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IF DISASTER STRIKES . . . HOW READY ARE YOU?

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Susan Fowler McNally is a partner in the law firm of Gilchrist & Rutter. The firm emphasizes real estate and business law, and also handles environmental law, bankruptcies, employment law and civil litigation matters, including complex business, franchise and intellectual property litigation. Gilchrist & Rutter provides highly responsive, top quality legal services to clients with whom we develop enduring relationships. Gilchrist & Rutter handles numerous commercial lease transactions each year covering several hundred thousand square feet of office, retail and other commercial space for both landlords and tenants. Ms. McNally's practice focuses primarily on real estate transactions, including purchases and sales, commercial and retail leasing, secured and unsecured financings, asset management contracts and construction, design professional and consultant contracts.

Ms. McNally received her law degree from UCLA Law School in 1981. She received her undergraduate degree (B.A.) from University of the Pacific, Raymond/Callison College graduating with highest academic honors in 1978.

Ms. McNally has been a speaker at numerous seminars and she has been quoted in many articles on real estate issues in the Wall Street Journal, the American Bar Association Journal, the Commercial Lease Law Insider and Lawyers Weekly U.S.A. Ms. McNally has written two chapters in the "Lease Negotiation Handbook" a book jointly published in 2003 by ALI-ABA and AECRE, as well as a chapter in "The Commercial Property Lease," a book published by the American Bar Association in 1993. Ms. McNally has been published in a many real estate related publications including the ABA Journal, Probate & Property, the Commercial Investment Real Estate Journal, Real Estate Issues, and the California Real Estate Journal and she received the 2002 Excellence in Writing Award from Probate & Property for "Letters of Credit in Lease Transactions, Part I and Part II." Ms. McNally served as a consultant to CEB with respect to the book published in 1996 titled "Office Leasing Drafting and Negotiating the Lease" and serves on the Board of Advisors of the Commercial Lease Law Insider.

Ms. McNally is a member of the American Bar Association (Section on Real Property, Probate and Trust, Real Property Division Committee, Vice-Chair of the Industrial Lease Committee 2002-2004, Vice-Chair of the Emerging Issues Committee 1998-2002, Chairperson of the Subcommittee on Use and Exclusivity Clauses 1992-93), Section on Business Law, Forum on the Construction Industry); California Bar Association (Section on Real Property, Section on Business Law); Los Angeles County Bar Association (Section on Real Property, Arbitration Committee); Women Lawyers Association of Los Angeles; Irish American Bar Association; CREW-Los Angeles (Chairperson of the Membership Committee 1993 & 1994, Program Event Chair for July, 1996 program, General Counsel, Director and Co-Chair of Resources and Volunteers Committee 2000); Construction Owner's Association of America; and the Building Owners and Managers Association. Ms. McNally is licensed to practice before the state courts of California, U.S. District Court (Central District) and California U.S. Court of Appeals (9th Circuit).

Ms. McNally has been featured in Real Estate Southern California's 2000, 2001 and 2003 lists of "Most Powerful Women in Commercial Real Estate in Southern California." Ms. McNally was appointed to the Board of Advisors of the Commercial Lease Law Insider. Ms. McNally is included in the following biographical listings: Who's Who Worldwide; International Directory of Distinguished Leadership; Who's Who of Emerging Leaders in America; International Leaders in Achievement; Who's Who in American Law; Who's Who in California; 2,000 Notable American Women; Who's Who Among Rising Young Americans; 5,000 Personalities of the World; Who's Who of Contemporary Achievement; Who's Who of Business Leaders; North American Directory of Who's Who and International Leaders in Achievement.

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I. RISK ALLOCATION IN COMMERCIAL LEASES.

In the wake of the September 11, 2001 attacks on New York and Washington, D.C. and the letters containing anthrax that were delivered shortly thereafter, we are reminded that disasters, both natural (i.e., tornadoes, hurricanes, floods, fires and earthquakes) and man-made (i.e., bombings, riots, bio-chemical attacks) afflict landlords and tenants more frequently than we like to assume. As real estate professionals, what can we do to plan ahead for the disasters yet to come? In addition to making sure that commercial leases adequately address issues such as damage and destruction, insurance requirements, rent abatement, landlord's and tenant's rights to terminate the lease, tenant's right to make repairs and deduct the cost thereof from rent, mortgagee's rights to require insurance proceeds to be applied toward paying down the loan instead of being used for repairs and what costs can be passed through to tenants as operating expenses, we should advise our clients on how best to minimize risks and allocate those risks that cannot be eliminated to landlords' and tenants' respective insurance carriers.

A. THE COMMON LAW RULE

Absent an express contractual obligation to the contrary, neither a landlord nor a tenant of commercial property has a legal obligation to repair improvements to a tenant's premises ("**Tenant Improvements**") or the tenant's fixtures, furnishings, equipment and other personal property ("**FF&E**") under the common law rule. Thus, leases should expressly state which party is responsible for repairing Tenant Improvements and FF&E, as well as the structural portions of the building and improvements to the common areas ("**Base Building Improvements**").

Unless the party responsible for repairing improvements has an extremely high net worth (and thus can afford to self-insure), it is prudent to include a provision in the lease which requires the party responsible for repairing improvements to carry adequate insurance to cover the cost of such repairs. Such a lease provision allocates the risk of paying for such repairs to the responsible party's insurance carrier.

B. WHAT RISKS ARE COVERED BY INSURANCE?

1. Named Perils vs. All Risks. Property insurance can be written to cover named perils (in which case only those perils named are covered) or to cover all risks (in which case only those perils specifically excluded are not covered). What is commonly referred to as "all risks" coverage is now called "causes of loss-special form" coverage, and it is usually broader than named perils coverage. It is more difficult for insurers to deny coverage under a causes of loss-special form policy than a named perils policy because the insured must prove that the loss was caused by a peril insured against in a named perils policy and the burden is on the insurer to establish that the loss was caused by a peril excluded from a causes of loss-special form policy.

Most property insurance policies contain exclusions for, among other things, upgrades required to comply with laws enacted after the construction of the improvements, floods, and earth movement (e.g. earthquakes, land slides, subsidence and volcanic eruptions). Causes of loss-special form property insurance policies also contain separate coverage limitations on certain categories of property loss, including valuable papers, records, computer equipment and electronic data damage, debris removal, pollutant cleanup and removal and increased cost of construction. Insured parties may want to negotiate to have some of the exclusions deleted from their property insurance policies, or obtain expanded coverage limits for items which are subject to low coverage limitations.

2. **Endorsements.** Some of the endorsements to consider adding to a property insurance policy include:

a. ***Valuable papers, records and computer equipment.*** This endorsement covers (or increases the coverage for) the cost of replacing blank computer disks, CDs and film plus transcribing expense if duplicates exist, but if duplicates do not exist coverage is usually limited to \$2500 for the cost of reconstructing lost data.

b. A ***separate electronic data processing ("EDP") policy*** may be obtained to cover the cost of reconstructing lost data including software and macros developed in-house. Note that business interruption coverage for losses resulting from damage to EDP equipment is usually available as an endorsement to the EDP policy.

c. ***Leasehold interest insurance.*** This coverage is of special interest to tenants who enjoy below-market rent. Leasehold interest coverage covers the amount by which the cost of renting space in another building for the remainder of the tenant's lease term exceeds the rent the tenant is obligated to pay pursuant to its lease for the remainder of the term when the landlord terminates the lease due to damage or destruction. This endorsement provides coverage when a tenant subleases its premises, as well as when the tenant occupies the premises itself. Coverage is also available for the unamortized portion of Tenant Improvements and FF&E paid for by the tenant.

d. To the extent a tenant is not entitled to rent abatement during any period when the premises are unusable, such tenant should consider obtaining an ***extra expense*** endorsement to cover the cost of renting other premises during the period a tenant's premises is being repaired after a casualty. Such an endorsement reimburses the tenant for the duplicative rents incurred. Such an endorsement should be written to cover the tenant's share of operating expenses and taxes and other payments required by the lease, as well as base rent. Extra expense coverage does not cover lost income, but it does cover the extra expense of equipping a temporary office on short notice.

e. **Contingent business income.** Most standard property policies exclude coverage for indirect losses unless the indirect loss was caused by a covered direct loss. For example, a fire may destroy the premises of the anchor tenant of a shopping mall, resulting in a decrease in customer traffic in the shopping mall which, in turn, may cause other tenants whose premises were not damaged by the fire to suffer significant loss of income. Such lost income would not be covered by standard business interruption or rent coverage insurance, but would be covered by dependent or contingent business income coverage which covers loss suffered as a result of damage to the property of another business on whom the insured depends (e.g., a manufacturer or supplier of products sold by the insured).

f. **Sprinkler leakage and leakage caused by earthquakes.** Much of the damage to commercial office buildings caused by the Northridge earthquake resulted from automatic sprinkler systems going off. Consequently, tenants in earthquake-prone areas will want to make sure that their sprinkler leakage insurance includes an endorsement adding coverage for leakage caused by earthquakes.

g. **Building ordinance or law endorsement.** This endorsement covers the cost of any upgrades required due to building codes and other regulations enacted after the original construction of the insured property. The building ordinance endorsement covers loss resulting from the enforcement of zoning and land use laws, as well as building codes, including Title III of the Americans With Disabilities Act of 1990 ("**ADA**") (excluding the cost of alterations the insured was required, but failed, to make prior to the loss).

h. Coverage for radio or television antennas and satellite dishes under most property insurance policies is limited to \$1,000 per occurrence and covers only losses resulting from fire, lightning, riot or aircraft. Full coverage, as to perils and limits is available under the **radio or television antennas endorsement**.

i. **Utility services - direct damage endorsement.** The utility services - direct damage endorsement (formerly known as the off-premises services - direct damage endorsement) covers losses resulting from an interruption in utility service if the cause of the service interruption is a covered cause of loss. Consequently this endorsement would cover service interruption resulting from a fire but would not cover service interruption resulting from a mechanical breakdown of the utility company's equipment.

3. **Replacement Cost vs. Actual Cash Value.** Most leases require tenants to carry property insurance in an amount equal to the replacement cost of the insured property. Note that it is important to carry replacement cost value rather than actual cash value insurance because replacement cost value is not reduced by depreciation. Even when there is no stated coinsurance requirement on the face of the policy, if the replacement cost exceeds the policy limits, the insured will be

deemed to have coinsured (i.e. self-insured) the excess amount and will be penalized in an amount proportional to the underinsured value of the insured property. For example, assume that the replacement cost of the insured property is \$450,000, the insured carries only \$275,000 of property insurance with an 80% coinsurance requirement (i.e. the insured has assumed that \$275,000 represents 80% of the actual replacement cost of the insured property), a fire occurs and the insured suffers a \$150,000 loss. The insurance company would apply the following formula to compute the amount to be paid to the insured:

$$\begin{array}{rcl}
 \$ \text{ Loss X} & \frac{\text{Policy Limit}}{\text{Actual Replacement Value} \times \text{Coinsurance}} & = \$ \text{ Recovery}
 \end{array}$$

Thus, using the facts assumed above, the insured would recover only \$114,583 (less any deductible amount) because:

$$\$150,000 \text{ X } \frac{\$275,000}{(\$450,000 \times .80)} = \$114,583.$$

To avoid the possibility of a coinsurance penalty, the insured should either (a) obtain agreed value coverage (previously known as an agreed amount endorsement); or (b) have a contractor confirm that the policy limit is the actual replacement cost and obtain an inflation guard endorsement which automatically increases the policy limit by a stipulated percentage annually.

C. DAMAGE AND DESTRUCTION.

Most commercial office leases specifically address how loss is to be allocated between the landlord and the tenant in the event of a casualty which damages the premises and/or the building. Usually the landlord will have the right to terminate the lease if the damage is so substantial that it either will cost more than a stated amount (which is usually tied to the amount of insurance proceeds available to complete such repairs), or will take longer than a stated period of time (which is usually tied to the period of landlord's rent loss coverage), to repair. Tenants with sufficient leverage also frequently have the right to terminate the lease if the time it takes to complete the repairs exceeds a stated amount of time.

Both parties may want to reevaluate their damage and destruction clauses to see how (or if) they handle off-site events which impair access to the premises. If, as was the case for many buildings in the neighborhood of the World Trade Center in New York, there is no access to the building, even

though there is no direct damage to the building, the tenant may prefer to terminate the lease and relocate rather than wait until the neighborhood is repaired and access to the premises is restored.

D. **RENT ABATEMENT.**

The risk of remaining obligated to continue paying rent after the premises are damaged can be insured against by a tenant carrying business interruption insurance. Conversely, the risk of rent being abated upon damage or destruction of a tenant's premises, can be insured against by a landlord obtaining rent loss insurance. It is generally easier for landlords to recover for claims made under rent loss insurance than for tenants to recover for claims made under business interruption insurance. Both landlords carrying rent loss insurance and tenants carrying business interruption insurance should carry such insurance with the same carrier issuing their property damage insurance to give their insurance carrier the proper incentive to pay any property damage claims quickly and thus minimize the period of rent loss or business interruption.

Because a tenant's rent includes tenant's pro rata share of the premium for any rent loss insurance carried by the landlord, a tenant's rent should be abated to the extent the landlord actually receives rent loss insurance proceeds, provided tenant cannot (and does not) use its premises due to the insured casualty. Regardless of the extent of the damage to such premises, if the tenant continues to occupy its premises, such tenant is usually not entitled to rent abatement. If a landlord does not carry rent loss insurance, the lease usually does not provide for rent abatement and a prudent tenant will carry business interruption insurance, even if the lease does not require the tenant to do so.

Whether the tenant's obligation to pay operating expenses and taxes will be abated along with the abatement of the base rent is an issue which should be specifically addressed in the lease. Mortgagees may object to leases which allow abatement of operating expenses and taxes unless the landlord's rent loss insurance is adequate to cover such amounts.

An abatement provision which disallows rental abatement until the tenant is prevented from using its premises for more than a specified number of days is justifiable to the extent the time period matches the deductible provision in the landlord's rent loss insurance. Tenants should consider carrying business interruption insurance (and/or obtain an extra expense endorsement) which will cover the deductible period on landlord's rent loss insurance or acknowledge the fact that they are self-insuring the risk of remaining obligated to pay rent when the premises are untenable. Tenants should make sure any business interruption insurance they carry: (a) does not have exclusions for perils such as earthquakes or floods if they carry insurance for such perils; and (b) does cover all rent (including operating expenses and taxes) not abated, as well as the cost of obtaining temporary facilities, renting equipment, reorganizing or replacing business records, overhead for personnel and lost profits.

The parties to a lease should also address how long the rent abatement period should last. If the lease requires the landlord to repair both the Base Building Improvements and the Tenant Improvements, the rent should be abated until the premises are in substantially the same condition as on the day immediately preceding the casualty. Another question to anticipate is whether the rent will be abated beyond the period of time it takes for landlord to complete repairs to the Base Building Improvements if the landlord is only obligated to repair the Base Building Improvements. If the lease does not provide that rent will abate for a period of time sufficient to enable the tenant to rebuild its Tenant Improvements and move back into the premises, the tenant bears the risk of being obligated to pay rent before it is able to recommence operating its business from the premises.

E. **RIGHT TO TERMINATE.**

The common law provides that a tenant's obligation to pay rent is independent from a landlord's obligation to provide the premises; consequently, a lease is not automatically terminated when the premises are damaged or destroyed. Although many states have adopted statutes which provide tenants the right to terminate their lease in the event their premises are damaged or destroyed, most landlords require tenants to waive such statutory rights. Nevertheless, most landlords insist on having the right to terminate the lease upon damage or destruction.

A right to terminate a lease upon damage or destruction may be triggered by (1) the time the landlord estimates it will take to complete the repairs exceeding a specified period of time, (2) the percentage of the premises or the building damaged exceeding a specified percentage, or (3) the cost of completing the repairs exceeding a specified dollar amount. If the cost of repairs is used as a trigger for the right to terminate, the provision may be further limited to the availability of insurance proceeds to cover such repair costs.

If the availability of insurance proceeds is used as a condition to the landlord's repair obligation, the parties must resolve how uninsured and underinsured risks will be addressed. Additionally, since every insurance policy is subject to a deductible amount, the sufficiency of insurance proceeds to effect the necessary repairs must be defined to include both the insurance proceeds collected and the deductible or self-insured retention amount. If a party is responsible for carrying certain minimum amounts of insurance and fails to do so, such party should be treated as having elected to self-insure such risk and the unavailability of insurance proceeds should not impact such party's repair obligations.

The amount of time which must elapse before a right to terminate the lease is exercisable should take into account the amount of time required to determine the extent of the damage and the nature of the repairs required, the amount of time necessary to remove debris, prepare the architectural and engineering plans necessary to obtain the pertinent building permits, rebuild the Base Building

Improvements and Tenant Improvements and get all necessary governmental approvals to reoccupy the premises (i.e. certificate of occupancy).

F. **TENANT'S RIGHT TO REPAIR AND DEDUCT.**

Although many states grant tenants a statutory right to make repairs and deduct the cost of such repairs from rent, landlords usually require tenants to waive such statutory rights. Landlords are concerned, among other things, that tenants will impair the building systems (such as the central air conditioning, electrical or elevator systems) or the structural integrity of the building if the tenants attempt to repair anything other than Tenant Improvements. Landlords are also concerned that tenants will resort to such a self-help remedy to resolve any disputes with the landlord as to the type, extent or reasonable cost of any repairs needed, thus depriving landlord of the opportunity to make decisions which, in a multi-tenant building, affect more than one tenant.

G. **MORTGAGEE RIGHTS.**

Landlord's mortgagee may have the right to require that insurance proceeds be applied to pay down a loan secured by the landlord's interest in the building rather than applied toward repair costs. A tenant, especially one who has made substantial investments of its own money in Tenant Improvements, may ask its landlord to provide the tenant with a non-disturbance agreement from the landlord's lender which requires the lender to agree that the lender will permit insurance proceeds to be used for repairs, but should be aware that the lender may only be willing to permit insurance proceeds to be used for repairs if the lender's security is not impaired. Tenants in California should be aware that there are several cases which have prevented lenders from requiring insurance proceeds to be used to pay down a loan where the lender was unable to show that its security was impaired.¹

H. **WHAT COSTS CAN BE PASSED THROUGH AS OPERATING EXPENSES?**

Operating expense provisions in commercial leases usually provide that the cost of making repairs can be passed through to tenants, but the cost of replacing destroyed property is usually treated like capital improvements. Tenants frequently negotiate to have capital improvements excluded from operating expenses, unless they are installed to reduce the costs of operating, maintaining or repairing the building, or to comply with any law enacted after the lease is executed ("**Cost-Saving Capital Improvements**"), in which case they are amortized over their useful life. Tenants may also attempt to exclude from operating expenses the cost of repairs which would have been covered by insurance the landlord was required, but failed, to carry, or at the very least, require such costs to be amortized over their useful life like Cost-Saving Capital Improvements. Note that such a provision

¹ See Schoolcraft v. Ross, 81 Cal.App.3d 75, 80; 146 Cal.Rptr. 57 (1978); Tucker v. Lassen Savings & Loan Association, 12 Cal.3d 629, 639; 116 Cap.Rptr. 633 (1974); and LaSala v. American Savings & Loan Association, 5 Cal.3d 864, 878; 97 Cal.Rptr. 849 (1971)

contemplates that the lease will require the landlord (rather than merely give the landlord the right) to carry certain minimum amounts of insurance and many leases contain no such insurance requirement for the landlord.

Operating expense provisions usually permit insurance deductible amounts to be passed through to tenants. Tenants may want to negotiate for reasonable limits on the deductible amounts on insurance carried by the landlord but should be aware that reduced deductible amounts mean increased premiums. Such a limitation should provide that if a landlord elects to carry insurance with a deductible (or self-insured retention) amount in excess of a specified amount or a "reasonable amount customarily carried by landlords of similar buildings", the excess deductible amount may not be passed through to the tenant as an operating expense. However, since tenants do benefit by paying lower premiums for insurance with a high deductible amount, it is reasonable for a landlord to insist that to the extent the landlord is precluded from passing the cost of any excess deductible through as a standard operating expense, the landlord should be permitted to pass it through as if it were a Cost-Saving Capital Improvement (i.e. amortizing such amount over the useful life of the property repaired).

Upgrades required to comply with building codes enacted after the building was constructed are generally not deemed repairs and, unless a building ordinance endorsement is obtained, are not covered by property insurance. Some landlords will agree to obtain the building ordinance insurance endorsement to cover required upgrades, or to exclude costs of compliance with building codes and other laws enacted prior to the execution of the lease, from operating expenses. Note that the cost of compliance with laws enacted after the execution of the lease will generally be included in operating expenses.

Cleanup and disposal of debris is considered a repair and thus is ordinarily passed through as an operating expense. Although cleanup and disposal costs are usually covered by property insurance, there may be an exclusion in the insurance policy for removal of hazardous materials, such as asbestos. A tenant should ask its landlord to reimburse it for any costs incurred by the tenant for removal of any hazardous materials not placed in the premises by such tenant. A tenant should also request its landlord to exclude hazardous material removal costs from operating expenses.

I. **EMERGENCY PLAN.**

In addition to making sure the lease and both landlord's and tenant's insurance policies adequately address what will happen when disaster strikes, landlords and tenants should have an emergency plan in place and keep copies of lists containing the names, addresses and both work and home phone numbers of all of their employees and equipment (especially computer and telephone) repair companies at more than one location outside the office. Back-up systems for computer data should be

maintained. Data should be backed up frequently and kept off-site (it won't do you any good if your back-up tape, disk or drive burns up in the drawer next to your computer).

Anyone whose premises contains hazardous materials should also maintain an up-to-date list of the types and quantities of all such materials, information on how to deal with those chemicals in various emergency situations, and both the work and home phone numbers of the emergency response team. The emergency response team should consist, at a minimum, of the facility environmental risk manager, environmental consultant and response contractors, attorney experienced in both environmental law and contract matters, insurance agent and insurance adjuster.

Many landlords and tenants have also conducted security audits to help them identify both the strengths and weaknesses in their security programs and determine how to implement the most cost effective security program that enhances safety and minimizes the inconveniences inherent in increased security.

By being prepared, real estate professionals and their clients will be better able to weather the storms and other disasters they hope will not strike them.

J. **EVIDENCE OF INSURANCE.**

1. **Who should be covered as additional insureds?** At a minimum a landlord will want a tenant to cover the landlord, the landlord's property manager, the landlord's lender and their respective employees, successors and assigns as additional insureds. A sample additional insured lease requirement is set forth below:

Landlord and Landlord's property manager and lender(s) and their respective officers, partners, members, managers, employees, successors and assigns, shall be included as additional insureds under the Tenant's Commercial General Liability policy, using ISO additional insured endorsement CG 20 11 or a substitute providing equivalent coverage, and under the Tenant's Excess or Umbrella Liability policy, if any. This insurance shall apply as primary insurance with respect to any other insurance or self-insurance programs afforded to Landlord and the "other insurance" clause of this insurance shall not be modified.

The statement indicating that the tenant's insurance is to be primary does not specifically require an endorsement since the CGL policy states that it is primary; it is intended to

communicate the parties' intent and to prohibit the tenant from modifying its insurance to be excess. To avoid any claim by tenant's insurance carrier that landlord's insurance is jointly liable with the tenant's insurance, the landlord should be sure to modify the "Other Insurance" condition in its own CGL insurance to clarify that landlord's insurance is excess over any other primary insurance available to the landlord covering liability for damages arising out of the premises or operation for which the landlord has been added as an additional insured. This language is part of the ISO CGL form policy, but if the landlord has a manuscript policy you will want to double-check that such policy includes comparable language.

2. **What evidence of insurance should property managers insist on receiving?**

At a minimum a landlord should insist on receiving a certificate of insurance and additional insured endorsement (or blanket additional insured endorsement) from each tenant.

3. **When should renewal certificates be delivered?** Preferably renewal

certificates should be delivered sufficiently prior to expiration to enable landlord to obtain coverage on tenant's behalf if tenant fails to timely renew; however, as a practical matter, most renewal certificates are not provided until a week or two after the prior policy has expired. Bear in mind that most leases require landlords to give tenants 30 days' notice and an opportunity to cure any non-monetary default, so it makes sense to require the renewal certificate to be delivered in sufficient time prior to expiration of the existing policy for the landlord to give tenant notice and an opportunity to cure so that the cure period expires before the policy does.

K. **WAIVER OF SUBROGATION.**

When additional insured status is required, there is little need for the waiver of subrogation because an insurer may not subrogate against its own insured; however the waiver of subrogation may be of some benefit with respect to the landlord's agents, officers, directors, employees, successors and assigns if they are not specifically covered as additional insureds. In any event it may be helpful to include both the additional insured requirement and the waiver of subrogation to protect against subrogation in the event the tenant breaches its agreement to provide the required additional insured status because additional insured status requires an endorsement whereas a waiver of subrogation is effected by its inclusion in the lease. A sample waiver of subrogation clause is set forth below:

Tenant waives all rights against Landlord and its agents, officers, directors and employees for recovery of damages to the extent these damages are covered by the property insurance maintained by Tenant pursuant to Section ___ of this Lease.

L. **TERRORISM INSURANCE.**

Prior to September 11, 2001 most causes of loss-special form property insurance policies included coverage for damage caused by terrorism (but not for acts of war by sovereign nations). After incurring over \$40 billion in losses, the insurance industry promptly revised all property insurance policies to exclude acts of terrorism as covered risks. Until the Terrorism Risk Insurance Act (“**TRIA**”) was passed, few insurance carriers were willing to offer terrorism insurance. A July 2002 survey by the Mortgage Bankers Association revealed that in the first six months of 2002 roughly \$8.5 billion in transactions were either stalled, re-priced or not completed due to a lack of terrorism insurance. Although the TRIA induced carriers to make terrorism insurance available, it did not control pricing. Premiums for TRIA terrorism insurance have certainly come down but still cost between 10% of the property insurance premium and 1% of the total coverage. As a result, less than 15% of insureds carry terrorism insurance. Lenders frequently compel landlords to carry terrorism insurance for at least the amount of debt on the property. This is especially true for “trophy” buildings. Most terrorism policies provide one pool of funds to cover both repair costs and rental loss. Terrorism insurance offered under TRIA covers only terrorist acts by foreigners, thus ignoring the threat posed by our home-grown terrorists such as Timothy McVeigh (aka “The Oklahoma Bomber”). Although full terrorism insurance (i.e., terrorism insurance that covers both domestic and foreign terrorism) is available from a few underwriters (e.g., Lloyds of London), it has substantially higher premiums and deductibles than TRIA terrorism insurance covering only foreign terrorism.

Although the TRIA does not expire until September 1, 2005, the U.S. Treasury Department must decide by September 1, 2004 whether to extend the requirement that insurance companies offer terrorism coverage. The current conventional wisdom is that with the deficit growing daily the federal government has little appetite for extending the TRIA.

A short list of terrorism insurance-related issues landlords and tenants must consider includes:

(a) Whether the obligation to carry “all risk” insurance includes the obligation to carry terrorism insurance. (See Omni Berkshire Corp. v. Wells Fargo Bank, N.A. 02 Civ. 7378 (S.D.N.Y. 2/25/04), which held that even though “all risk” coverage included terrorism coverage at the time of the mortgage, the borrower’s obligation to carry “all risk” insurance did not require the borrower to obtain terrorism insurance, but only to carry insurance generally regarded as the equivalent of the “all risk” policy available in the marketplace at the time for acquisition of the insurance coverage).

(b) Whether either landlord or tenant can terminate the lease in the event of a terrorist act that impairs the tenant’s ability to use the premises.

(c) Whether the landlord is obligated to rebuild/repair the building if it is damaged or destroyed by a terrorist act. The stigma factor should be taken into account in addition to the cost and time to complete repairs.

(d) Can the landlord pass through to the tenants the cost of the terrorism insurance? Consider leases with a base year for operating expenses and whether the base year operating expenses would need to be adjusted to take into account the cost of new insurance carried by the landlord which was not carried during the base year. Similarly, consider an adjustment to the base year if it falls in a year where an insurance price spike occurs (2001, for example, if the landlord renewed its coverage after September 11, 2001) and then subsequently drops as the market stabilizes.

(e) Must the tenant carry terrorism insurance?

M. **SAMPLE LEASE REQUIREMENTS AND DRAFTING SOLUTIONS.**

1. **Hypothetical Situation.**

- (a) Fully-leased and fully-occupied multi-tenant office building.
- (b) Earthquake triggers fire sprinklers. There is no structural damage, but major water damage.
- (c) There is damage to Tenant Improvements, tenants' FF&E and the building systems (including elevators and telephone switches) which renders the leased premises unusable and inaccessible.

2. **What insurance should a Landlord consider carrying?**

- (a) ***Property Damage.***
 - (i) Causes of loss-special form insurance covering all Base Building Improvements.
 - (ii) Earthquake insurance and earthquake sprinkler leakage endorsement (usually no additional premium).
 - (iii) Demolition endorsement.
 - (iv) Increased cost of construction endorsement. This covers the cost of upgrades required due to building codes enacted after the original construction.

(b) ***Time element.***

- (i) Rental income loss.
- (ii) Expediting expense endorsement.
- (iii) Lessor's interest in lease endorsement. This covers the risk of a lease with above-market rent being terminated pursuant to damage and destruction provisions in a lease; therefore, it pays the difference between the rent stated in the lease and the current fair market value rent for the balance of the term of the lease.

3. **What insurance should Tenant consider carrying?**

(a) ***Property damage.***

- (i) Causes of loss-special form covering the Tenant Improvements, FF&E and tenant's personal property.
- (ii) Earthquake sprinkler leakage endorsement.
- (iii) Valuable papers, records and computer equipment endorsement. This covers the cost of replacing blank computer disks, CD's and film, but does not cover the cost of reproducing lost data. A separate electronic data processing policy may be obtained to cover the cost of restoring lost data.
- (iv) Electronic data processing policy.
- (v) If tenant is responsible for rebuilding its Tenant Improvements, tenant should also get an increased cost of construction endorsement.

(b) ***Time element.***

- (i) Business interruption insurance. Also consider getting the extended period of indemnity to extend the coverage through the date that tenant's business returns to the level it was at immediately prior to the date of the damage.
- (ii) Extra expense insurance. This pays the extra expenses incurred to get back into business immediately (ex. portable telephones, renting temporary alternative space while damage is being repaired).
- (iii) Lessee's interest in lease endorsement. This covers the amount by which the cost of renting alternative space for the remainder of the tenant's lease term exceeds the

rent tenant is obligated to pay pursuant to its lease when the landlord terminates the lease due to damage.

(iv) Ingress egress endorsement. Covers loss of revenue due to lack of access to premises.

(v) Contingent business interruption. Standard property damage policies usually exclude coverage for indirect losses unless the indirect loss was caused by a covered direct loss.

II. MINIMIZING RISKS WHEN HIRING CONTRACTORS.

A. ASSUMPTION OF RISK.

B. INSURANCE.

C. INDEMNIFICATION.

D. OWNER/MANAGER APPROVAL OF SUBCONTRACTORS.

E. PAYMENT CONTINGENT ON LIEN RELEASES.

F. BONDS.

G. NOTIFICATION TO OWNER/MANAGER OF POTENTIAL PROBLEMS.

1. Duty by Contractor to notify owner/property manager of potential problems.

2. Inaction by property manager/owner after receipt of notice can turn simple negligence into recklessness.

III. ENVIRONMENTAL RISKS.

A. DUE DILIGENCE.

B. STOP LOSS INSURANCE.

C. NOTIFICATIONS/DISCLOSURES.