsurance is a warranty to the insurance company that the amount of coverage being carried is equal to or greater than a stipulated percentage of the total value at risk. ISO and other property insurance forms state that if the party maintaining the coverage underinsures the property by a percentage that is less than the stipulated coinsurance percentage (typically set out in the policy's declaration page), the insured's recovery will be reduced geometrically by a coinsurance penalty calculated in the manner set out in the policy. A typical coinsurance percentage is 80% or 90% (*see* ISO CP 00 10 12). This coinsurance penalty can reduce a loss recovery significantly – and serves to encourage property owners to purchase limits that approximate the Actual Cash Value or Replacement Cost, as applicable.

As an example, if the Replacement Cost of the insured property is $5,000,000, the coinsurance percentage is 80%, the policy limits are $3,000,000, the loss is $100,000 and the deductible is $10,000, then the

coinsurance penalty will be triggered because the insured owner has insured its property for less than 80% of its insurable value (the $5,000,000 value that could have been insured, multiplied by the 80% coinsurance percentage, equals $4,000,000 – an amount greater than the $3,000,000 coverage limits that were purchased). Because the coinsurance penalty has been triggered, the following will occur:

(i) The value of the property at the time of the loss ($5,000,000), will be multiplied by the co-insurance percentage ($5,000,000 X .80 = $4,000,000),

(ii) The stated limits of the coverage ($3,000,000) will be divided by the figure in (i), ($3,000,000 divided by $4,000,000 = .75),

(iii) The amount of the loss ($1,000,000) before the application of the deductible will be multiplied by the figure calculated in (ii) ($1,000,000 X .75 = $750,000),

(iv) The deductible will be subtracted from the figure in (iii) ($750,000 - $10,000 = $740,000), and

(v) The insurer will pay the result ($740,000).

The remainder of the loss amount ($260,000) will not be covered. One way for an insured to avoid the application of the coinsurance penalty is to be sure that the property is insured for its full insurable value at all times – or at least for the coinsurance percentage of this full insurable value. In the example above, if the property had been insured for its $5,000,000 Replacement Cost, the amount of the loss the insurer would have paid in this example would have been $990,000 ($1,000,000 minus the deductible of $10,000).

But sophisticated property owners can also avoid the coinsurance penalty by having their policies written with either an Agreed Value endorsement, or under the ISO Form CP 00 10 10 12 Building and Personal Property Coverage Form, by electing Agreed Value as an Optional Coverage on the Declarations Page. If Agreed Value coverage applies, the insurer stipulates an agreed value for the insured property and suspends the operation of the coinsurance clause – the key here is to be sure that a Schedule of Values for the property is actually agreed to by the insurer and incorporated into the policy. This may require periodic appraisals and corresponding adjustments to the property's Agreed Value. It is also best to exclude coinsurance penalties expressly in the Agreed Value policy or endorsement.

If the Landlord or Tenant has many locations, it probably insures its property by means of a "blanket" policy covering more than one of its properties. The insured assumes that a fire or other peril will probably not affect more than one of the covered properties at a time, so the insured covers these properties in a bundle at a lower cost per property. Typically blanket policies include at least a 90% coinsurance requirement. To avoid the

coinsurance penalty in a blanket policy, this policy should include an Agreed Value Endorsement incorporating a Statement or Schedule of Values fixing an amount for each location (and excluding the coinsurance penalty).

Even if the insured obtains an Agreed Value coverage in its the policy and incorporates a Statement or Schedule of Values, the insured should be sure that the policy does not also contain a Limitation on Loss Settlement – Blanket Insurance (Margin Clause), the ISO Form CP 12 32 06 07 or its equivalent. A "margin clause" is an endorsement to a blanket policy that limits the amount of recovery to a percentage of the stipulated value, usually ranging from 1.05% to 1.20%. It eliminates much of the benefit of a blanket limit that would allow the full amount of the policy limits to be available to pay for any one loss, which is intended to avoid the risk inherent in an individual property policy – the application of the standard limitation in the policy that limits the maximum coverage (even where Replacement Cost coverage has been elected) to the amount of the policy because the amount of insurance under a blanket policy covering multiple properties should inevitably be higher than the amount under a single property policy. It also forces the insured to adequately cover the individual properties in its Schedule of Values.

D. The Tenant's Coverage for Loss of Its Leasehold Interest.

A Tenant with a Lease that is under-market, a Tenant that has pre-paid a great deal of its rent, or a Tenant that has made substantial tenant improvements to the leased premises should consider obtaining Loss of Leasehold Interest coverage by endorsement to its property policy (ISO form CP 00 60 06 95). The ISO form CP 00 60 06 95 states that if the leased property is damaged by one of the Covered Causes of Loss, the insurer will pay:

(a) the "Net Leasehold Interest," defined as the present value of the (I) monthly rental value of the leased premises minus (II) the actual monthly rent and other amounts payable under the Lease (the present value will be determined by the rate of interest set out on a Schedule), plus

(b) the unamortized portion of the Tenant's improvements that will be lost by reason of the termination of the Lease (this is important if these Improvements and Betterments are not damaged, but if by reason of damage elsewhere in the building, the Landlord terminates the Lease), and (c) the amount of any Prepaid Rent (amortized by the number of months remaining in the Lease).

This coverage is important for a Tenant obligated to insure the tenant improvements under its Lease, and can be extended to cover those constructed by the tenant as well as those in place before the tenant took

occupancy. If the Tenant is so obligated, the Tenant needs to be sure it has procured the correct amount of coverage that matches its obligation under the Lease.

E. Loss of Rents and Loss of Business Income.

Property owners of leased property as well as Tenants operating businesses need coverage for their business losses if a fire or other event damages their property and causes their business to suffer. For property owners, these business losses generally take the form of coverage for loss of rents (loss of rental value). For Tenants, their business losses generally take the form of coverage for loss of business income (formerly called business interruption). Both Tenants and Landlords also need coverage for the Extra Expenses they incur by reason of the fire or other loss event.

1. How to Obtain Coverage for Loss of Business Income and Loss of Rental Value.

A property policy, even a Special Form policy, by itself, does not cover loss of business or loss of rental value. The property owner or tenant must have that policy endorsed to include this important coverage. But the coverage for these business and rental losses is still tied to the base property policy and its Covered Causes of Loss. Without additional special coverage by an additional endorsement, nothing will be payable under the policy unless the loss was caused by damage to the insured's real or personal property caused by a Covered Cause of Loss as defined in the Basic Form, Broad Form, or Special Form portion of the policy.

ISO form CP 00 32 10 12 is the current coverage form for lost Business Income (without Extra Expense), and ISO form CP 00 30 10 12 is the current endorsement form describing coverage for lost Business Income (with Extra Expense). Both forms will cover Loss of Rental Value if that coverage is specifically selected and shows on the Declarations Page – in other words, if the correct box is checked.

2. What Is Lost Business Income and Rental Value?

Lost Business Income is (i) the Net Income (Net Profit or Loss before income taxes) that would have been earned or incurred but for the insured peril plus (ii) the continuing normal operating expenses, including payroll. If Extra Expense Coverage has been procured by the insured, the policy will pay those expenses incurred to avoid further loss (other than the cost of extinguishing a fire), but only if the aggregate award including these expenses equal or are less than the loss that would have been payable had these expenses not been incurred. Extra Expense Coverage is discussed in greater detail below.

Loss of Rental Value is a subset of this loss of Business Income and is calculated as (i) the "Net Profit or Loss before income taxes that would have been earned or incurred as rental income from tenant occupancy of the premises . . ., including the fair rental value of any portion of the described premises which is

occupied by [the insured]", plus (ii) "Continuing normal operating expenses incurred in connection with the that premises . . . ." The coverage for continuing normal operating expenses includes payroll and charges that tenants are legally obligated to pay that the Landlord would otherwise be obligated to pay (e.g., pass throughs of operating expenses). Of course, if the Landlord does not have to pay certain expenses after the loss and during the period of restoration (e.g., janitorial costs for the damaged portion of the premises), they cannot be included.

Loss of Business Income and Loss of Rental Value coverage not only has a maximum insured amount as a coverage limit, but the recovery will also be limited to the loss suffered during a maximum period of time. Generally, this time period is the "period of restoration." Under the ISO form CP 00 32 10 12, this is: (a) the period during which the insured's business activities are slowed or stopped or a part of all of the premises are rendered untenantable, but not longer than (b) the period beginning 72 hours after the physical loss or damage caused by the Covered Cause of Loss and ending on the earlier of the date on which the property *should have* been repaired, replaced, or rebuilt with reasonable speed and similar quality or the date on which business is re-opened at a permanent location. This "period of restoration" will not be extended for delays caused by laws that place restrictions on the construction, use, or repair of the physical property or that require the insured or others to deal with pollutants. A business should consider obtaining an additional coverage period of up to 90 to 120 days or longer, but this additional period must be elected, paid for and shown on the Declarations.

As in the case of loss of physical property, an insured that underinsures its loss of Business Income/Rental Value by too great a percentage may be hit with the coinsurance penalty. The insured can avoid this penalty by obtaining Agreed Value coverage, but this usually requires submission of a business income worksheet estimating the Business Income or Rental Value and it requires that the insurer make this estimate an agreed part of the policy.

3. Coverage for Extra Expenses.

Insured Tenants should cover their Extra Expenses as well as their loss of Business Income. The ISO form CP 00 30 10 12 includes both coverage for loss of Business Income/Rental Value and these Extra Expenses. "Extra Expenses" are the necessary expenses the Tenant incurs during its "period of restoration" that it would not have incurred if there had been no loss or damage – it includes expenses like the cost of the insured's relocation and other costs of continuing its operations at a temporary location to avoid or minimize business losses. If the insured elects to include Extra Expense Coverage, under the ISO Form CP 00 30 10 12 the time period of restoration for purposes of Extra Expense Coverage will begin immediately after the physical loss or damage.

Landlords also need coverage for their Extra Expenses, such as the cost of establishing a temporary leasing office or other steps they may take to minimize losses.

Loss of business income coverage can be obtained with or without coverage for extra expenses, but loss of business income coverage with extra expenses is the best way to avoid a dispute with the insurer over whether the expenses incurred by the business after the casualty are "continuing normal operating expenses" automatically covered by the loss of business income policy, or are extra expenses requiring additional coverage (and limits of coverage).

4. How Lease Provisions Tie Into Loss of Business Income/Rental Value Coverage.

If the Lease provides that the Tenant must continue paying its rent after a loss and during the restoration – a provision that should be included in a net lease in which the Tenant is insuring the physical building and is obligated to restore it – then the Tenant's Loss of Business Income coverage should provide proceeds for the rent payments during the restoration as a "continuing normal operating expense."

If the Lease provides that the rent will abate after a loss and until the property is restored – a provision that should be included in a lease in which the Landlord is carrying the property insurance and in which the Landlord has the restoration obligations – then the Landlord's Loss of Rental Value insurance should reimburse Landlord for the abated rent. But the Landlord's Loss of Rental Value insurance is not designed to pay when the Tenant remains obligated to pay the rent.

Landlords and Tenants can get into trouble when the Landlord is insuring the building and carrying the loss of Rental Value insurance, but the Lease provides that in some circumstances, for example, if the damage is caused by the Tenant's negligence, the Tenant's rent will not abate. In that case, although the Landlord has been paying for loss of Rental Value insurance and thinks that it will be reimbursed by the insurer for its rental loss, the insurer is likely to take the position that because the Tenant is obligated to continue to pay the rent, the insurer is not obligated to cover the lost rent. In that situation, the Landlord may be left with only a breach of contract claim against the Tenant for the rent. This is not a desirable result, and it could be a significant risk if the Tenant has moved out and lacks the resources continue to pay the unabated rent. A Landlord should avoid these provisions – and understand that if there's a fire or other damage to its property, its best remedy is to provide that the rent will abate regardless of whether the loss is due to the Tenant's negligence or a so-called "act of God" or other peril (as long as it is a Covered Cause of Loss under the Landlord's property policy). The Landlord can then look to its Loss of Rental Value coverage, not to its displaced Tenant.

II. Coverages to Add to the Base Policy (and Limitations to Avoid).

A. Add Building Ordinance or Law Coverage.

A standard Replacement Cost property damage policy does not cover the added cost of complying with laws and ordinances that may be required as a condition of restoration. These requirements may result in the owner spending substantial sums that were not contemplated. For example, it does not cover the cost of (1) tearing a damaged building down when demolition is required by governmental authorities, as is often the case where the building is damaged to the extent of more than 50% of its value (often where the building is "non-conforming" – meaning it no longer complies with the current zoning code requirements with respect to setbacks, size, height, etc.); (2) tearing down the undamaged portion of the building; or (3) adding features to a damaged building, sometimes including undamaged portions (for example, sprinklers, upgrades to electrical systems due to new code requirements, or new energy use reduction components) when the building was not previously required to contain these features (perhaps because it was grandfathered). A property owner can obtain coverage for these exposures by obtaining an ISO form CP 04 05 10 12 Ordinance or Law Coverage or similar type of endorsement. Of course, the damage must be from a loss that is caused by a Covered Cause of Loss – separate coverage will be required for building ordinance coverage if the loss is from a flood or earthquake.

There are three types of building ordinance coverage options available under the ISO Form CP 04 05 10 12: Coverage A, which covers the loss in value of the undamaged portion of a building if the ordinance or law requires the demolition of the undamaged portion as well as the damaged portion; Coverage B, which covers the cost of demolishing and clearing the site if the ordinance or law requires the demolition of the undamaged portion as well as the damaged portion; and Coverage C, which covers the increased cost of construction necessary to comply with current laws and ordinances (for example, by the addition of a sprinkler system). All three types of coverage are valuable. Coverages A and B are important to an owner that must demolish all or part of the improvements to satisfy local codes. Coverage C is important when the owner rebuilds and must include improvements (such as a sprinkler system or upgraded electrical work) required by laws that were not in effect when the building was originally constructed.

B. Add Coverage for Increase in Rebuilding Expenses and Extended Restoration Period.

If a disaster affects the entire area in which the property is located, then it is likely that materials suppliers and contractors will be scarce and will naturally increase their charges. An endorsement like ISO CP 04 09 10 12, entitled "Increase in Rebuilding Expenses Following Disaster (Additional Expense Coverage on Annual Aggregate Basis)," provides coverage for additional expenses up to a specified additional expense percentage

when (1) the covered cause of loss results in a declaration of a state of disaster by state or federal officials or occurs in close temporal proximity to a declared disaster, (2) the expense of labor or materials increases as a result of the disaster and the total cost exceeds the applicable limit of expenses, (3) the insured owner repairs or replaces the damaged building, and (4) the insured owner notifies the insurer within 30 days of completion of any work to the insured building that increased the replacement cost by 5% or more. The ISO endorsement requires information either in the endorsement itself or in the Declarations specifying the percentage of the limit of insurance or the value of the building that will be provided under this endorsement. Coinsurance may also apply, and there are sub-limits for debris removal and coverage for ordinances or laws if the policy contains an Ordinance or Law Coverage endorsement. It is also possible to cover losses sustained during an extended period of time during which the insured's operations are suspended as a result of having to comply with any ordinance or law that regulates the work or requires tearing down any undamaged portions of the property by means an additional endorsement (*see* ISO CP 15 31 10 12 – Ordinance or Law – Increased Period of Restoration).

C. Add Mechanical Breakdown.

Mechanical breakdowns (this might include HVAC systems destroyed by a power surge) are causes of loss that are excluded in the ISO form and other typical property damage policies. However, this coverage, formerly known as boiler and machinery coverage, can be obtained through a separate policy or endorsement. The ISO form CP 10 46 10 12 entitled "Equipment Breakdown Cause of Loss" provides such coverage as an endorsement to the ISO Causes of Loss – Special Form policy.

D. Watch Out for Vacancy.

Under many policies, including the ISO form CP 00 10 10 12, if a building has been vacant for longer than 60 days or another stipulated period, the insurer will not pay for losses caused by vandalism, sprinkler leakage, building glass breakage, water damage, theft, or other types of vacancy-related losses, and the recovery for other types of covered losses will be reduced, typically by 15%. The placement of furniture in the building will not satisfy this requirement. These policies generally define a building as vacant unless at least 31% of its total square footage is (i) rented to a Tenant and used by the Tenant to conduct its customary operations or (ii) used by the building owner to conduct customary operations. This percentage can be changed under an endorsement like the ISO form CP 04 60 10 12 (Vacancy Changes). A waiver by the insurer must be obtained to continue full coverage during periods of vacancy. Consequently, if an owner knows that a substantial portion of its property will be vacant (for example, if the policy is placed in effect before the property has been fully leased or after a

Tenant occupying more than 69% of the building has vacated the property), it should notify its insurer and obtain a vacancy permit.

E. Avoid the Protective Safeguard Endorsement.

Insurers often add an endorsement requiring that the insured maintain certain listed protective devices or services such as a sprinkler or burglar alarm system. (See CP 04 11 09 17, which covers fire-related protective safeguards, and CP 12 11 10 00, which is for burglary- and robbery-related protective safeguards) Despite its name, a Protective Safeguards Endorsement is not "special coverage." Instead it is a special exclusion from coverage that benefits the insurer (probably explained as justifying a lower premium). If a CP 04 11 09 17 endorsement or its equivalent is part of the policy and a fire occurs while the sprinkler system reported as installed in the building is not working, the insurer may deny coverage (all coverage, not just part of the coverage), unless the insured previously notified the insurer that the sprinkler system was not working and obtained assurance that the property would be covered during this period.

For an example of exactly how damaging a Protective Safeguards Endorsement can be, see the recent case of *Continental Casualty Co. v. Equity Industrial Maple Heights, LLC*, 2016 WL 2927847 (N.D. Ohio May 19, 2016). The case involved a subrogation action by Tenant's insurance company that had paid over $55 million in losses to the Tenant, Fannie May Confection Brands, Inc. ("Fanny May"), for lost inventory and equipment in a warehouse fire. The Landlord filed a motion to dismiss the insurance company's complaint against it on the ground that the Lease contained waiver of subrogation provision. The motion was denied. The complaint alleged that the Landlord was responsible for and had failed to maintain fire suppression and sprinkler system as required under the Lease and that the Landlord was also liable for negligence, gross negligence and "wanton and careless conduct" in failing to maintain the systems. Under Ohio law, a waiver of subrogation provision is not valid where the conduct allegedly causing the loss is due to the gross negligence or reckless conduct on the part of the party causing the loss. In a later opinion, Continental Casualty Co. v. Equity Industrial Maple Heights, LLC, 2017 WL 1317123 (N.D. Ohio April 10, 2017), the court addressed an attempt by the Landlord to sue Fannie May on a third party complaint in Fannie May's insurance company's subrogation claim against the Landlord. In its third-party complaint, the Landlord alleged that Fannie May was obligated under the Lease to maintain the fire suppression and sprinkler system and to indemnify the Landlord for its failure to do so. Fannie May filed a motion to dismiss the claims asserted against it on the grounds that any claim against it should have been asserted as a defense to the insurance company's subrogation claim, not as a separate claim against Fannie May, and the court agreed. No reported decision on the merits of the case has been issued at this point.

F. More Exotic Types of Business Loss Coverage to Consider.

1. Utility Interruption.

By a special endorsement for utility interruption, a property owner or business operator can obtain coverage for loss of business caused by an interruption in utility supply services (including water, communication or power supplies) that originates outside the insured property. The ISO form CP 04 17 10 12 Utility Services – Direct Damages endorsement provides coverage only if the off-site utility equipment is damaged by a Covered Cause of Loss (a cause of loss that would be covered if the damage were to the Tenant's own property). Overhead transmission or distribution lines are generally excluded, as is loss or damage to electronic data even though the equipment damage (e.g., fiber optic transmission lines) would be covered.

2. Contingent Business Income.

A property owner or business operator can also obtain Contingent Business Income insurance that covers the business losses it suffers when a Covered Cause of Loss damages property other than the insured property. ISO endorsements CP 15 08 10 12 and CP 15 09 10 12 describe this coverage as the actual loss of business income sustained by reason of the necessary suspension of operations at the insured's property by reason of a direct physical loss or damage to another specified property (the "dependent property") caused (of course) by a Covered Cause of Loss. Loss of electronic data at the dependent property is not covered, however. The dependent property should be a property whose operation is crucial to the operation of the insured's business, such as a primary supplier if the insured is a manufacturer, or a shopping center if the insured operates an outparcel.

G. Add Flood Coverage.

A standard ISO property policy – even a Special Form policy – excludes damage caused by flood, surface water, waves, tides, tidal water, overflow of a body of water, and spray from any of these (whether or not driven by wind). Flood coverage can be obtained through the National Flood Insurance Program (NFIP), which is administered by the Federal Emergency Management Agency (FEMA). However, the commercial property coverage limits for NFIP coverage are low: $500,000 for each building and $500,000 for its contents. In addition, only Actual Cash Value is covered – Replacement Cost is not covered. Loss of Business Income/Rental Value loss is also not covered under the NFIP.

Flood Zones A and V are the areas at the greatest risk of flooding. However, some lenders require flood insurance for properties not in these Flood Zones. In addition, property owners of high-value property generally should obtain flood insurance on the private market in an amount that exceeds the NFIP limits. This excess

coverage is commonly provided by means of a Difference-in-Conditions ("DIC") endorsement or policy. In either case, the owner may be able to obtain non-FEMA flood insurance for the property's full replacement cost and business income for a price. However, if the property is within Flood Zones A or V, the insured will need to maintain both the NFIP coverage and the additional coverage as excess coverage (with the NFIP coverage amount as a deductible).

Unfortunately for property owners in flood-prone communities, the NFIP is subject to periodic reauthorization by Congress. At the time of these materials, the authorization for the NFIP extends only to September 30, 2019, according to FEMA's website. Congress will have to reauthorize the NFIP if it is to continue after that date.

H. Add Terrorism Coverage.

Terrorism insurance is often required by lenders. Since the World Trade Center attacks in 2001 (and the resulting insurance-policy terrorism exclusions), Congress has enacted a series of laws designed to make terrorism coverage available – most recently the Terrorism Risk Insurance Program Reauthorization Act of 2007, which was extended to December 31, 2020, by the Terrorism Risk Insurance Program Reauthorization Act of 2015 (H.R. 26) ("TRIA")[1] – by providing a process for shared public and private compensation for insured losses suffered in an act of terrorism. The Secretary of the Treasury published its final rule under TRIA on December 21, 2016, which became effective January 17, 2017 and is published in the Code of Federal Regulations at 31 CFR Part 50 ("Final Rule").[2]

Insureds that maintain terrorism coverage should realize the limited circumstances in which this coverage will actually pay for damage. Only acts certified as acts of terrorism by the Secretary of the Treasury after consultation with the Secretary of Homeland Security and the U.S. Attorney General trigger payment and then only if the aggregate property and casualty losses exceed $5,000,000. *See* 31 CFR §§ 50.4(b)(2), 50.6(a). The Final Rule governs the certification and claims payment process, as well as the process for collecting from participating insurers intended to help the Secretary analyze the effectiveness of TRIA's program. "Insured losses" covered under TRIA include only losses "resulting from an act of terrorism (including an act of war, in the case of workers' compensation) that is covered by primary or excess property and casualty insurance issued by an insurer." 31 CFR. §50.4(n)(1). TRIA only covers commercial lines and directors and officers liability insurance. Thus, it does not cover health or life insurance, flood insurance, commercial automobile insurance, among others,

[1] TRIA, as adopted in Pub. L. 114-1 on January 12, 2015, is codified at 15 U.S.C. §6701 (note) et seq.

[2] The Final Rule and information on the changes made between the issuance of the proposed rule and Final Rule can be found online at https://www.regulations.gov/document?D=TREAS-TRIP-2016-0005-0029 (last visited June 7, 2019).

and does not cover any personal lines of insurance. 31 CFR. §50.4(w).

The April 15, 2013 Boston Marathon bombings were a terrorist act, but not a "certified act of terrorism" under the TRIA, in part because the insured property losses did not reach the TRIA minimum of $5 million. Three people died, and it was widely reported that 264 people were injured in the blasts.[3] However, TRIA deals with insured losses to property, not injuries to human beings and death.

III. Making the Parties' Restoration Obligations Match Their Insurance.

The party that owns the building ordinarily should be the party that maintains the property insurance coverage on that building, and the party that maintains this property insurance coverage ordinarily should be the party obligated to restore the building if it is damaged.

Problems arise for the party with the restoration obligations if that party does not also maintain the property insurance. If the Landlord maintains the insurance coverage but the Tenant has the restoration obligations, the Tenant needs to be sure that the Lease requires the Landlord to provide sufficient funds for restoration, generally to be held in trust, before the Tenant must start work, limits the Tenant's restoration obligations to the insurance amounts provided by the Landlord, and limits the required time for restoration to a reasonable time after these proceeds are provided. The Tenant should also require that the Landlord make it a loss payee as its interests may appear or an additional insured as its interest may appear on the Landlord's policy.

The same principles apply if the Tenant maintains the property insurance coverage on the Landlord's building but the Landlord has the obligation to restore. In this situation it is even more important for the Landlord to be the loss payee and additional insured on the Tenant's property insurance policy. The ISO Form CP 12 18 06 07 (Loss Payable Provisions) endorsement can be used to add the Landlord (as a Building Owner) as a Loss Payee and the ISO Form CP 12 19 06 07 (Additional Insured – Building Owner) endorsement can be used the add the Landlord as an Additional Insured to a Tenant's property insurance policy. In addition, the Landlord should obligate the Tenant to pay all deductible and self-insured amounts, it should limit its restoration obligations to the insurance proceeds and other amounts provided for this purpose by the Tenant, and it should assure that the period during which it must restore will not start until the Tenant provides the insurance proceeds for the restoration (particularly if the Lease grants the Tenant an option to terminate the Lease if the Landlord fails to complete the restoration within a specified period of time).

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[3] *See* Boston Marathon bombing, Wikipedia at https://en.wikipedia.org/wiki/Boston_Marathon_bombing (last visited June 9, 2019).

It is very important to the Landlord that the Tenant's rent not abate if the Tenant is maintaining the property insurance on the building. The Landlord probably cannot maintain independent loss of rents insurance if it is not maintaining the property insurance policy (though it may be able to add loss of rents coverage to a contingent or back-up property policy). Rather than relying on the Tenant to insure the Landlord's loss of rents (if the Tenant can even do that), the Landlord should require the Tenant to maintain loss of business income insurance and to provide in the Lease that the rent will not abate. If the rent does not abate, the rent will be part of the "continuing normal operating expenses" paid by the proceeds of Tenant's Loss of Business Income policy. If the Landlord is obligated to restore and maintains its own property insurance, then the Landlord's coverage should include loss of Rental Value coverage, and rent should abate regardless of whether the Tenant's negligence caused the damage, though if Tenant is performing the restoration, the Landlord should limit the period of the Tenant's rent abatement to the end of loss of rents coverage under the Landlord's policy.

IV. Waiver of Claims/Waiver of Subrogation–Each Party Should Be Responsible for Its Own Property.

Most modern leases require each party to insure its own property – or at least permit each party to assume that the other party will insure its own property. For the risk of property damage to be truly allocated to each party's insurer, however, the party carrying the coverage must waive its right to sue the other party for an insured property loss (as well as a loss that could have been insured even if the policy is not carried) that, in turn, results in a loss by insurer of its rights of subrogation.

A. What Is a Right of Subrogation and Why Should It Be Waived?

By law (equity) and most insurance contracts, insurers that pay for damage to their insureds' property are "subrogated" to the claims that their insureds have against the person that caused the damage. This means that they can step into their insureds' shoes and sue the person or persons that damaged the property to recover the damage amounts paid by the insurer. By virtue of this "subrogation" right, a Tenant's property insurer is "subrogated" to the Tenant's claims against its Landlord and has the right to sue the Landlord to recover the proceeds that it paid to the Tenant. *See, e.g., Allstate Ins. Co. v. Mazzola*, 175 F.3d 255 (2d Cir. 1999).

But if the insurer's rights of subrogation have been waived properly by the Tenant's waiver of claims against the Landlord in the Lease, then the insurer will not have the right to recover these proceeds from the Landlord, even if the Landlord negligently caused the fire and the loss. *See, e.g., Travelers Indemnity Co. v. AA Kitchen Cabinet & Stone Supply, Inc.*, 106 A.D.3d 812, 964 N.Y.S.2d 634 (2013).

Conversely, the Tenant can avoid being sued by the Landlord's building insurer for damage to the building caused by the Tenant by having the Landlord waive its claims against the Tenant for damage that could easily have been insured by the Landlord.

B. How Can an Insurer's Rights of Subrogation Be Waived?

Generally, a party can waive only its own rights, so of course, the insurer can waive its own right to make claims against another party. However, today, an insurer's rights of subrogation are customarily waived by its insured's express waiver of claims in the Lease or a construction contract, and this waiver is generally binding on the insurer.

The best waivers of subrogation include two elements: (1) a waiver by each party of claims against the other party for all property damage that is insured by a Special Form Causes of Loss policy of property insurance (this is the most comprehensive form policy and the successor to the old "all risk" policy); and (ii) a waiver of each party's insurer's rights of subrogation against the other party. However, even Special Form Causes of Loss policies do not automatically include coverage for all types of property loss or damage; for example, without a special endorsement or policy, they do not include coverage for flood and water back-up from a sewer or drain or for loss of business income and rental loss. A waiver of subrogation should include these types of losses as well physical damage caused by fire and the other common risks.

The following is an example of a simple mutual waiver of subrogation provision that includes these elements:

> Notwithstanding anything to the contrary set out in this Lease, Tenant hereby assumes all responsibility for insuring, and waives its entire right of recovery against Landlord and its property manager for, any and all loss of or damage to Tenant's property, including, without limitation, its leasehold improvements, its furniture, fixtures, equipment, and other personal property and its loss of business income, caused by or arising out of a cause of loss insured or that could have been insured against by a Causes of Loss – Special Form policy of property insurance with additional flood and loss of business income coverage, even if this loss or damage is due to the negligence of Landlord or its property manager, agents, or contractors. In addition, notwithstanding anything to the contrary set out in this Lease, Landlord hereby assumes all responsibility for insuring, and waives its entire right of recovery against Tenant for, any loss of or damage to Landlord's property, including, without limitation, the premises, the building in which the premises are located, all of Landlord's other improvements, all of Landlord's furniture, fixtures, equipment, and other personal property, and Landlord's loss of business income and rents, caused by or arising out of perils insured against or that could have been insured against by a Causes of Loss – Special Form policy of property insurance with additional flood and loss of business income and rental value coverage, even if this loss or damage is due to the negligence of Tenant or its occupants, agents, or contractors. This waiver includes a waiver by each of Tenant and Landlord of all rights of subrogation that its property insurers may have against Landlord or its property manager or against Tenant, as the case may be.

C. Is an Endorsement to the Policy Necessary?

With respect to most property policies, no. Under commonly used ISO form property insurance policies, the insured party has the right to waive its right to recover from third parties, but this waiver ordinarily must be before a loss, as well as the right to bind its insurer to this waiver, although a Landlord is permitted to waive the right to recover a loss covered by its property insurance policy against its Tenant after the loss. *See, e.g.*, ISO Form CP 00 90 07 88 (Commercial Property Conditions). However, to cover situations in which the policy does not permit the insured to waive rights of subrogation, the Lease should provide that if the policy does not permit this waiver, then the insured must obtain an endorsement in which the insurer agrees to waive its right of subrogation.

D. What Is the Effect of Laws Limiting a Party's Right to Waive Claims?

Waivers of claims may be limited by state anti-indemnity laws, particularly with respect to damage caused by gross negligence or intentional misconduct or claims for personal injury. However, most laws permit a waiver to be effective against a compensated surety like an insurer. Even Illinois law, which prohibits a lease provision that indemnifies a landlord for its own negligence, indicates that public policy does not prohibit a waiver in a commercial lease of claims for property damage caused by the other party's ordinary negligence. *See* 765 ILCS 705/1. For a more complete discussion of the law regarding limited indemnity, *see* Marie A. Moore, *Indemnification Provisions in Leases: What We Ask For and What Really Matters*, 22 PROB. & PROP. 33 (Sept./Oct. 2008).

E. What Happens If the Lease Does Not Contain a Waiver of Claims/Subrogation?

If the Lease is silent as to the insurer's right of subrogation to recoup the proceeds it has paid to cover the insured's property damage or liabilities, the court may as a matter of the common law in the applicable jurisdiction either find that the insurer has *no* right of subrogation (despite its contractual right of subrogation in the insurance policy) or has an *equitable* right of subrogation. In some states, such as Florida, Illinois and Indiana, there is no hard and fast rule, and the court will make its determination as to whether the insurance company may enforce a right of subrogation on a case-by-case basis, based on the court's judgment as to the intent and reasonable expectations of the parties under the terms of the Lease and the facts of the case. Given the differences among the states as to whether the insurance company has or doesn't have an equitable right of subrogation, the better practice is to address this issue in the Lease.

1. Majority Common Law Rule.

A majority of courts follow a common law rule that a Landlord's property insurer may not subrogate against a Tenant whose negligence has caused damage to the Landlord's property. These courts have found that the Tenant is an implied coinsured under the Landlord's property insurance policy. These courts have concluded that the Landlord's agreement to procure property insurance covering the building implies an obligation by the Landlord to insure the building for the benefit of both the Landlord and the Tenant. This is the so-called "Sutton's Rule" named after the case *Sutton v. Jondahl*, 532 P.2d 478 (Okla. Ct. App. 1975), which involved the lease of a home that was damaged by a fire caused by a mishap involving the Tenant's son's chemistry set and an electric popcorn popper the son was using to heat some chemicals. The court articulated the rule as follows:

> Under the facts and circumstances in this record the subrogation should not be available to the insurance carrier because the law considers the tenant as a co-insured of the landlord absent an express agreement between them to the contrary, comparable to the permissive-user feature of automobile insurance. This principle is derived from a recognition of a relational reality, namely, that both landlord and tenant have an insurable interest in the rented premises—the former owns the fee and the latter has a possessory interest. 532 P.2d at 482.

In the *Sutton* case, the court went on to state:

> as a matter of sound business practice the premium paid [by the landlord for the fire insurance policy it procured] had to be considered in establishing the rental rate on the rental unit. Such premium was chargeable against the rent as an overhead or operating expense. And of course it follows then that the tenant actually paid the premium as part of the monthly rental. 532 P.2d at 482.

Other courts that have followed the so-called *Sutton* rule have likewise reasoned that the Tenant has indirectly paid for the insurance, either through rent or through an expense pass through.

2. Minority Common Law Rule.

The minority rule (sometimes referred to as the "Anti-Sutton Rule"), which is followed in a number of jurisdictions, including New York and Texas, is based on the common-law presumption that a Tenant is liable for the Tenant's own negligence and subject to the equitable principle of subrogation. Upon payment by the Landlord's insurer for an insured property loss, the Landlord's insurer is subrogated to the Landlord's rights and claim against its Tenant and can sue the Tenant to recoup the insurance proceeds, absent an express agreement to the contrary in the lease. The covenant requiring the Landlord to insure its own property is not equivalent to a waiver of recovery or a waiver of subrogation.

In *Galante v. Hathaway Bakeries, Inc.*, 6 A.D.2d 142, 176 N.Y.S.2d 87, 92 (N.Y. 1958), which was based partly on common law, a lack of explicit language in the Lease to the effect that the Tenant was to make all necessary repairs to the interior of the demised premises reasonable wear and tear and damage by fire

and unavoidable casualty excepted, and partly on Section 227 of the New York Real Property Law (which allows a Tenant to surrender the premises and cease paying rent thereafter if a premises are so destroyed or damaged through no fault of the Tenant that they are unfit for occupancy, unless there is an express agreement to the contrary in the lease), the Tenant was relieved of its responsibility to make repairs to the premises and the building following a fire only when the damage was not caused by Tenant's fault. As a result, the Tenant was not protected from liability for its own negligent acts when the entire interior of premises was destroyed by a fire claimed to be the result of Tenant's negligence. Likewise, in *Phoenix Ins. Co. v. Stamell*, 21 A.D.3d 118, 127, 796 N.Y.S.2d 772 (N.Y. App. Div. 2005), a college's insurer was entitled to bring a subrogation action against a student who negligently set fire to her residence hall after she lit a candle in her room and fell asleep, and the resulting fire that started in her room spread to other parts of the residence hall. This was because "the law as well as public policy considerations in New York support the right of Phoenix to maintain this subrogation action against defendant . . . . It is . . . well established in New York that 'contracts may not be construed to exempt parties from the consequences of their own negligence in the absence of express language to that effect.'" The court had also noted in the *Phoenix* opinion that there were various provisions in the student's residence hall contract and the Handbook of Community Standards addressing student liability for damage to residence halls and furniture. 21 A.D.3d at 120.

In *Publix Theatres Corp. v. Powell*, 71 S.W.2d 237 (Tex. Comm. App. 1934), a Tenant agreed in the Lease to carry fire insurance on the leased theatre building, at the Tenant's expense, naming the Landlord as the insured. After the theatre was completely destroyed by fire, the insurer paid, but the Landlord still sued the Tenant for the loss. The Texas court declared that to permit the Landlord to keep the insurance money and also to collect from the Tenant would be to allow the Landlord a double recovery, not allowed by law. *Id.* at 241.

3. Case-by-Case Common Law Rule.

In still other jurisdictions, as noted above, where the Lease does not explicitly address the right of subrogation, a number of courts have attempted to ascertain the intent of the parties as to whether the Tenant should be considered a coinsured under the Landlord's policy on a case-by-case basis by considering

> the lease as a whole, the reasonable expectations of the parties, and the principles of equity and good conscience.

Dix Mutual Ins. Co. v. LaFramboise, 597 N.E.2d 622, 626, 149 Ill. 2d 314 (Ill. 1992) (lease of a farmhouse and farm).

In the *Dix* case, the Illinois Supreme Court reviewed the provisions of the Lease for a farm and farmhouse. It noted that the Lease clearly exempted the Landlord from liability for damage to the Tenant's

personal property and provided the Tenant assumed all risk with respect to it. Although the Lease did not address property insurance on the leased premises at issue, the fact that the Lease stated the Landlord was not liable for damage to the Tenant's personal property and the Landlord took out a fire insurance policy covering the leased premises meant the parties intended each would be responsible for its own property. Therefore, the Tenant was not liable for fire damage to the premises, and the Landlord would be obligated to look solely to its insurance as compensation. Furthermore, the insurance company was prohibited from pursuing a subrogation claim against its own insured or any person or entity who had the status of a coinsured under the insurance policy. Because the Tenant was essentially paying for the Landlord's insurance policy through his rent payments, the Tenant gained the status of a coinsured under the Landlord's insurance policy, and both parties "intended that policy would cover any fire damage to the premises no matter who caused it." *Id.* Accordingly, the landlord's insurance company was not permitted to maintain a subrogation action against the tenant.

This same rule has been held applicable in Illinois to commercial leases in a number of cases. For example, *see Stein v. Yarnell-Todd Chevrolet, Inc.*, 241 N.E.2d 439, 41 Ill. 2d 32 (Ill. 1968). The *Stein* case Lease obligated the Tenant to procure and maintain certain types of insurance (e.g., plate glass damage, damage by boiler or boiler explosion, public liability and "damage or injury to employees of the lessee"). 241 N.E.2d 442. The Lease was silent on whether the Landlord was obligated to carry any insurance, but did obligate the Tenant to reimburse the Landlord for any premium increases for the Landlord's insurance policy and to cease any activity that would "invalidate any insurance policy maintained on the building or leased premises" which the court held meant the parties intended the Landlord would carry insurance on the real estate. *Id.* In addition, the Lease specified the Tenant was to "return the premises and all leasehold improvements and fixtures therein in as good condition as when lessee took possession, ordinary wear and tear or damage by fire or other casualty beyond lessee's control excepted." *Id.* at 440. Accordingly, based on "the lease as a whole, we judge that the parties manifested a pervading intention that the lessee was not to be liable for damage through fire resulting through the lessee's negligence." *Id.* at 443. *See also Nationwide Mut. Fire Ins. Co. v. T&N Master Builder & Renovators*, 959 N.E.2d 201, 355 Ill. Dec. 173, 2011 IL App (2d) 101143 (Ill. App. 2011) (same anti-subrogation rule applicable to residential leases applies to commercial lease where clause holding commercial holdover Tenant liable for damages sustained to premises while in Tenant's possession did not apply to damages caused by fire because lease surrender clause specifically excepted losses by fire).

California, Florida and Indiana also have employed the case-by-case approach. A comparison of the most recent Florida case and the most recent Indiana case illustrate how difficult it is to predict what the result

will be when the Lease is silent on whether the insured was entitled to a right of subrogation and the courts in a particular state employ the case-by-case approach to determine whether an insurer is entitled to exercise its right of subrogation to recover from a party to a Lease who causes damage to the property of the other party to that Lease. In a recent Florida case, the Landlord's insurance company was entitled to pursue a subrogation claim against the tenant, but in a recent Indiana case, the Landlord's insurance company was prohibited from pursuing a subrogation claim against the tenant.

The Florida Court of Appeals decided the *Zurich American Ins. Co. v. Puccini, LLC d/b/a 5 Napkin Burger*, 2019 WL 454222 (Fla. App. 2019), case in February 2019. The subrogation claim by the Landlord's insurer (Zurich American Ins. Co.) involved a $2.1 million loss paid by that insurer against a restaurant tenant (5 Napkin Burger) following a fire started in the Tenant's restaurant. The Tenant argued it was an implied coinsured under the Landlord's property insurance policy. Applying the case-by-case rule adopted in Florida, and based on the language of the Lease, the court held the parties intended that the Tenant should bear the risk of loss due to damage to the premises caused by its negligence, that the Tenant was not an implied coinsured under the Landlord's property policy, and that the Landlord's insurance company could proceed with its subrogation action against the Tenant. The court found that it was clear from the following Lease provisions that the parties did not intend to shift the risk of loss for damage caused by the Tenant's negligence to Zurich:

(1) Rent Not Abated for Tenant Negligently Caused Fires. Paragraph 41 provided that "rent shall not be abated and Tenant shall be fully responsible for all repairs and damages if Premises are partially or totally destroyed by fire or any other casualty caused by Tenant or its agents." The court noted, "Not only does Paragraph 41 not exculpate Tenant for its own negligence, it expressly holds it liable."

(2) Exception to Landlord's Structural Repair Obligation for Repairs Due to Tenant's Negligence. Paragraph 33 eliminated the Landlord's duty to make repairs to the "structural aspects and elements of the Building," if such repairs were "occasioned by any intentional or negligent act of Tenant, its agents, or its employees."

(3) Unilateral Provisions Expressly Waiving Landlord Liability. Paragraph 9 waived liability of the Landlord for "any loss or damage to any of Tenant's personal property or Premises unless directly caused by the gross negligence or willful misconduct of Landlord … nor shall Landlord be liable for … damages incurred or suffered by the Tenant … or others occasioned by … fire…." The court reasoned that by the "plain language" of Paragraph 9 of the Lease, the risk

of loss was shifted from the Landlord to the Tenant, absent gross negligence or willful misconduct on the Landlord's part.

(4) Tenant Indemnified Landlord for all Damages Arising Out of Occurrences in the Premises. Paragraph 24 required the Tenant to indemnify the Landlord "from any and all … damages … arising from or out of any occurrence in or upon the Premises …."

(5) Tenant Indemnified Landlord for all Costs Resulting from Tenant's Failure to Properly Maintain the Premises. Paragraph 31 required the Tenant to be responsible for and to indemnify the Landlord for any "costs … relating to such damages … resulting from Tenant's failure to properly maintain the Premises …."

(6) Tenant Was Required to Insure or Self-Insure its Own Losses; Waiver of Recovery for Losses for Which Tenant Should Have Maintained Insurance. Paragraph 25 placed the burden on the Tenant to procure and maintain insurance for its own benefit and to name the Landlord as an additional insured, rather than requiring the Landlord to maintain insurance for the benefit of the Tenant. Paragraph 25 provided:

> 25. INSURED LOSS OR DAMAGE: In any event of loss or damage to the Building, the Premises and/or any contents, each party shall first exhaust its own insurance coverage before making any claim against the other party. As Tenant is obligated to maintain insurance to fully cover all of its losses, in the event Tenant sustains a loss not fully covered by its own insurance, Tenant acknowledges that it is self-insured for any uncovered loss; Tenant expressly waives the right to make any claim against the Landlord or seek recovery of any damages from the Landlord or its insurance company arising out of any loss or incident for which the Tenant should have maintained its own insurance.

(7) Tenant Was Required to Maintain Property Insurance and Liability Insurance for Property Damage Naming Landlord as Additional Insured; Tenant Indemnified Landlord for Claims for Which Tenant Was Insurable. Paragraph 26 required the Tenant to maintain (among others) the following coverages:

> (a) Fire/Windstorm/Property Insurance with extended coverage endorsement on Tenant's fixtures, equipment, furnishings and other contents of the Premises, for the full replacement cost of said items; and (b) Comprehensive Commercial / Public Liability Insurance … sufficient to protect against liability for damage claims … arising out of accidents occurring in or around the Premises in a minimum of … $1,000,000.00 for property damage…. Such insurance policies shall provide coverage for Landlord's contingent liability on such claims or losses, and shall name Landlord as an additional insured party…. Tenant shall maintain sufficient insurance to fully protect Tenant from all losses and damages; Tenant indemnifies and saves Landlord harmless for any claim for which Tenant was insurable.

(8) Operating Cost Rent Did Not Obligate Landlord to Insure Tenant. Paragraph 45 required the Tenant to pay as additional rent 70% of the Landlord's operating expenses, including insurance premiums. The court rejected the Tenant's argument that by paying the majority of the cost of the property insurance maintained by the Landlord, the Tenant was to be protected by that insurance, and that there was an implied waiver of subrogation. The court found that nothing in the Lease explicitly required the Landlord to purchase property insurance or to name the Tenant as an insured under any insurance policy procured by the Landlord.

The lesson learned from a careful review of the Lease provisions relied on by the court in the *5 Napkin Burger* case, is that all of the Lease provisions have to be reviewed to be sure they are consistent with what the parties intend and with the insurance provisions, even when a waiver of claims or right of recovery language is included in the Lease. There were a number of potential problems with the Lease clauses in the *5 Napkins Burger* case.

First, there was no waiver on the part of the Landlord, which left the Tenant exposed for the full cost to replace the Landlord's damaged building following a fire. We have no indication from the case whether the Tenant was able to pay the loss, to replace or restore its own damaged property and resume occupancy, or even to pay the rent, but if this was a single location small business operation (as opposed to a large restaurant chain), by not waiving its right of recovery, the Landlord might have ended up with a replaced empty shell of a building and no tenant. Note that the Tenant's ability to pay rent that was not abated when the fire was caused by the Tenant's negligence might be dependent on whether the Tenant carried loss of business income insurance covering the period during which the restaurant was being restored. If the Tenant did not carry such insurance, the Landlord who may have thought it was getting the upper hand in the negotiation with its Tenant or justified in obligating the Tenant to continue to pay rent when the Tenant was the one who caused the fire, may have just "cut off its nose to spite its face." The Landlord's own rent loss insurance typically will not reimburse it when the Tenant's rent is not abated, and the Tenant is unable to pay the rent because it can't pay for economic reasons (e.g., being out of business), and because it has no loss of business income insurance.

Second, the Lease provided the Landlord was not obligated to rebuild or repair structural damage to the building caused by the Tenant's negligence. If the Landlord elected not to repair, even if it carried full replacement cost insurance, the most it could recover from its insurance company would be the actual cash value of the loss, not the full cost to repair or restore. There is no indication in the case whether the loss paid by the Landlord's insurer was replacement cost or actual cash value, but the difference could be very significant.

Third, from the Tenant's perspective, it did agree in the Lease to waive its right of recovery against the Landlord, which would have been effective had the Landlord caused the fire or had the fire been due to causes other than the Tenant's negligence. Also, the Tenant's waiver extended to all losses for which it was "insurable" – not for amounts the Tenant was obligated to insure – leaving it up to the Tenant to decide whether it needed more and different types of insurance above and beyond customarily obtained coverages. Under this language, if the Tenant failed to obtain a particular type or limits of insurance that could have covered the loss that later occurred, it would not be able to assert a claim against the Landlord. Despite all of these waivers by the Tenant, there was no reciprocal waiver from the Landlord. Moreover, to add "insult to injury," the Lease obligated the Tenant to pay 70% of the Landlord's insurance premiums as part of the operating expenses, but this factor alone was not enough for the court to find an implied waiver of subrogation on the part of the Landlord.

Indiana first adopted the case-by-case rule for determining whether a Landlord's insurer could bring subrogation action against a negligent Tenant for damage to the leased premises in 2014 in *LBM Realty, LLC v. Mannia*, 19 N.E.3d 379 (Ind. App. 2014). In that case, which contains an extensive summary of the so-called "*Sutton* Rule" (the majority rule) and the minority rule, the court concluded that the Landlord's insurance company was entitled to bring a subrogation action against a residential apartment Tenant who had caused a fire to the unit she leased. However, because the court concluded there was no clear and enforceable provision in the Lease that would have put the Tenant on notice she would be responsible for damage she caused to areas of the multi-unit apartment building outside of her leased premises, the court determined the insurance company could not seek recovery for those amounts from the Tenant.

In a more recent commercial lease case, still applying the case-by-case approach, the Indiana Court of Appeals distinguished the holding in the *LBM Realty* case. *See Youell v. Cincinnati Insurance Co.*, 117 N.E.3d 639 (Ind. Ct. App. 2018). The *Youell* case involved a subrogation claim by a Landlord's insurer against a commercial Tenant. When the building was damaged by a fire, the Landlord's insurer paid $227,653 to repair the damage. The Tenant filed a motion for judgment on the pleadings on the insurer's subrogation claim, arguing the insurer had no right to a subrogation claim against the Tenant for the loss. The court agreed, holding:

> the Commercial Lease Agreement unambiguously provides that Landlord would insure the building and Tenant would insure its personal property inside the building. . . . Landlord and Tenant's agreement to insure was thus an agreement to provide both parties with the benefits of the insurance and expressly allocated the risk of loss in case of fire to insurance. 117 N.E.3d at 642.

The court was able to distinguish the *Youell* case from the *LBM Realty* case because in the *LBM Realty* case the Lease did not require the Landlord to maintain property insurance and only recommended that

the Tenant obtain renter's insurance. As a result, the parties' expectations with respect to liability for damage to the leased premises were unknown. 117 N.E.3d at 643.

If the tables are turned and the Landlord negligently damages the property of the Tenant, courts are more reluctant to recognize an implied waiver in the Landlord's favor. The reason for the distinction is that there is no payment of the Tenant's insurance through rent, no surrender clause applicability, and probably no reasonable expectation on the part of the Landlord that it will be free from liability. *See* Ann Peldo Cargile, *Implied Waivers of Subrogation in Leases*, 12 Prop. & Prob. 22, 27 (January/February 1998).

V. **The Risks of Relying on the Tenant to Insure the Landlord's Property.**

Property owners that rely on the Tenant to maintain the insurance covering damage to the owner's property face a number of risks. First, the Tenant may have a high deductible or self-insured retention amount, and if the Tenant does not have the assets to cover the deductible or self-insured retention amount, the Landlord may not be able to recover these amounts. Second, with a blanket policy, if there is an area-wide fire, storm, or other peril and the Landlord permits the Tenant to deal directly with the blanket insurer, the Tenant may find a way to use the funds to restore other locations but not the one owned by the Landlord. Third, a Landlord will find it much more difficult to negotiate with and enforce its rights against its Tenant's insurer, whereas its rights with respect to insurance that it maintains directly are much more certain. Finally, as discussed below, it is very hard for a Landlord to confirm that its Tenant is actually carrying the required insurance now that certificates and evidence of insurance are clearly not proof of insurance. The Landlord must obtain and review the insurance policies – or the relevant parts of them – to be sure that the required coverage is being maintained.

For these reasons, the most conservative approach for property owners is to maintain their own property insurance coverage and if at all possible, price that cost into the rent paid by the Tenant under the Lease – even if the Lease is a triple net lease. When the Landlord carries its own property insurance on its own building, the Landlord (1) controls the insurance placement and deductibles, (2) can satisfy its lender's property insurance obligations, (3) doesn't risk having the policy invalidated by the Tenant's violation of policy conditions, (4) will receive notice of cancellation, (5) will be able to directly negotiate claims adjustments, (6) can satisfy the reconstruction obligations it has under the Lease, and (7) does not have to obtain a copy of and review the Tenant's policy.

If the Lease is already in place and gives Tenant the right to maintain the property insurance, or if the Tenant is a national tenant that will not agree to Landlord maintaining the insurance, then the Landlord can take steps to minimize its risk. The Landlord's Lease should require that it be a loss payee and additional insured on

all of the insurance covering Landlord's building. Neither is completely satisfactory on its own, and the Landlord should try to be both.

A standard loss payee endorsement (ISO form CP 12 18 10 12) requires that claims be paid jointly (the Tenant as well as the Landlord will be a payee of the proceeds), it provides no protection to the Landlord against the policy being invalidated by actions of the Tenant, and it provides the Landlord with no notice of cancellation. Similarly, a standard building owner's Additional Insured endorsement (ISO form CP 12 19 06 07) makes the building owner a Named Insured for the building only, but loss is adjusted with both the Tenant and the building owner as their interests may appear. In addition, as is the case when the Landlord is a loss payee, the policy may be invalidated by the Tenant's actions, and the insurer is not obligated to provide the Landlord with notice of cancellation. The Landlord should attempt to obtain an endorsement that requires the insurer to adjust the claims for damage to the building with the Landlord (the building owner) only, and for an endorsement in which the insurer agrees to give the Landlord notice of cancellation or modification. There is an ISO Form Notice of Cancellation to Designated Entity(s) that can be used for the commercial property coverage, the commercial general liability coverage, and commercial liability umbrella coverage parts of the ISO form policies. Under this endorsement, the insurer only agrees to give notice of cancellation stating the effective date for cancellation – it does not agree to provide notice of any modification. It does not apply to cancellations for non-payment of premium, and the notice can be sent by any means chosen by the insurer. Unless a different number of days' advance notice is specified in the endorsement, the notice will be no more than the number of days' advance notice they are required to provide to the Named Insured.

In instances where a Tenant insists on carrying property insurance on leased property, such as a single tenant building, the Landlord may be able to secure Contingent Property coverage through its property insurance carrier. Contingent Property locations can be scheduled under the Landlord's master property policy and coverage will apply on an excess or contingent basis for any claims that fall outside of the Tenant's coverage or when the Tenant's limits of insurance are inadequate to cover the full extent of the loss. The Landlord's insurance broker should be able to negotiate reduced rates for Contingent Property coverage since, in theory, such coverage would only come into play when the Tenant's coverage is insufficient. Of course, property insurance carriers providing Contingent Property coverage will likely require annually-updated Evidence of Property Insurance certificates of insurance from the Tenant in order to provide some assurance that "primary" coverage is in place. Contingent Property coverage provides a solution that is preferable to "double-insuring" assets where the Tenant insists on maintaining property insurance on the leased premises. Otherwise, both parties will be

paying full premium for duplicative coverage, under which only one insurance recovery will take place (carriers will not indemnify insureds for amounts above and beyond the actual loss sustained).

VI. The Lender's Rights and Protections.

Lenders have done a good job of persuading insurers and insurance commissioners to protect their interests. Under the ISO Form CP 00 10 10 12 Building and Property Coverage Form, "mortgageholders" (including trustees) shown in the Declarations will be paid for covered loss or damages "in their order of precedence, as interests may appear." Under this provision, a mortgageholder will be entitled to receive a loss payment even after it has commenced a foreclosure or other similar action against the building. Also, if the Named Insured's claim is denied because of its acts or failure to comply with the terms of this Coverage Form, the mortgageholder will still be entitled to receive loss payment as long as it pays any unpaid premiums at the insurer's request, submits a proof of loss within 60 days after receiving notice that the Named Insured failed to do so, and notifies the insurer of "any change in ownership, occupancy or substantial change in risk known to the mortgageholder." Once this occurs, all of the terms of the Building and Property Coverage Form apply directly to the mortgageholder.[4] The insurer also agrees in this Coverage Form to provide notice to the mortgageholder at least 10 days before cancellation for nonpayment of premium or 30 days for any other reason and at least 10 days before expiration if the insurer elects not to renew the policy.

If the policy obtained by a Landlord or a Tenant is not on this ISO Form, a lender with whose loan is secured by a mortgage, deed of trust, or security interest can also protect its interest by requiring a mortgagee endorsement on all property insurance covering the mortgaged property or a similar lender's loss payable endorsement. A typical mortgagee endorsement creates a direct contract between the insurer and the lender that will survive violations of the policy by the insured party (unless the mortgagee knew of the violation and failed to stop it), it requires the insurer to give prior notice of policy cancellation or material modification to the mortgagee, it permits the mortgagee to pay any premium that is due, and it permits the mortgagee and the Named Insured to divide the proceeds between themselves based on the insurable interest held by each of them.

A mortgagee of real property or security interest holder of personal property may also be protected by a lender's loss payable endorsement such as an ISO form CP 12 18 06 07 or other equivalent manuscript forms provided by the insurer, which gives the mortgagee or security interest holder protections similar to those

[4] Note that upon making any payment to a mortgageholder on account of any acts by the insured or failure to comply with the terms of the Coverage Form, the insurer is subrogated to the rights of the mortgageholder under the mortgage to the extent of the amount the insurer has paid, and the mortgageholder's right to recover the full amount of its claim is not impaired. At the insurer's option, it also has the right to pay the entire principal plus accrued interest on the mortgage. If it does this, the mortgage and note are transferred to the insurer and the insured is obligated to pay the remaining mortgage debt to the insurer.

provided in the mortgagee endorsement. In such an endorsement, the insurer agrees to pay the loss payees as their interests may appear, even if a loss payee has begun foreclosure with respect to the property. If the insured property owner has failed to comply with the policy, the lender will nevertheless have the right to receive its proceeds if it pays the premium when the borrower has failed to do so, if it submits a signed, sworn proof of loss within 60 days after the insurer's notice of the insured's failure to submit this proof of loss, and if it has notified the insurer of any change in ownership, occupancy, or substantial change in risk of which the lender is aware. The ISO form (and most other equivalent endorsement forms) also requires the insurer to give the mortgagee at least 10 days prior notice of a cancellation for nonpayment of premiums and 30 days prior notice of a cancellation for any other reason, and requires the insurer to provide the mortgagee with at least 10 days prior notice of election not to renew on the expiration date.

To be sure that its Tenant is obligated to provide this coverage to its mortgagee, the Lease should require the Tenant to name all of the owner's mortgage holders as loss payees pursuant to a lender loss payable endorsement like the ISO form CP 12 18 06 07 and to provide the owner's mortgage holders with the documents required by the mortgage holders, including the policy if required by the lender or if the lender does not require the entire policy, a certified copy of the Declarations Page and the lender loss payable endorsement and other endorsements required by the lender.

VII. The Big Concern: How Can a Party Obtain Proof of the Other Party's Insurance?

When a party – whether Landlord or Tenant, Owner or Contractor – relies on insurance being maintained by the other party, the party relying on the coverage needs to be able to obtain proof that this coverage is in place, in the right amounts, and with the right coverages. In most Leases, the parties require the production of forms of certificates of insurance with respect to liability insurance and forms of evidence of insurance with respect to property coverage. These one-page forms are easy to read and easy to understand and administer, but they cannot be relied upon. The commonly used forms for these certificates or evidence are promulgated by ACORD (the Association for Cooperative Operations Research and Development), a nonprofit that serves the insurance industry by, among other things, developing standard forms. Because its members are primarily insurance underwriters, the ACORD forms reflect the concerns of the underwriters, and those underwriters do not want to be bound by a one-page form filled out by a clerk.

As a result, these certificates and evidence of insurance are not proof or evidence of anything; in fact, they state on their face that they are not binding on the insurer. The insurers take the position that a one-page form cannot override a policy comprising pages and pages of coverages and limitations on coverages. W.

Rodney Clement Jr., *Is a Certificate of Insurance a Worthless Document?*, 24 PROB. & PROP. 46 (May/June 2010). These forms no longer even say that the insurer will give – or endeavor to give – the certificate holder notice of coverage cancellation. If the certificate holder wants this notice, it needs to obtain an endorsement to the insured's policy in which the insurer commits to give this notice. In addition, the certificate holder is not automatically an Additional Insured; the party that wishes to be an Additional Insured needs to obtain a copy of the actual endorsement.

One of the ways a party that is relying on insurance that the other party is maintaining can protect itself is to require the insuring party to provide, from time to time, and in addition to a certificate of insurance, a certified copy of the policy itself, or at least the Declarations Page, the Schedule of Forms and Endorsements comprising the policy, and all endorsements that are needed to provide the required coverage. And the party relying on the coverage must then review the policy or the other information provided to assure that the documents provide the required coverage and do not contain endorsements that diminish that coverage.

VIII. Builders Risk Insurance.

A. What Is Builders Risk and What Does It Cover?

Whenever embarking on a construction-related project, whether it be a new building or renovations of an existing building, one issue to consider is what type of property insurance that should be procured. Builders risk is a form of property insurance designed specifically for construction projects. According to the International Risk Management Institute, Inc. ("IRMI") website definition of a "Builders Risk Policy,"[5] it is:

> A property insurance policy that is designed to cover property in the course of construction. There is no single standard builders risk form; most builders risk policies are written on inland marine (rather than commercial property) forms. Coverage is usually written on an all risks basis and typically applies not only to property at the construction site, but also to property at off-site storage locations and in transit. Builders risk insurance can be written on either a completed value or a reporting form basis; in either case, the estimated completed value of the project is used as the limit of insurance.

Builders risk insurance, while it is a form of property insurance, is intended to cover many risks that permanent property insurance excludes from coverage. Some modest amounts of renovations or repairs are covered by typical permanent property insurance, but permanent property insurance is underwritten and priced on the basis of statistics on how likely a fire, wind storm or other type of "covered cause of loss" will occur.

Builders risk insurance is considered "first party" coverage, meaning it provides coverage for the owner and other parties with an insurable interest in the insured buildings or projects under construction or undergoing major renovation. The party or parties insured (both the first named insured and any other insureds named in the

[5] This definition can be found online at https://www.irmi.com/term/insurance-definitions/builders-risk-policy (last visited June 9, 2019).

policy) must have an insurable interest in order to be covered. An insurable interest under a property insurance policy means that the person intended to be included in the coverage has a financial interest in the property insured (*e.g.*, the building) and will suffer some degree of financial loss if the property is damaged or destroyed.

Construction projects, by the very nature of what is occurring at the insured site, have a very different risk profile from that of completed buildings. For example, material and equipment are being delivered to the site, and other materials are being delivered that need to be stored before they are installed. The installation and construction work is being performed by many different subcontractors at the site – many of whom are working at the same time. Flammable processes (*e.g.*, welding) are often being conducted in areas where flammable materials are stored.

Also, during the course of the work associated with the construction project, the value of the insured property is changing. Contractors and material suppliers perform work, but aren't paid immediately. If a fire occurs, not only are they entitled to be paid for the work performed before the damage, but they will have to be paid to reconstruct the portion of the work that was damaged. Debris will have to be removed and disposed of before the reconstruction work can begin, and delays in completion of the project are likely to occur as a result of the damage.

Builders risk insurance is intended "to transfer the risk of accidental physical damage to the work from the owner, contractors, subcontractors, and sub-subcontractors to the builders risk insurer. In this way, the financial resources for funding repairs are assured, and the project can move forward. The alternative of stopping the project and litigating between the parties is neither desirable nor practical." IRMI, The Builders Risk Book (October 2010), Chapter 1, Introduction to Builders Risk Insurance.[6]

Unlike commercial property insurance policies that are frequently written on standard forms, with the Insurance Services Office, Inc. ("ISO") forms being the most commonly used as the basis for an underwriter's forms, most insurers who underwrite builders risk coverage elect to draft and use their own policy forms. Builders Risk Book, Chapter 1. ISO does have a Builders Risk Coverage Form (*see, e.g.*, ISO CP 00 20 10 12). The American Association of Insurance Services, Inc. ("AAIS") has also promulgated several forms for providing builders risk coverage, such as the Builders' Risk Coverage Scheduled Jobsite Form Comprehensive Form (AAIS IM 7050 08 12), which is used for new construction projects, and the Builders' Risk Coverage Rehabilitation and Renovation Form (AAIS IM 7054 08 12), which is used for rehabilitation or renovation of existing buildings or structures.

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[6] The Builders Risk Book ("Builders Risk Book") is an online book available by subscription through IRMI's website at https://www.irmi.com/products/the-builders-risk-book.

B. Review the Entire Policy and Declarations or Schedule of Coverages to Understand What Coverage Is Included and Excluded

In order to complete the policy and to know what types of losses are covered by the ISO Builders Risk Coverage Form, it must be paired with one of the ISO Causes of Loss Form (*e.g.*, Basic, Broad or Special). In the AAIS coverage forms, the perils covered are part of the Builders Risk Coverage form, and typically cover all risks of direct physical loss or damage unless specifically excluded. In addition, one must review the Declarations Page (ISO form policy) or Schedule of Coverages (AAIS), to obtain the specifics on coverages that are included, such as whether the policy will provide replacement cost coverage or whether it will only provide coverage for the actual cash value of the loss, the amounts of the deductibles for various types of losses, and if applicable, lesser limits (sometimes called sub-limits) for various types of coverages.

The other information that must be negotiated with the insurance company and reviewed by the insured and its broker or other insurance consultant are the overall limit of insurance (*i.e.*, the maximum amount of the insurance coverage) and any special sub-limits (*i.e.*, reduced amounts) for specific types of losses. The amounts of any deductibles and self-insured retentions are important to understand. Finally, it is important to know whether the policy contains a co-insurance (sometimes called "underinsurance") provision in the event the overall limit on the amount of insurance is not equal to the estimated value of the project upon completion. Some of this information is included in the Declarations or Schedule of Coverages pages of the policy, but sometimes sub-limits and co-insurance provisions are included within the policy itself (or both).

C. Additional and Supplemental Coverages

The ISO Causes of Loss Forms also contain certain "Additional Coverages." One such coverage is for debris removal, but only for the insured's property that is covered by the policy. There is a sublimit that applies to debris removal, which limits it to 25% of the deductible under the policy plus the amount paid for the direct physical loss for the Covered Property, although the policy will pay an additional $25,000 for debris removal costs where the debris removal costs exceed that amount and the limit of insurance on the Covered Property that sustained the damage. The AAIS Builders Risk Coverage forms contain similar provisions for debris removal (under a section of the policy called "Coverage Extensions"), but the additional amount is limited to $5,000 instead of $25,000. If these limits are too low, based on the nature and type of project, they can be increased (for an increase in premiums) by special endorsement.

The AAIS Builders Risk Coverage Forms contain more coverages under the standard policy provisions called "Coverage Extensions" and "Supplemental Coverages" than the Additional Coverages under the ISO Form Builders Risk Coverage Form. The Coverage Extensions in the AAIS Forms include the emergency removal or

storage of property to prevent a loss (limited to $10,000), losses caused by theft of property (limited to $50,000), limited coverage for the presence of fungus caused by a covered cause of loss (limited to $15,000), and direct physical loss or damage caused by a covered peril to covered property while waterborne (limited to $10,000). The AAIS Forms indicate the Supplemental Coverages may have limits different than the full limits applicable to the covered property if those limits are shown on the schedule of coverages to the policy, but if no separate limit is identified, the full limits apply. The list of Supplemental Coverages is different in the Scheduled Jobsite Form from the list of Supplemental Coverages in the Rehabilitation and Renovation Form.

The Supplemental Coverages in the AAIS Scheduled Jobsite Form include (i) expediting expenses, (ii) expenses to re-erect scaffolding, (iii) fire department service charges, (iv) damage or loss to personal property that will not become a permanent part of the project while being installed or stored in the covered building or structure (limited to $10,000), (v) extraction of pollutants from land or water if the discharge, dispersal, seepage, migration, release, or escape of the pollutants is caused by a covered peril (limited to $25,000 per location), (vi) rewards paid to an eligible person for information leading to the arrest and conviction of any person unrelated to the insured for arson, theft or vandalism involving a covered loss or for the return of stolen covered property (limited to $4,000), (vii) sewer backup (limited to $10,000), (viii) damage caused by a covered peril to material and supplies to be incorporated into the building or structure, business personal property of the type covered under clause (iv), and trees, shrubs and plants while temporarily stored at another location; (ix) damage caused by a covered peril to the same types of items included in clause (viii) while in transit; and (x) trees, shrubs and plants planted or installed within 1,000 feet of a covered building or structure as long as they are at a covered jobsite and being permanently planted as part of the construction project, but only if they are damaged by fire, lightning, explosion, riot or civil commotion, falling objects or vandalism and then only up to the amount of $10,000.

These AAIS Supplemental Coverages also include coverage for the value of undamaged parts of a covered building or structure that are required to be demolished as a result of the enforcement of any ordinance or laws for undamaged parts of a building (but the coverage is not in addition to the applicable limit of coverage for the property covered by the policy). The AAIS Supplemental Coverages also cover the increased cost to repair, rebuild or reconstruct the undamaged portions of a covered building when they need to be demolished as a result of the enforcement of building, zoning or land use ordinances, laws or decrees in effect at the time a covered peril occurs. In order to recover the added costs under this Supplemental Coverage, however, the structure must be repaired or rebuilt for a similar type of occupancy (unless otherwise required by the building, zoning or land use ordinances, laws or decrees), and the structure must actually be repaired or replaced at the

same or another location as soon as reasonably possible after the loss (not exceeding two years, unless the insurance company agrees to extend the time period during the two-year period). In addition, the added costs cannot be incurred as a result of pollutants or fungus or if the insured was required to comply with the building, zoning or land use ordinances, laws or decrees prior to the occurrence of the covered peril. This laws and ordinance coverage is limited, however, to $50,000.

The AAIS Builders Risk Coverage Forms Supplemental Coverages in the Rehabilitation and Renovation Form are more limited than in the Scheduled Jobsite form. They include only (i) extraction of pollutants from land or water if the discharge, dispersal, seepage, migration, release, or escape of the pollutants is caused by a covered peril (limited to $10,000 during each 12-month period of the policy); (ii) damage caused by a covered peril to covered building materials while temporarily stored at another location but only if the temporary location has been "specifically allocated to or otherwise identified with a 'jobsite' described on the 'schedule of coverages'" in the policy (limited to $10,000); and (iii) building materials while in transit (limited to $10,000).

D. Completed Value Form or Reporting Form

Builders Risk Insurance policies can be written to cover a single project or multiple projects. If written for a single project, the completed value for the project is used as the amount of the insurance. This type of coverage is usually what is procured by owners, since they more frequently are involved in constructing only one project at a time. If an owner has multiple projects under construction at a given time, which might be the case for developers procuring builders risk insurance coverage, or construction companies if they procure the builders risk policy for the projects for which they are the contractor, then a "reporting form" policy is used.

"If the builders risk coverage is written on a completed value basis, the policy premium is calculated and paid at the beginning of the policy period." *See* Chapter 11 of the IRMI Builders Risk Book. However, if the anticipated completed value of the project increases during the course of construction due to change orders, it is important to increase the coverage limits (and pay the corresponding increase in premiums) in order to remain fully insured and avoid a potential reduction in coverage by reason of the coinsurance penalty. In contrast, if the builders risk coverage is written on a reporting form basis, "the insured is required to submit periodic reports (usually monthly or quarterly) of the values in place at the end of the reporting period. The amount of the premium for each reporting period is determined by multiplying the reporting form rate by the value reported by the insured for that reporting period." *Id.*

The advantage of procuring builders risk insurance on a reporting form basis is that the premium is lower initially than it is for the completed value policy because the premium is paid over time based on the values

reported during the progress of construction. The disadvantage of the reporting form "is that if the amounts reported are inaccurate or late and a loss occurs, the insured will likely end up retaining part of the loss." *Id.* For example, under the ISO Form CP 11 05 06 95 Builders Risk Reporting Form, if the insured fails to file with the insurer reports of value as required, the insurer "will not pay more than the value stated in the last report filed before the loss." Also, if the insured fails to file any reports of value, the insurer "will not pay more than the actual cash value as of the inception date" of the coverage provided for the project. This could be very small assuming the policy is procured before construction actually commences. Finally, the insurer "will not pay more for any loss than the proportion the values last reported before the loss bears to the actual cash value of the Covered Property on the effective date of the report." Even with a builders risk policy issued on the basis of a reporting form, under the ISO Form, the insurer will not pay more than the total limit of coverage even if the reported values exceed the limit.

E. Optional Coverages – Agreed Value, Inflation Protection and Replacement Cost

The ISO Form of Building and Personal Property Coverage Form (CP 00 10 10 12) allows for the selection of an Agreed Value for the property. If an Agreed Value is specified in the policy, then the Coinsurance/Underinsurance provisions of the policy will not apply, and the insurer agrees in the policy to pay "no more for loss of or damage to the property than the proportion that the Limit of Insurance under this Coverage Part for the property bears to the Agreed Value shown for it in the Declarations." If the policy period is extended or the anticipated cost to complete the project increases while the policy is still in effect, the insured must be sure the Agreed Value is sufficient and if not to increase the Agreed Value to avoid the effect of co-insurance.

Replacement Cost coverage is also optional under the ISO Form of Building and Personal Property Coverage policy. Even if the policy is written on a replacement cost basis like the permanent property insurance policy, the insurance company will not pay on a replacement cost basis until the lost or damaged property is actually repaired or replaced, and the repair or replacement must also be made as soon as reasonably possible after the loss or damage. In the interim, the insurance company will pay the actual cash value of the loss without having the insured waive its right to recover the replacement cost as long as the insured notifies the insurance company of the intent to seek replacement cost coverage within 180 days after the loss or damage.

Under the Builders Risk Coverage Forms, coverage will end if the covered building or structure (or existing building, in the case of the Rehabilitation and Renovation form) is occupied in whole or in part without the insurer's prior written consent. If the renovations or rehabilitation is occurring in an existing building that remains occupied during the course of the work, it will be important to address this with the insurance company to be sure

this provision is not being violated. The AAIS form Schedule of Coverages includes a "Permission to Occupy" section of the Schedule which, if completed with the insurer granting permission to occupy, will eliminate the prohibition on occupancy, and will specify the date as of which occupancy is permitted. It is critical for this part of the Schedule to be completed properly so there is no doubt the insurer has agreed the owner is entitled to continue to occupy the building during the performance of the work so as not to invalidate the builders risk coverage. There will likely be an increased premium to be paid because "the exposure to loss is greater once the property is occupied." Builders Risk Book, Chapter 7, When Coverage Begins and Ends.[7]

Similarly, under the ISO Builders Risk Coverage Form (CP 00 20 10 12), the insurance provided by the policy "will end when one of the following first occurs:

a. This policy expires or is cancelled;

b. The property is accepted by the purchaser;

c. Your interest in the property ceases;

d. You abandon the construction with no intention to complete it;

e. Unless we specify otherwise in writing:

(1) 90 days after construction is complete; or

(2) 60 days after any building described in the Declarations is:

(a) Occupied in whole or in part; or

(b) Put to its intended use."

F. Named Insured v. Additional Insured

Typically the persons named as insureds in a builders risk insurance policy will include the owner, general contractor and subcontractors. How the insurance company adds them will depend on the forms adopted by the insurance company and what the contracts signed by the parties say about how they are required to be named. The Builders Risk Book strongly recommends the owner, "including contractors of all tiers" be named insureds "as long as the policy's terms and conditions grant identical coverage to all insureds." It is not necessary to

[7] There is a different but similar risk that coverage will be compromised if the rehabilitation and renovation work for an existing building or structure is significant enough to require the building to be vacated prior to the commencement of the work and the owner expects to rely on its permanent property insurance policy. As noted in Part II.D above, most permanent property insurance policies contain provisions that invalidate or reduce the coverage if a building has been vacant for more than 60 consecutive days prior to a loss or damage occurs. For example, if a building has been vacant for more than 60 consecutive days, the ISO Form Building and Personal Property Coverage Form (CP 00 10 10 12) will not pay for loss or damage caused by vandalism, sprinkler leakage (unless the system has been protected against freezing), glass breakage, water damage, theft or attempted theft. In addition, with respect to any other Covered Causes of Loss, the insurer will reduce the recovery that otherwise would have been available by 15%. However, this policy form also states that "[b]uildings under construction or renovation are not considered vacant." To avoid invalidating or reducing the available insurance under a permanent property insurance policy when significant rehabilitation or renovation work is planned, an owner needs to review the facts and its policy with its broker or insurance consultant well before the building is vacated and the work is planned to start to determine whether builders risk insurance should be procured or whether it will be able to rely on its existing policy.

distinguish between "named insureds" or "additional insureds." Chapter 6, Who Is Covered: Naming the Parties Appropriately.[8]

Naming everyone as an insured (or named insured, if that is the term used in the particular policy),[9] "gives the project owners, contractors, and subcontractors equal coverage and equal standing under the policy." Under the policy, each insured has the right to make a claim directly with the insurance company if the owner (or policy holder) fails to do so. The Owner has an insurable interest throughout construction regardless of whether it builds for itself – direct damage to the Insured property (equal to funds expended for its own labor and supplies, as well as payments to the general contractor and subcontractors and possibly material suppliers) because it owns the project. The general contractor has an insurable interest from commencement of construction to final acceptance and payment; its claim is for direct damages for labor, supplies and profit provided to the project that remain unpaid by the owner. Likewise, subcontractors have insurable interest from start of their work through final acceptance and payment. The only exceptions to all parties having an interest in coverage under the policy would be for delay in completion and soft cost coverages, which are typically reserved for the owner and mortgage holders, according to IRMI. *See* Builders Risk Book, Chapter 6, Named Insured Status Recommended.

Another reason for naming the contractors and subcontractors as insureds is that it "should provide them with immunity from subrogation . . . in the event that there is a covered loss that is alleged to have been caused by their negligence." Why is this? Because of the general principle that an insurer cannot subrogate against its insured. *Id.*

Finally, naming the owner, general contractor and subcontractor as insureds will typically satisfy the requirements of any standard form construction contract. *Id.*

One concern sometimes voiced with an owner naming the contractor and subcontractors as insureds is that if the policy is not divisible or several, then coverage for all of the insureds could be void if one of the insureds violates a condition or intentionally causes a loss or otherwise breaches the policy provisions, thereby invalidating the coverage for all insureds. According to the Builders Risk Book, the way to avoid this problem is to be sure the policy has a "severability of interests," multiple insureds" or "divisible contract" clause. With these clauses, the

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[8] According to IRMI, the phrase "as their interests may appear" is unnecessary and should not be included when naming the insureds on the policy because the named insured's recovery for loss is not only limited by the policy limit, but also that person's or entity's insurable interest." Adding the phrase "as their interests may appear" can only cause problems. *Id*.

[9] The Builders Risk Book, Chapter 6 does not recommend material suppliers be named as insureds. Their primary exposure is their insurable interest in the products they supply, but "a builders risk policy, as its name implies, is intended primarily to protect the interests of builders – the project owners who have the construction done and the contractors who perform the construction work." Including material suppliers raises warranty concerns as well as preventing subrogation against a material supplier for defective materials.

policy is clarified so that each insured will remain covered no matter what "bad acts" might be performed by any of the other insureds. Chapter 11 Other Policy Conditions.

The Builders Risk Book, Chapter 11 recommends a severability endorsement (called a separation of interests endorsement by ISO) with language similar to the following:

> this Policy shall apply as if a separate policy had been issued to such party [meaning the insured or named insured identified in the endorsement] provided that the total liability of the insurer to all parties collectively shall not exceed the sums insured and limits and sub-limits of liability specified in the Schedule or elsewhere in the Policy or endorsed thereto

Unlike the ISO Commercial General Liability Coverage Form (CG 00 01 04 13), neither the ISO Causes of Loss Forms or Builders Risk Coverage Form, nor the AAIS Builders Risk Coverage Forms contain such language. This means a severability of interests or separation of interests endorsement should be procured due to the number of entities that will have an insurable interest under a Builders Risk insurance policy.

In addition, if the Builders Risk Policy form being issued contains language similar to the ISO Causes of Loss – Special Form, which excludes coverage for dishonest or criminal acts committed by the insured, its partners, members, officers, managers, employees and leased workers, directors, trustees or authorized representatives (other than destruction), and voluntary parting with any property through a fraudulent scheme or false pretense, and the AAIS Builders Risk Coverage Forms, which exclude coverage for misrepresentation, concealment or fraud by the insured, the policy language would have to be amended to prevent the fraudulent act of a contractor or subcontractor or one of their respective employees as an insured under the policy from preventing recovery by the owner, and vice versa.

These concerns are why owners procuring Builders Risk insurance policies often elect to name the contractor and subcontractor as additional insureds. Adding a waiver of subrogation endorsement may then get one back to the same place, however. Despite the recommendation of IRMI, often the policies will identify these additional insureds "as their interests may appear." With either approach, the policy form should be reviewed carefully to be sure there are no gaps in coverage.

There are many other issues lurking in Builders Risk insurance policies that would need to be addressed in a session dealing only with Builders Risk insurance, including who should carry the coverage, mortgageholder coverage, exclusions from coverage and covered property. Other topics include wrap-up type Owner Controlled Insurance Programs (OCIPs) and Contractor Controlled Insurance Programs (CCIPs) which can include Builders Risk coverage as well as liability, workers compensation, environmental, professional liability and other types of coverages that are well beyond the scope of this Session. Because the other property insurance ISO Forms are

made a part of the ISO Builders Risk policy, some are the same as discussed above for permanent property insurance, but the AAIS Builders Risk Coverage Forms are different.

IX. Conclusion.

Owners that wish to protect the value of the property they own need insurance that covers that value – and provides funds to rebuild if they wish to rebuild after it is damaged or destroyed. The only way to get this coverage is to understand what is covered and not covered by insurance, and the endorsements needed to fill gaps. In addition, the wording in insurance policies changes frequently, and insurance policies are typically purchased for one-year policy periods, language in a long-term Lease or other contract can easily become outdated over time, resulting in uninsured property and risks. Each time a Lease or contract is amended, the insurance and indemnification provisions should also be reviewed to confirm that they are still accurate – and the Landlord needs to find out whether the insurance obligations are current.

Most importantly, we need to remember that Landlords, Tenants, and owners under construction contracts are taking risks when they rely on the other party's insurance – or an obligation by the other party to procure this coverage. The safest course – and one all lawyers should recommend to their clients – is that each party carry its own insurance for its own property, and if that is not possible, at least back-up property insurance that will provide coverage if the other party fails to comply with its contractual property insurance obligations.