MARSH & McLENNAN AGENCY

WORLD CLASS. LOCAL TOUCH.

SPECIAL REPORT

I THOUGHT THE LANDLORD WAS INSURING THE BUILDING I LEASE . . .

(06/27/2014)

This Special Report was written by Kenneth R. Hale, J.D., CPCU, AAI, LIC of Marsh & McLennan Agency LLC. Mr. Ken Hale can be contacted at 734-525-2412 or khale@mma-mi.com. More Special Reports are available at www.mma-mi.com.

• **DEFECTIVE LEASE CLAUSES THAT RELATE TO BUILDING DAMAGE** • **LIMITED COVERAGE UNDER THE TENANT'S LIABILITY INSURANCE FOR BUILDING DAMAGE**	**CAN RESULT IN A MAJOR UNCOVERED LOSS FOR THE TENANT**

In this whole area of leases, there is a huge potential for uncovered losses because the coverage available to the tenant for damage to the leased building is typically going to be non-existent under most basic policies purchased by a tenant.

Part of our function as risk managers and professional insurance buyers is to review the risk of loss provisions of leases for clients that lease office, retail or commercial space from others.

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 chargebacks, in most cases.

HOWEVER, A TENANT DOES NOT HAVE THE BENEFIT OF THE LANDLORD'S 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, if they have agreed to repair or rebuild under the repair provision of the lease, they will likely have liability for the damaged or destroyed building.

A TENANT CAN BE SUED FOR CATASTROPHIC BUILDING DAMAGE BY ITS LANDLORD OR THE LANDLORD'S INSURANCE CARRIER IF TENANT'S NEGLIGENCE CAUSED THE DAMAGE.

LACKING NEGLIGENCE, THE LEASE MAY STILL IMPOSE THIS RESPONSIBILITY CONTRACTUALLY.

THE TENANT'S COMMERCIAL GENERAL LIABILITY POLICY PROVIDES VERY LIMITED COVERAGE FOR DAMAGE TO BUILDINGS LEASED BY AN INSURED FROM ANOTHER PARTY.

A claim by the landlord's insurance company, or by the landlord, for reimbursement for casualty losses (such as a fire and other perils) incurred by the landlord 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 and even if it is an Act of God (such as lightning or wind damage).

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 specific building insurance) under the tenant's liability policy will provide only limited, if any, coverage.

THIS IS BECAUSE THE TENANT'S COMMERCIAL GENERAL LIABILITY POLICY SPECIFICALLY EXCLUDES CLAIMS ARISING OUT OF DAMAGE TO THE LANDLORD'S BUILDING WITH A LIMITED EXCEPTION.

The standard Commercial General Liability policy without special endorsements 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 and few carriers cover water damage claims (such as overflow of plumbing or bursting of pipes).

AS YOU CAN SEE FROM THE FOLLOWING SCHEDULE OF MAJOR INSURANCE CARRIERS, EVEN WITH BROAD FORM LIABILITY EXTENSION ENDORSEMENTS, THE TENANT'S LEGAL LIABILITY COVERAGE (WITH THE EXCEPTION OF TWO CARRIERS) 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 form endorsements.

For a first-class office space, assuming a repair cost of $250 per square foot, a $250,000 limit would only cover an office with 1,000 square feet. A 10,000 square foot office will have a repair cost in the area of $2,500,000. For a manufacturing building at $135 per square foot, a $250,000 limit would only cover a 1,851 square foot leased building.

As you can see from this chart, only one insurance carrier covers almost all situations that could do damage to a leased premises under a Broad Form Extension endorsement. Major causes of loss for damage are overflow of plumbing, bursting of water pipes 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.

Here is an example: We all have coffee machines in our offices. Water is connected by way of an inexpensive plastic tube and is attached by a plastic grommet. Over a weekend, the grommet breaks causing water to flow through the building over the weekend. The landlord's insurance

company will likely pay for the repairs and then sue you to recover its payments.

Without the broad form extension endorsement, you are not covered for this claim! Even if you did have this extension, only 5 of the 8 insurance carriers studied would cover this claim.

(See following chart
of Comparison of Commercial General Liability Policy
Special Extension Endorsement for Damage to Leased Premises)

COMPARISON OF COMMERCIAL GENERAL LIABILITY POLICY SPECIAL EXTENSION ENDORSEMENT FOR DAMAGE TO LEASED PREMISES

		COMPANY A: $500,000	COMPANY B: LESSER OF 25% BLDG. OR PP $250,000	COMPANY C: $300,000	COMPANY D: $1,000,000	COMPANY E: $300,000	COMPANY F: $300,000	COMPANY G: $300,000	COMPANY H: $250,000
1)	Fire	X	X	X	X	X	X	X	X
2)	Explosion	X	X	X	X	X	X	X	X
3)	Lightning	X	X	X	X	X	X	X	X
4)	Smoke	X	X	NO	X	X	NO	X	X
5)	Smoke from fire, explosion or lightning	X	X	X	X	X	NO	X	X
➔ 6)	Water	NO	X	X	X	NO	NO	X	X
7)	Water from fire protection systems	X	X	X	X	X	NO	X	X
8)	Building glass legal	X	X	X	X	X	NO	X	X
9)	Building burglary legal	X	X	X	X	X	NO	X	X
10)	Building components in tenant's premises that you are required to insure	NO	X	NO	X	NO	NO	$5,000	X
11)	Contractually assumed repair cost arising out of an accident where no tenant negligence	NO	X	NO	X	NO	NO	X	NO
12)	Collapse	NO	X	NO	X	NO	NO	X	X
13)	Vehicles	NO	X	NO	X	NO	NO	X	X
14)	Vandalism	NO	X	NO	X	NO	NO	X	X
15)	Weight of ice, sleet or snow	NO	X	NO	X	NO	NO	X	X
16)	Wind or hail	NO	X	NO	X	NO	NO	X	X

How Do We Solve This Problem?

1. The first method of partially 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 negligence 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.

   There are some insurance carriers that use a much broader form. An example is Company D on our chart. Even then, however, the limit is only $1,000,000 and you will want to negotiate excess coverage in that carrier's umbrella.

2. The other method is to purchase full building coverage on the building, although this can be expensive. The Tenant Legal Liability form is typically 25% of the building rate. You are going to be paying 100% of the rate (only to cover your insurable interest as the tenant) if you purchase full building coverage.

THE MOST IMPORTANT THING YOU CAN DO IS TO ALLOW YOUR INSURANCE ADVISOR TO PROVIDE 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, NOR DO THE REPAIR CLAUSES INCLUDE AN EXCEPTION FOR FIRE AND CASUALTY LOSSES.

What To Look for in Lease Agreements

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

Repair Clauses

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 negligent acts 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 a result of the tenant's negligence or the negligent 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 the extent the landlord doesn't have insurance and does require negligence on the part of the tenant. The problem is, the tenant has no control over the quality of the landlord's insurance program.

Here is another defective repair clause:

Note: *No exception for fire and other casualty losses.*

> ***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.*
>
> *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*

Note: *No exception for fire and other casualty losses.*

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.

This is a good example of a repair clause that is based on a contractual obligation to pay, regardless of negligence, which is not covered on a Tenant's Legal Liability coverage form with most insurance carriers.

Waiver of Subrogation

2. We look at the waiver of subrogation clause. Subrogation is the process an insurance company uses to seek reimbursement from the responsible party for a claim it has paid. 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 a tenant has no control over the quality, limits, or deductible under a landlord's insurance policy, it must look at this waiver of subrogation provision on the basis that the landlord will have no insurance whatsoever. Therefore, it is worthless.

   The following is a poor, but typical, waiver of subrogation clause:

   ***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:

> ***Waiver of Subrogation****. Landlord and Tenant will each look to their 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.

Rent Abatement

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 or other acts of God.

> *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, if any; 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.

Any reference to negligence should be negotiated out of a lease.

Lease Termination

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 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 under most circumstances.

This means that the tenant will have to move to a new location while the building is being repaired or rebuilt, and this could take at least a year. The tenant may have to pay rent to the original landlord if it was negligent in causing the damage and also to a landlord of a temporary location. This is in addition to the cost to move two times!!

Conclusion

A LEASE, AND THE TENANT'S INSURANCE, MUST BE DRAFTED AND NEGOTIATED WITH A GREAT DEAL OF EXPERTISE TO MAXIMIZE THE TENANT'S PROTECTION.

HAVING THE RIGHT PROFESSIONAL INSURANCE BUYER AND RISK MANAGER IS CRITICAL TO PROPERLY PROTECT YOUR BUSINESS.