SPECIAL REPORT

DEFECTIVE TENANT LEASE PROVISIONS CAN DESTROY A TENANT'S BUSINESS IN THE EVENT OF DAMAGE OR DESTRUCTION OF A LANDLORD'S BUILDING

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Part of our function as risk managers is to review the risk of loss provisions of leases from a tenant's standpoint.

Landlords have less of a problem with defective leases because they control their own insurance program (and if not, they should) because they buy their own insurance on the building that they lease to others. On the other hand, tenants pay for the landlord's insurance through charge backs. However, they do not have the benefit of the insurance and they are actually in the position of being sued by the landlord's insurance carrier or the landlord itself if they were negligent directly or indirectly in damaging the landlord's building. Furthermore, even if they did not do anything to cause the damage, they have agreed to repair or rebuild under the repair provision of the lease.

A claim by the landlord's insurance company or by the landlord for reimbursement for losses incurred can arise out of:

1. Ordinary or gross negligence of the tenant, the tenant's employees, agents or invitees, even where there is no lease agreement.

2. Repair clauses in leases that impose the responsibility for repairing building damage, even where the tenant was not negligent.

Assuming the landlord or the landlord's insurance company makes a claim under either of these two concepts, it is likely the tenant's insurance (assuming the tenant has not purchased building insurance) under the

tenant's liability policy will provide only limited coverage. This is because the tenant's general liability insurance specifically excludes claims arising out of damage to the landlord's building that the tenant leases or occupies with a limited exception.

The standard commercial general liability policy provides only $100,000 in coverage for damage to a landlord's premises, and this is limited to fire only. Even then coverage applies only if the damage was as a result of the tenant's negligence. Contractually assumed claims under the repair clause provisions would not be covered because this is a standard exception under the contractual liability exclusion of the commercial general liability policy. Under most repair clauses, the tenant has to pay for repairs even when no negligence is involved.

Higher limits can be purchased by tenants under the commercial general liability insurance, and some carriers will add additional perils, but few carriers will cover contractually assumed damage.

As you can see from the attached schedule of major insurance carriers, even with broad form liability extension endorsements, the tenant's legal liability coverage (with the exception of Chubb) does not cover all damage caused by the tenant's negligence or all contractually assumed repair costs. Furthermore, even where coverage is provided, the limits themselves are typically not going to be sufficient with most carriers providing limits as low as $250,000 even under the broad from endorsements.

For a first class office space, assuming a repair cost of $200 per square foot, a $250,000 limit would only cover an office with 1,250 square feet. A 10,000 square foot office will have a repair cost in the area of $2,000,000. For a manufacturing building at $100 per square foot, a $250,000 limit would cover a 2,500 square foot leased building.

As you can see from the attached chart, only one insurance carrier covers virtually all situations that could damage a premises from a perils standpoint. Major causes of loss for damage are overflow of plumbing caused by tenant negligence and smoke arising out of defective equipment where no fire has occurred. As you can see, other than fire, these are not universally covered.

The first method of solving this problem is to utilize the tenant's legal liability coverage form and attach it to a Special Cause of Loss form giving you all-risk coverage. This covers the tenant's legal liability. However, legal liability assumed in a contract or agreement by way of repair clauses is an important exception. For example, if there is lightning damage to the premises, it is unlikely that the lightning would be caused by the legal liability of the tenant. Under a repair clause of a lease, the tenant likely will be assuming that liability unless there is an exception for repairs arising out of fire or casualty losses. Even under the tenant's legal liability coverage form, this would not be covered because the Special Cause of Loss form excludes contractually assumed liability.

The other method is to purchase full building coverage on the building although this can be expensive. Whereas the tenant legal liability form is typically 25% of the building rate, you are going to being paying 100% of the rate only to cover the insurable interest of the tenant if you purchase full building coverage.

The most important thing you can do is to allow us to have input on lease agreements, either new agreements or renewals, before they are signed. In our review of literally hundreds of lease agreements, we have found very few that do not have defective waivers of subrogation or repair clauses.

In our review of leases, we look for the following:

1. We examine the repair clause. The following is an actual repair clause from a lease I recently reviewed.

   ***Repairs**. Landlord shall make all structural and maintenance repairs to the Building, all repairs and replacements which may be needed to the mechanical, HVAC, electrical and plumbing systems in and servicing the Premises. Landlord shall comply with all required governmental rules, laws, statutes and regulations applicable to the maintenance of the Building. In the event any repair is required by reason of grossly negligent or intentional act of Tenant or its agents, employees, invitees or of an other person using the Premises with Tenant's express or implied consent, Landlord may make such repair and invoice the Tenant for same, unless Landlord actually recovers the entire cost through insurance proceeds.*

Note that this repair clause does not contain an exception for fire or casualty losses, and standing alone it requires the tenant to replace the entire premises if damaged by a fire or other casualty if the damage was as a result of the tenant's gross negligence or the intentional acts of an employee or client. This example is not the worst of the repair clauses because it at least limits the tenant's responsibility to gross negligence or intentional acts and does not include contractually assumed responsibility.

Here is another defective repair clause:

> ***REPAIRS***. *The Tenant shall take good care of the Premises and the fixtures in the Premises and shall keep the Premises in good order, condition, and repair at the Tenant's expense during the Term, including the replacement of all interior broken glass and exterior glass broken by the Tenant with glass of the same size and quality. If the Tenant does not make necessary repairs within a reasonable time and adequately, the Landlord may, but need not, make such repairs and the Tenant shall promptly pay the Landlord for the cost thereof as additional rent. On the expiration of the Term or on earlier termination or cancellation of this Agreement, the Tenant shall surrender the Premises and the Landlord's fixtures in as good a condition as of the time of delivery to the Tenant, subject to reasonable wear and tear. All injury to the Building or fixtures caused by moving of the Tenant in and out of the Building caused by the Tenant and any damage done by water, steam, electricity, fire or other substances to the Building or fixtures, or to the property of other tenants in the Building caused by Tenant may be repaired by the Landlord at the expense of the Tenant, and the cost thereof shall become immediately due and payable by the Tenant as additional rent upon the delivery of a statement of such costs by the Landlord to the Tenant, or mailing the same, postage prepaid, to the Tenant as its last known address*.

This is a good example of a clause that is based on a contractual obligation to pay regardless of negligence, which is not covered on contractual liability or tenant's legal liability coverage with most insurance carriers.

2. We look at the waiver of subrogation clause. Below you will see a defective waiver of subrogation clause because it indicates that the waiver does not apply to the extent that the landlord is unable to collect from its insurance carrier. Because we have no control over the quality or the limits under a landlord's insurance policy, you must look at this waiver of subrogation on the basis that the landlord will have no insurance whatsoever. Therefore, it is worthless.

   Waiver of Subrogation*. Notwithstanding any provision of this Lease to the contrary, each party waives any and every claim which arises or which may arise in its favor against the other party during the Term, any extension or renewal for any and all loss or damage to any of its property located within or upon or constituting a part of the Building to the extent covered by an insurance policy. Each insurance policy Landlord or Tenant is required to obtain and maintain under this Lease shall contain a provision whereby the insurance company issuing the policy waives all claims for subrogation, consistent with the provisions of this paragraph*.

   The following is a clause that I like better:

   Rent Abatement*. Landlord and Tenant will each look to its own insurance for recovery of any loss resulting from fire or other casualty. Landlord and Tenant release one another from such claims. Landlord and Tenant waive any right of recovery of insured claims by anyone claiming through them, by way of subrogation or otherwise, including their respective insurers. This release and waiver remains effective despite either party's failure to obtain insurance. If either party fails to obtain insurance, it bears the full risk of its own loss.*

   This clause accomplishes two goals. The first is to waive the rights of the landlord to sue if the landlord does not have insurance or has defective insurance. The second is to block the landlord's insurance company's ability to sue the tenant. These are two independent issues.

3. The third clause we look at under lease agreements is the rent abatement clause. Below you will find a defective rent abatement clause in that it indicates the rent does not abate if the tenant was

negligent in causing the loss. We need to assume that in the event of major damage to the premises, it is likely to be the tenant's fault short of a lightning claim.

> *During any period of restoration, the Base Rent for such period shall be reduced in proportion to the portion of the Leased Premises that has been rendered untenantable as a result of such damage, provided that there shall be no reduction of Base Rent during any period of delay caused by the failure of Tenant to repair or replace fixtures, equipment, merchandise or other contents of the Leased Premises or by reason of its failure to adjust its own insurance. Landlord shall have no duty to repair, replace or restore Tenant's fixtures or Tenant's improvements above those defined in Exhibit C-2 in the event of damage by fire, casualty or other cause. There shall be no reduction of Base Rent if such fire or other cause of damage shall have resulted from the negligence or willful act of Tenant or its agents, employees, invitees, guests, or licensees. If both Tenant's and Landlord's "loss of rents" coverage terminates before repairs are completed in damaged areas, Landlord will abate the rent and expenses for that affected percentage of the space until habitable by the Tenant unless damage was caused by Tenant's negligence.*

Continuing expense, such as rent, is covered under the tenant's business interruption form; however, utilizing this for this continuing expense deprives the tenant of limits that may be required for other needs. Furthermore, in the event of long term damage, it could take two years to repair a building. Many tenants will likely have a 12 month actual loss sustained form.

4. The fourth language we look at is the ability of the tenant to terminate the lease in the event of major damage. Below you will find a typical clause.

> ***Major or Uninsured Damage**. In the event the Premises or the Building, or any portion thereof, is damaged or destroyed by any casualty to the extent that Landlord is not obligated, under Paragraph 12.01 above, to rebuild, repair or restore the damaged portion thereof, then Landlord shall within forty-five (45) days after such damage or destruction, notify Tenant of its election, at its*

option, to either (i) rebuild, restore and repair the damaged portions thereof, in which case Landlord's notice shall specify the time period within which Landlord estimates such repairs or restoration can be completed; or (ii) terminate this Lease effective as of the date the damage or destruction occurred. If Landlord does not give Tenant written notice within forty-five (45) days after the damage or destruction occurs of its election to rebuild or restore and repair the damaged portions thereof, Landlord shall be deemed to have elected to terminate this Lease. Notwithstanding the forgoing, if Landlord does not elect, or is deemed not to have elected, to terminate this Lease, Tenant may terminate this Lease if either (i) Landlord notified Tenant that such repair or restoration cannot be completed within two hundred seventy (270) days after the casualty or (ii) the damage or destruction occurs within the last twelve (12) months of the Term, unless Tenant's actions or omissions are the cause of the damage. If Tenant has the right to terminate the Lease in accordance with the above provisions, Tenant may so elect by written notice to Landlord which must be given within thirty (30) days after Tenant's receipt of Landlord's notice of its election to rebuild or thirty (30) days after expiration of such forty-five (45) day period where Tenant has failed to elect. Upon Landlord's receipt of such notice, the termination shall be effective as of the date the destruction occurred.

Note in this clause the lease cannot be cancelled by the tenant; it can only be canceled by the landlord.

Conclusion

In this whole area of leases, there is a huge potential for uncovered losses because the limit is typically going to be too low under most policies.