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Workshop 15

**The Property Insurance Mirage:
Are Your Insurance and Your Tenant's Insurance Sufficient?**

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by:

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Landlords need to be sure that if a storm, fire, or accident damages the leased property, they will receive sufficient funds to rebuild and if the rent abates, they will recover their rental losses. Tenants also need to know that if their furniture, fixtures, equipment, or inventory are damaged, they will be able to recover quickly for their loss of property and business income so that they can resume business. The coverage that will permit the Landlord and the Tenant to recover the funds necessary to rebuild and replace their property is "Property Insurance." Don't use the term "casualty insurance" to mean insurance for loss of or damage to improvements or to their contents – insurance professionals use that term to mean liability insurance. "Property Insurance" is the understood name for insurance covering loss of or damage to property.

In these materials, we'll refer to various forms used by the insurance industry to provide this property insurance coverage. Many of these published, standard insurance forms were developed by the Insurance Services Office, Inc. ("ISO") - 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 property insurance form setting out the covered Causes of Loss is CP 10 30 10 12 – the 10 30 indicates that it's the Special Causes of Loss form and the 10 12 is the edition's date, October 2012. As time passes,

insurers make coverage revisions, so the newer forms add provisions like virus exclusions; in other words, the newer forms generally provide narrower coverage than the older ones. A national landowner or retailer is likely to have a “manuscript,” or specially worded, policy, but the coverages and exclusions in these customized policies will probably be based on the most recent ISO forms.

I. What Property Insurance Should be Required and Maintained?

A. The Various Forms That Comprise the Policy. An ISO-form property insurance policy is generally made up of two main forms: one describing the categories of property that the insurer will replace or restore (the “Covered Property”), and the other describing the types of loss that will trigger the coverage (the “Causes of Loss”). In addition, the insured party must determine the amount that will be insured – an amount that will be set out in the Declarations page of the policy. Endorsements provide additional coverages, for example, coverage of loss of rents or loss of business income. For some coverages, for example, flood coverage, a separate policy may be required. This section will describe the policy components and some of the available endorsements.

B. The Covered Property. The portion of the policy describing the Covered Property is often called the Building and Personal Property Coverage Form – the ISO form is currently CP 00 10 10 12. Generally, the Covered Property 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,” including 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 interest in fixtures, alterations, installations, and additions made a 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 (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).

C. The Causes of Loss. The separate “Causes of Loss” form sets out the events that will trigger the insurer’s obligation to pay for the insured property. There are three basic ISO commercial property “Causes of Loss” form policies:

- > Basic Form -- covers only listed risks, including fire, lightning, vehicles, aircraft, and civil commotion (generally ISO form CP 10 10 10 12).
- > Broad Form --- 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).
- > Causes of Loss - Special Form -- 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).

The Causes of Loss – Special Form policy provides the best coverage and 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, the Lease should require the Tenant to carry this insurance under a Causes of Loss - Special Form policy (the “Special Form” policy).

The listed exclusions to the Special Form 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 policy are volcanic eruption, blasts, dust, and lava. See ISO CP 10 30 10 12. 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).

D. The Insured Amount.

(i) *Replacement Cost vs. Actual Cash Value.* The limits of coverage set out in the Declarations Page are the most that an insurer will pay on account of any single occurrence – the insurer’s liability is limited to the lesser of the fixed policy limits (a dollar amount) or the Replacement Cost or Actual Cash Value, whichever is selected. The Replacement Cost and Actual Cash Value are the following:

- (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 – the 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 and to avoid the “coinsurance” penalty for underinsuring.

Replacement Cost is the coverage most often required by lenders, and it is the coverage that should be required by Landlords when they permit Tenants to insure their buildings. Even with Replacement Cost coverage, if the improvements are 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. 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.

(ii) *Coininsurance.* Insurers won’t permit the insured party to carry only \$100,000 of insurance on a building that will cost \$500,000 to restore (if totally damaged) without a substantial penalty – called the “coinsurance” penalty. 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, 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 is intended to encourage property owners to purchase limits that approximate the Actual Cash Value or Replacement Cost, as applicable.

Coinsurance Penalty = The amount of insurance the insured “did” carry, divided by the amount of insurance they “should” have carried, times the loss, net of deductible. 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 should have been insured, multiplied by the 80% coinsurance percentage, equals \$4,000,000 – an amount greater than the \$3,000,000 coverage limits that they did carry). Because the coinsurance penalty has been triggered, the following will occur:

- (a) The value of the property at the time of the loss (\$5,000,000), will be multiplied by the co-insurance percentage ($\$5,000,000 \times .80 = \$4,000,000$),
- (b) The stated limits of the coverage (\$3,000,000) will be divided by the figure in (i), ($\$3,000,000$ divided by $\$4,000,000 = .75$),
- (c) The amount of the loss (\$1,000,000) before the application of the deductible will be multiplied by the figure calculated in (ii) ($\$1,000,000 \times .75 = \$750,000$),
- (d) The deductible will be subtracted from the figure in (iii) ($\$750,000 - \$10,000 = \$740,000$), and
- (e) The insurer will pay the result (\$740,000).

The remainder of the loss amount (\$260,000) will not be covered.

The party maintaining the coverage (or the Landlord who owns the building if the Landlord is permitting the Tenant to insure that building) needs to be sure that the recovery will not be reduced by the coinsurance penalty. One way for an insured to avoid the application of the coinsurance penalty is to be sure that the stated policy limits reflect Property’s full Replacement Cost (or Actual Cash Value as the case may be) at all times – or at least are greater than the coinsurance percentage of this full insurable value. 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 the Agreed Value as an Optional Coverage on the Declarations Page. When the Agreed Value coverage applies, the insurer stipulates an agreed value for the insured property and suspends the operation of the coinsurance clause, but the insured party needs to be sure that a Schedule of Values for the property is actually agreed to by the insurer and incorporated into the policy – and that this Schedule of Values is kept current throughout the life of the policy. If the insured party is using a “blanket” policy covering more than one of its properties, that blanket policy should include an Agreed Value Endorsement fixing the agreed value for each location and waiving the coinsurance penalty.

E. The Endorsements and Additional Coverages.

(i) *Coverage for Loss of Business and Loss of Rents.* Property owners of leased property need loss of rental value coverage for the rental income they will lose if a fire or other casualty makes leased premises unusable. Tenants also need loss of business income coverage for the profits they will lose if the casualty prevents their operations and for the continuing operating expenses that they must necessarily continue to incur while they are not operating. In addition, both Tenants and Landlords need coverage for the Extra Expenses they may incur by reason of the fire or other loss event; for example, Extra Expenses coverage may permit the Tenant to move to and open in to a temporary location or the Landlord to open a temporary management office.

A property policy, even a Special Form policy, by itself, does not cover loss of business or loss of rental value. An endorsement to that policy is needed for this loss of rents/loss of business coverage – there will be no coverage for loss of rents/loss of business income without this endorsement. 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).

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 and rent if it is not abated. If Extra Expense Coverage has also been obtained, 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 is equal or less than the loss that would have been payable had these expenses not been incurred.

Loss of Rental Value is calculated in the same way as loss of Business Income and is (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 continuing normal operating expenses may include payroll and other charges that the Landlord would otherwise pass through to the Tenants – but only if the Tenant’s obligation to pay these charges has abated by reason of the casualty.

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 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 untenable, 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 a 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.

It is very important for the insured party to understand that its loss of Rental Value/loss of Business Income coverage is tied to the Causes of Loss identified in the Causes of Loss portion of the policy. This means that if the loss is caused by an excluded loss, for example a flood, the loss of Rental Value/loss of Business Income will not be covered. This is an important point today, when many insureds have made claims for the loss of Rental Value/loss of Business Income caused by the COVID-19 pandemic, and are facing insurer arguments that their business losses were not caused by a covered Cause of Loss under their policy.

(ii) *Building Ordinance or Law Coverage.* A standard Replacement Cost property damage policy will not cover added costs of complying with some laws and ordinances; for example, it will not cover the cost of (1) tearing down a damaged building 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 (this may be the case when 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 a similar type of endorsement. As always, the damage must be from a loss that is caused by a Covered Cause of Loss – separate coverage must be obtained (if available) for building ordinance coverage if the loss is from a flood or earthquake.

Three types of building ordinance coverage are 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). 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.

(iii) *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 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.

(iv) *Mechanical Breakdown.* Mechanical breakdowns (this might include HVAC systems destroyed by a power surge) are excluded from the Covered Causes of Loss 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 such as ISO form CP 10 46 10 12 entitled "Equipment Breakdown Cause of Loss."

(v) *Vacancy.* This is not an endorsement, but it is a standard policy provision that insured parties need to understand. Many policies, including the ISO form CP 00 10 10 12, stipulate that if a building has been vacant for longer than 60 days or another fixed 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 an insured 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 (this includes the period before a newly constructed building is tenanted).

(vi) *The Protective Safeguard Endorsement.* This is an endorsement often added by insurers (perhaps explained as justifying a reduced premium) that the insured party should avoid. It requires 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). 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.

(vii) *More Exotic Types of Business Loss Coverage.* The insured party can often obtain the following types of Business Income coverage:

- (a) Utility Interruption – By a special endorsement, 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, but only if caused by a Covered Cause of Loss. Overhead transmission or distribution lines are generally excluded, as is loss or damage to electronic data even though the equipment damage would be covered.
- (b) Contingent Business Income – By a special endorsement, a property owner or business operator can also obtain Contingent Business Income insurance that covers the business losses it suffers at the insured's property when a Covered Cause of Loss damages another 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.

(viii) *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). A separate flood coverage policy 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. This provision must be authorized periodically – at the time these materials were prepared, the authorization extended only through September 30,

2021. Congress can modify the NFIP when it reauthorizes it, and most anticipate higher premiums in flood-prone areas in the future.

(ix) *Terrorism Coverage.* 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 This legislation provides a process for shared public and private compensation for insured losses suffered in an act of terrorism. 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 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. Also, TRIA deals with insured losses to property, not bodily injuries or death.

II. Who Should Insure What Part of the Property?

A. *The Clear Cases.* The clear fact situations: (i) in a lease of a portion of a multi-tenant building, the Landlord should insure the building and have the restoration obligations, and (ii) in a lease in which the tenant builds and pays for the improvements on an outparcel or a stand-alone piece of property, the tenant should insure the building and (perhaps) have the restoration obligations. But many leases are not within these clear fact situations.

B. *The Perils of Net Leases.* In many “net” leases of stand-alone property, the Landlord owns and has paid for the building, but the Tenant wants to carry the property insurance on the building as part of its overall insurance program. This can be dangerous for the Landlord. 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 because certificates

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

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. Finally, the Landlord should not agree to restore a building insured by the Tenant – at least not unless Landlord's restoration obligations are conditioned on Landlord receiving sufficient insurance proceeds from the Tenant.

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 Tenant will not agree to Landlord maintaining the insurance, then the Landlord can take steps to minimize its risk in the Lease. The Landlord's Lease should require that it be a loss payee and additional insured on all of the insurance covering Landlord's building. 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 the 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 standard ACORD Evidence of Insurance form no longer requires that the insurer even use reasonable efforts to give the certificate holder 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 an endorsement in which the insurer agrees to give the Landlord notice of cancellation or modification, though notice of modification may be an issue and the insurer is unlikely to agree to provide notice of cancellation for non-payment of premium.

C. *The Tenant's Improvements and Losses.* Even when the Landlord is insuring the building and other improvements that it owns, the Tenant can and should insure its own Business Personal Property, including 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.

In addition, 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 (or paid for) 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:

(i) 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

(ii) 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

(iii) the amount of any Prepaid Rent (amortized by the number of months remaining in the Lease).

D. *Waivers of Claims and Subrogation.* 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 or entity that caused the damage. This means that they can step into their insureds' shoes and recover the amount paid from the person or entity that damaged the property. By virtue of this "subrogation" right, if Tenant's property is damaged by a defect in the Landlord's building or the Landlord's negligence, the Tenant's property insurer can proceed against the Landlord to recover the damage amounts that it paid to the Tenant. See, e.g., *Allstate Ins. Co. v. Mazzola*, 175 F.3d 255 (2d Cir. 1999).

Consequently, once the parties have agreed on their property insurance allocations, each of them must include in the Lease a waiver by the other party of claims arising from damage to or loss of property that the waiving party was to have insured. 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, a property 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. But to cover situations in which the policy does not permit the insured to waive the insurer's 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 expressly waives its right of subrogation.

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, but if either party's policy does not permit the insured to waive the insurer's rights of subrogation, then that insured party will have its property policy or policies endorsed so that its insurer expressly waives all rights of subrogation with respect to the other party.

Of course, if the Tenant is insuring the Landlord's building, then this should not be reciprocal – only the Tenant should waive rights and claims against the Landlord. The Landlord should not waive its claims because this Tenant really will be liable for loss or damage to the Landlord's property, and if the Tenant has not maintained the correct coverage, then the Landlord needs to have the right to proceed against the Tenant.

Also, most Landlord forms start with a one-sided waiver of claims by the Tenant – without a reciprocal waiver by the Landlord. It's then up to the Tenant (or its lawyer) to ask that the waiver be made reciprocal (though if the Tenant is paying a portion of the Landlord's property coverage, a court may find a waiver of subrogation to be implied).

III. The Business Income and Rental Loss Concerns of Each Party and how to Harmonize Them.

Generally, only the party that maintains the property coverage can insure for its own loss of Rental Value or loss of Business Income – the loss of Rental Value/loss of Business Income endorsement is an addition to the property policy covering loss of or damage to the physical property. Consequently, a Landlord that insures loss of or damage to its building also covers its loss of Rental Value resulting from that loss or damage, and a Tenant that insures loss of or damage to its Business Personal Property also insures its loss of Business Income resulting from that loss or damage. In a lease, the Landlord's lawyer must be sure to consider these two types of coverages and how they work together when it drafts the Lease's rent abatement and casualty termination provisions.

A party's loss of Business Income or loss of Rental Value coverage also includes coverage for its "continuing normal operating expenses." If the rent does not abate, then the continuing rent is part of the Tenant's

“continuing normal operating expenses” and is included as part of the Tenant’s loss of Business Income coverage. In other words, the Tenant will recover from its insurer the amounts it needs to pay its rent. On the other hand, if the rent does abate, then the Landlord’s loss of Rental Value insurance should reimburse the Landlord for this rent that was abated by reason of the damage – Landlord should not be able to recover rent that does not abate is not recoverable from the insurer.

This highlights the importance of there being no rent abatement upon casualty if the Tenant is insuring the Landlord’s building. The Tenant will probably not be able to obtain insurance for Landlord’s loss of Rental Value, but the Tenant can cover its own “continuing normal operating expenses,” including its own continuing rent obligations, through its own loss of Business Income coverage. This can also be an issue if the net lease permits the Tenant to terminate by reason of the damage. If the Tenant terminates the Lease by reason of the casualty, it has no continuing obligation to pay rent, and Landlord does not have insurance covering that rental loss; in other words, Landlord is out of luck.

Landlords and Tenants can also get into trouble when the Landlord is insuring the building and carrying the loss of Rental Value insurance, but the Lease provides that 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, there is no loss of rent, and the insurer is not obligated to provide coverage. 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, particularly 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 it is maintaining the loss of Rental Value coverage, its best remedy is to provide that the rent will abate upon fire or other casualty, 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). The Landlord can then look to its loss of Rental Value coverage, not to its displaced Tenant.

IV. Property Damage Caused by Construction.

Some types of property damage caused by Tenant’s construction will not be covered by Landlord’s property insurance. For example, neither damage caused by faulty design, workmanship, or construction nor damage caused by collapse or loss of structural integrity by reason of construction is covered by a Special Form – Causes of Loss policy. Consequently, if Landlord is performing the construction, Landlord should obtain, and if Tenant is

performing the construction, Landlord should require the Tenant to maintain certain additional coverages, including the following:

A. Builders Risk Insurance. Builders Risk Insurance is the property insurance designed specifically for construction projects. According to the International Risk Management Institute, Inc. (“IRMI”) website definition of a “Builders Risk Policy,” 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.

See <https://www.irmi.com/term/insurance-definitions/builders-risk-policy>. Builders Risk insurance is necessary during construction projects 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 is to occur – it is not intended for loss or damage risks arising during construction.

B. Coordination of the insurance coverages between Tenant and Owner. The issues that many Owners need to understand before their Tenant embarks on a construction policy are the need to coordinate the existing property insurance and the Tenant’s builder’s risk policy, as well as the need to coordinate the parties’ liability insurance programs. These issues include:

- (i) Should the builder’s risk insure the entire building including the improvements to be constructed?
- (ii) Should the property insurance allow a waiver of subrogation against the contractors?
- (iii) Does the lease stipulate who will own the work post-completion?
- (iv) Does the lease stipulate who is to insure the work during construction?
- (v) Does the lease stipulate that Landlord and Landlord’s lender must be loss payees?

The lease needs to address construction and renovation work, separate from Tenant’s operations and required insurance coverages. It can either be generic and indicate that the Tenant must obtain Owner approval prior to commencement of any work and this approval can be subject to Landlord’s conditions (preferably in Landlord’s discretion or at least its reasonable business judgment). Or, the lease can be very specific as to how the work will be coordinated and the insurance that the Tenant and its contractors are required to maintain. Set out below are a few lease provisions with respect to Tenant’s construction to consider from the perspective of the Landlord’s insurance program:

Sample Indemnity During Construction:

Indemnity. During all construction, and without limiting the Tenant's other indemnity obligations under the Lease, the Tenant shall indemnify, protect, defend, save and hold harmless the Landlord and each Landlord party from and against, any and all claims, demands, and causes of action that may be imposed on, incurred by or asserted or threatened to be asserted, against the Landlord or any Landlord party, whether or not the Landlord or such Landlord party shall also be indemnified as to any such claim, demand, or other cause of action by any other person, in any way relating to or arising out of (i) any event, condition or circumstance related to the design, development, construction or completion of the improvements by or on behalf of Tenant or any Tenant party or any other construction or other work within the Tenant's control, (ii) fraud, misapplication of funds, illegal acts or willful misconduct on the part of the Tenant, (iii) any Bankruptcy event of default, or (iv) the actual or alleged discharge, dispersal, release, storage, treatment, generation, disposal or escape of pollutants or other toxic or hazardous materials on, in or from the premises caused by Tenant or any Tenant party. This obligation to indemnify, defend, and hold harmless Landlord and each Landlord party will include, without limitation, all attorneys' fees and necessary litigation expenses.

Notice of Construction Commencement.

Tenant shall submit to Landlord in writing the following information at least five (5) business days prior to the commencement of construction of Tenant's work:

- a. The names and addresses of each of the major subcontractors that the Contractor intends to engage in the construction of Tenant's work. In addition, Tenant shall provide Landlord with the names, addresses and telephone numbers of two (2) individuals representing the Contractor who can be reached 24-hours a day during construction of Tenant's work.
- b. The anticipated commencement date of construction.
- c. Evidence of property, builder's risk or an installation floater, liability, and worker's compensation insurance reasonably acceptable to Landlord as to insurer, policy terms and coverage (which, as to property and liability insurance policies, may include, without limitation, naming Landlord as loss payee and as an additional insured using both additional insured endorsements CG 2010 10 01 and CG 2037 10 01).

Conformance with Working Drawings.

Tenant, at its sole cost and expense, shall cause Tenant's Contractors to perform all work required to complete Tenant's work substantially in accordance with the approved working drawings. Landlord shall have the right to observe Tenant's work, at Landlord's sole cost, but any such observation shall be strictly for Landlord's own purposes and shall not impose upon Landlord any express or implied duty to Tenant or any third party with respect to Tenant's work or the premises, including, without limitation, verification that Tenant's work is constructed in a good and workmanlike manner, substantially in accordance with the working drawings or in accordance in all material respects with applicable legal requirements.

Compliance with Codes.

All Tenant's Work shall be performed in a good and workmanlike manner in accordance with good industry practice, and shall comply in all material respects with applicable Federal, State, Municipal and County legal requirements, including, without limitation, the ADA) in effect at the time of permit issuance. All required building and other permits in connection with the construction and completion of Tenant's work shall be obtained and paid for by Tenant.

Security, Insurance, Storage and Clean-up.

Tenant shall have the sole responsibility for security of the premises and all Tenant's Contractors' materials, equipment and work from and after the commencement date of Tenant's work, and shall carry "Builder's Risk" Insurance for Tenant's work. Tenant shall maintain the premises and the surrounding areas (including maintaining emergency ingress and egress) in a clean, safe and orderly condition during construction. Tenant and Tenant's Contractors may not use the elevators in the building without the prior approval of the Landlord and, if so permitted, shall take all precautions to protect the elevator cabs, doors and mechanicals

from any form of damage and shall be liable for any damage that may occur. Landlord will provide Tenant's Contractors elevator padding to protect the elevators utilized for construction materials. Tenant shall promptly remove all unused construction materials, equipment, shipping containers, packaging, debris and flammable waste from the building. Neither Tenant nor Tenant's Contractors shall be permitted to deposit rubbish, dirt or debris in Landlord's trash containers or elsewhere in the building. Storage of construction materials, tools, equipment, and debris shall be confined within the premises.

Additionally, Landlords need to confirm Landlord's liability policy does not contain an endorsement indicating designated work and/or designated operations are excluded. Here's a recent version of an exclusion that an Owner discovered was part of its liability policy:

Any activities arising out of your "construction or development" operations. This exclusion applies regardless of whether such operations or work are or were performed or completed by you or on your behalf. This exclusion does not apply to your routine "maintenance or renovation" operations.

Lenders also address Tenant construction in their loan agreements with Landlords:

At all times during which structural construction, repairs or alterations are being made with respect to the mortgaged property by Landlord or any other person, including, without limitation, a Tenant, and only if the other insurance that Mortgagor is obligated to maintain does not apply, Mortgagor shall maintain or cause to be maintained the following: (1) Owner's contingent or protective liability insurance covering claims not covered by or under the terms or provisions of the below mentioned commercial general liability and excess liability insurance policies; and (2) the insurance provided for in subsection (i) above written in a so-called Builder's Risk complete value form (I) on a non-reporting basis; (II) against "special causes of loss" or "all risk" coverage (III) including soft costs; (IV) with an agreed amount endorsement waiving co-insurance provisional and (v) with permission to occupy such Eligible Pool Property.

V. How Can the Landlord Obtain Proof of the Tenant's Insurance?

When a party, whether Landlord or Tenant, relies on insurance being maintained by the other party, the party relying on the coverage needs to be able to obtain proof that this insurance 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 by themselves. 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 Broker or 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 a loss payee or additional insured; the party that wishes to be a loss payee or 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 or evidence 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. 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.