

HOT TOPICS ON INSURANCE AND RISK MANAGEMENT

Going totally or partially naked,
getting into a pool with strangers
and other risky behavior

January 31, 2005
Eugene L. Grant
Davis Wright Tremaine LLP
1300 SW 5th Avenue, Suite 2300
Portland OR 97201
503 778 5427
genegrant@dwt.com

INTRODUCTION.

A review of the case law on real property insurance and risk management issues over the last five years reveals familiar themes relevant to the ways transactional lawyer's document deals to allocate the risks and protect their clients. Of course the cases tend to reflect the deals where the lawyers failed to prepare documents that clearly protected their clients and thus the legal action. There are lessons to be learned from these cases and mistakes to be avoided.

SUBROGATION CLAUSES.

Cases continue to arise where the landlords and tenants have to litigate the subrogation claims of insurers alleging the landlord or the tenant was the party at fault for property damage covered by the insurance. Subrogation claims can succeed in the landlord-tenant context only if the parties fail to waive subrogation claims in their lease documents. The insurance industry uses standard form policies that contemplate and permit the waiver of subrogation claims on a reciprocal basis in order to provide a no fault allocation of risk between the parties with respect to property damage. It is important for both landlords and tenants to take advantage of this opportunity to waive subrogation rights, because the insurance industry also uses standard liability insurance forms that do not provide coverage to the insured for damage negligently caused to the property of the other party in a landlord and tenant relationship. Such coverage can be added by endorsement in the exceptional case where a waiver of subrogation cannot be obtained, but that coverage adds significant expense and essentially duplicates insurance coverage and increases the total insurance costs unnecessarily.

It is particularly important for tenants in large multi-tenant buildings to obtain a good waiver of subrogation clause to avoid a claim by the landlord or its insurance company for a total loss of the entire building. Recent cases have held a waiver of subrogation extended the property of the landlord beyond the premises. *Disabled Veterans Trust, C. v. Porterfield Construction, Inc.*, 996 S.W.2d 548 (Mo. Ct. App. 1999).

The cases on this subject almost always arise due to the lack of a waiver of subrogation clause in the lease documents. The usual argument presented by the party causing the fire is that subrogation claims were implicitly waived by the lease documents and that the party is an implied additional insured on the other party's property insurance policy.

Lexington Ins. Co. v. Raboin, 712 A.2d 1011 (Del. Super. 1998) is a typical recent case where the court held the landlord's insurance on a residential lease was obtained for the benefit of both parties defeating a subrogation claim against the tenant. See also *Towne Realty, Inc. v. Shaffer*, 777 N.E. 2d 47 (Ill. App. 2002) and *DiLullo v. Joseph*, 2002 WL 437166 (Conn. 2002) in which the courts upheld the implied waiver of subrogation theory. There is a split rule on this issue, with the courts most often holding in favor of residential tenants being sued by the landlord's insurance company. There is less sympathy and willingness of the courts to bail out commercial tenants and even less sympathy for commercial landlords. For example, in a recent case Massachusetts held that the implied waiver theory will be applied on a case by case basis for commercial tenants whereas the waiver will be implied for all residential tenants. *Seaco Insurance Company v. Barbosa*, 435 Mass. 772, 2002 WL 170719 (2/05/02). Accordingly, transactional lawyers should always make sure that subrogation claims are waived other than in those exceeding rare exceptions where there is an intent to limit or omit entirely the waiver of subrogation.

The one situation where the limitation or exclusion makes sense is when a party is self insured and will be paying for property damage out of their own pocket. That is rarely the case with landlords but is more frequently the case with high net worth tenants. It is common to see subrogation clauses drafted by tricky lawyers that are not entirely reciprocal or that are limited to the actual insurance carried by a party to set up a major claim for property damage by a party who is partially or wholly self insured. For this reason no transactional attorneys must always pay careful attention to whether there is a waiver of subrogation claims for property damage and to what extent there are limitations on the scope of the waiver. For example if only insurance company subrogation claims are waived and a party has no insurance then a direct claim by the party whose property was damaged may be possible. A complete waiver will cover both the claims of the parties as well as the subrogation claims of their insurance carriers.

INSURANCE REQUIREMENTS; TERRORISM INSURANCE

Another common issue in recent cases is scope of the insurance requirements in lease and loan documents. The scope of the term "all risk insurance" is often the subject of the dispute and terrorism coverage is often the specific insurance coverage at issue. It was recently held that the requirement in a mortgage instrument that the mortgagor acquire "all risk" policy does not obligate the mortgagor to acquire all of the coverage available under an "all risk" policy at the time of the mortgage, but only to acquire insurance generally regarded as the equivalent of the "all risk" policy as traded in the marketplace at the time for acquisition of the insurance coverage. *Omni Berkshire Corp. V. Wells Fargo Bank, N.A.*, 02 Civ. 7378 (S. D. N.Y. 2/25/04). This same case also held that pursuant to such a clause the lender is justified in requiring some level of terrorism insurance even though "all risk" policies now generally exclude such insurance. A New York appellate court more recently ruled that a mortgagor is obligated to obtain additional terrorism insurance coverage and that the mortgagee had properly obtained such coverage at the mortgagor's expense. *BFP 245 Park Co. v. GMAC Commercial Mortgage Corp.*, 2004 N.Y. App. Div. LEXIS 14394 (Nov. 30, 2004).

CONNECTION OF INDEMNITY AND ADDITIONAL INSURED COVERAGE

One of the most important recent cases to leasing lawyers regarding insurance and risk management is *Pennsville Shopping Center Corporation v. American Motorists Insurance Company*, 315 N.J. Super. 519, 719 A.2d 182 (App. Div. 1998). In that case the tenant's liability insurance carrier avoided the defense of a personal injury claim that was the fault of the landlord, because the lease indemnity clause had an exception for injury due to the fault of the landlord. The important holding in this case was that the extent of the additional insured coverage required by the lease is controlled by the limited scope of the Tenant's indemnification obligations to landlord. This result means that the additional insured coverage for the landlord will be largely nullified if the indemnification provision contains an exception for the landlord's negligence. There are many landlords and their attorneys who do not appreciate this connection between the insurance and indemnity provisions, and who routinely accept the tenant's request for an exception to the risk allocation provisions of the lease for the landlord's negligence.

From the tenant's perspective, a no fault allocation of risk makes sense to the extent the tenant has insurance coverage to back an indemnity that covers the landlord's negligence. Tenant's should be concerned about indemnifying against the landlord's negligence beyond the scope of their insurance coverage, and sophisticated tenants do insist on such a limitation of the indemnification obligation to actual insurance coverage if a complete exception for the landlord's misconduct cannot be obtained.

From the Landlord's perspective, the lawyer must be cautious of the possible effect of exceptions to any of the risk allocation provisions in the lease based upon the landlord's negligence or other misconduct. The holding in the Pennsville case would seem to support the proposition that the risk allocation provisions of the entire lease are relevant in determining the scope of the additional insured coverage. One approach that might work would be an override provision in the insurance clause stating that the additional insured coverage must cover the Landlord's negligence notwithstanding any provisions of the lease allocating liability for such negligence to the landlord. The better solution is to make all of the risk allocation provisions consistent with the additional insured requirements and to make those requirements explicit about the scope of the additional insured coverage. Of course the best provisions will do no good unless the landlord obtains proper evidence that the required additional insured endorsement has been obtained. There are many different forms of additional insured endorsements used, and the insurance requirements may be waived by a party's failure to obtain proper evidence of insurance.

LANDLORD LIABILITY DISCLAIMERS

The third leg on the landlord stool of risk management is the liability disclaimers sprinkled throughout lease documents. A recent California case is instructive on the general enforceability of such disclaimers and the courts very narrow and literal reading of such disfavored provisions. *Burnett v. Chimney Sweep*, 2004 Westlaw 2445249 (Cal. App. 11/2/04). The case involved an allegation of personal injury caused by mold in the walls of a small space in a hotel leased as a gift shop by the corporate landlord. The Tenants contended that they repeatedly notified the building owner and manager of the condition and that they did nothing to remedy it, all to

plaintiff's severe injury to both person and property including even emotional distress. The trial court granted summary judgment to all defendants on the basis of the following waiver of liability clause:

"Lessor shall not be liable for injury or damage to the person or goods, wares, merchandise, or other property of Lessee, ... whether such damage or injury is caused by or results from fire, steam, electricity, gas, water or rain, or from the breakage, leakage, obstruction or other defects of pipes, fire sprinklers, wires, appliances, plumbing, air conditioning or lighting fixtures, or from any other cause, whether said injury or damage results from conditions arising upon the Premises or upon other portions of the Building of which the Premises are a part, from other sources or places, and regardless of whether the cause of such damage or injury or the means of repairing the same is accessible or not.... Notwithstanding Lessor's negligence or breach of this Lease, Lessor shall under no circumstances be liable for injury to Lessee's business or for any loss of income or profit therefrom."

The court reversed, holding that owner's negligence might have been active in nature. Only passive negligence was disclaimed by this clause according to the court.

INSURANCE MARKET CRISIS

The New York Times recently reported that Marsh & McLennan agreed to a \$850 million settlement in the bid rigging, price fixing action brought by New York Attorney General, Spitzer. There is an ongoing contraction of the reinsurance market due to heavy actuarial losses with major companies pulling out of the casualty and property liability insurance field. In 2004 there were further catastrophic losses which, according to the Associated Press as of December 28, 2004, amount to \$20.5 billion dollars. These losses were due to four major storms in the eastern and southern US: Charley, Frances, Ivan and Jeanne. The following restrictions are now being written into many property, casualty and liability policies for general and sub-contractors: no coverage for residential work (e.g., condominiums and some even for single family residential subdivisions); no coverage for EFIS work, in some cases no coverage for subcontractors, no coverage for Completed Operations; no coverage for subsidence; no coverage for mold infestation or damage, and no coverage for water intrusion issues. Those insurers that are willing to continue to cover losses resulting from these types of defects or causes have dramatically increased insurance premiums. It has been common for premiums to be tripled or quadrupled from those charged only five years ago.

In this time of inflated insurance premiums and restricted or nonexistent coverage, the need is increased to pay attention to these lease risk allocation provisions such as insurance, indemnity, waivers and the like. When the insurance company will be paying for losses, the shifting of risks is really just a matter of whose insurance company will cover a particular risk. When the loss will come out of the parties own pocket, the willingness to cover the losses caused by the fault of the other party evaporates, while the attempts to shift the risk to the other party to the transaction are increased by the desire to avoid liability to the greatest extent possible due to the lack of insurance. Accordingly these issues are becoming more contested in the negotiation of real estate transaction.

EFFECT OF LIMITATIONS ON INDEMNITY

Other recent cases reinforce this connection between the insurance provisions and the indemnity provisions of the lease. In *Walsh Construction Co. v. Mutual of Enumclaw*, Advance Sheets 2005 # 04, 338 Or ___, (Oregon Sp. Ct. 01/27/05), the additional insured coverage for the owner was voided with respect to a claim based upon the owners negligence by the existence of an Oregon indemnity statute that prohibits an owner requiring a contractor to indemnify the owner against claims arising from the owner's own negligence. The result would have been the same presumably even if the indemnity limitation was contractual as is often the case. This case is also relevant by analogy to other states like Illinois that also have statutory prohibitions on the use of indemnity clauses to protect a landlord from its own negligence. A contrasting decision is *Presley Homes, Inc. v. American States Insurance Company*, 90 Cal App 4th (2001), the California Court of Appeals held that an insurer's defense obligation under an additional insured endorsement covered all claims in the litigation, including claims for which there was no possibility of indemnity coverage. This case does cement prior case law in California on this issue. The insurance industry typically has "knee jerk" reactions to this type of decision. Another California case on very similar facts and law to the Oregon case reached the opposite result. *American Casualty Co. of Reading, Pa. v. General Star Indemnity Co.*, (2005 Cal. App. LEXIS Cal. App 1/ 27/05)

In *McClore v. Hamilton County Board of Elections*, 720 N.E.2d 954 (Ohio App. 1 Dist. 1998), it was held that the tenant was implicitly obligated to indemnify the landlord when the lease did not expressly so provide, because the lease required the tenant to provide additional insured coverage for the landlord. This is essentially saying that an agreement to provide indemnity by insurance coverage is the equivalent of simply saying the tenant will directly indemnify the landlord. Almost all leases do contain both the insurance requirement and the indemnity requirement and this is a rare case of the courts bailing out the landlord whose lease was deficient.

SCOPE OF LIABILITY COVERAGE DISPUTES

The scope of insurance coverage is naturally a continuing source of appellate decisions. In *Sterling Builders, Inc. v United Nat'l Ins. Co.*, 93 CR2d 697 (Cal. App. 2000), it was held that although the liability insurance covered claims arising from wrongful entry or other invasion of private occupancy, the policy did not cover a claim that the insured fraudulently obtained easements over real property.

In a pair of recent decisions the courts reached opposite results respecting the scope of liability insurance coverage respecting the voluntary remediation of hazardous substances pursuant to CERCLA. *Certain Underwriters at Lloyd's, London v. Superior Court*, 103 Cal.Rptr.2d 672 (Cal. 2001); *Western National Mutual Insurance Co. v. Westling Manufacturing Inc.*, No. C8-01-360, (Minn. App. 9/18/01). In Minnesota coverage was upheld, but in California coverage was denied. In a similar case a housing developer won when liability insurance coverage was upheld for the costs of a voluntary program of building defect remediation prompted by lawsuits from some but not all of the unit purchasers in a large new housing project. *Barratt American, Inc.*,

Plaintiff and Appellant, v. Transcontinental Insurance Company, No. D036401 (Cal. App. 4th Dist. Div. One (10/4/02).

CONSTRUCTION DEFECT INSURANCE COVERAGE

Of course new residential construction defect claims and particularly condominium claims have created a crisis due to the high cost and lack of availability of product liability insurance coverage for developers. Smaller developers are either going naked without any insurance or are paying premiums that are very high. This may be the start of further consolidation in the residential development industry as the bigger players are the only ones who have the clout to obtain reasonable insurance coverage for new projects. Even for the medium and large project developers, residential projects are being insured for product liability purposes on a project based wrap up policy obtained for the benefit of the entire project team. These are sometimes also called “owner’s controlled insurance programs” (OCIP). A similar type program if sponsored by the contractor is called “contractor controlled insurance program” (CCIP).

Another approach to the insurance problem used by some developers is joining together in teams to obtain more purchasing power on a single liability policy with multiple named insureds and for multiple projects. Similarly homebuilders are investigating the possibility of forming cooperatives to create captive insurers similar to ALAS for lawyers. Many states, including Oregon, prohibit “fictitious grouping” for insurance programs posing a problem for wrap up programs as well group purchasing of a single policy. For example, Oregon prohibits insurers from making available “through any rating plan or form, property, inland marine, casualty or surety insurance, or any combination thereof, at a preferred rate or premium to any person based upon a fictitious grouping of that person.” ORS 737.600(2). “Fictitious grouping” is defined as “a grouping by way of membership, license, franchise, contract, agreement or any method other than common ownership, or use and control.” Arguably, parties could develop by contract common control or use to meet the exception to the definition of “fictitious grouping.” But the Oregon Insurance Commissioner’s office, however, interprets this statute as prohibiting general “wrap up programs”.

In 1981, Oregon adopted special legislation to allow wrap-up programs which were authorized only for certain specified large public projects. See Senate Bill 929 (1981). These programs generally offer the following advantages:

- They provide a high quality safety program through coordinated loss prevention activities
- They provide uniform insurance coverage and high limits for all participants, thus eliminating gaps and overlaps in coverage and assuring that all participating entities are adequately protected
- They provide broader coverage than many contractors normally carry or can secure
- They assist small subcontractors in securing coverage
- Obtaining the right kind of coverage at the right price can be a particular problem for many minority, disadvantaged or women-owned contractors.
- They reduce insurance premium costs as the result of economies secured through combined buying power.
- They avoid disputes between insureds of different insurance companies, which tend to

benefit claimants.

It should be noted that, depending on the size of the projects and the negotiating strength of the sponsor, these wrap-up programs can be written to cover not only the general and subcontractors but also all the design professionals on the project. In some cases the design team is unable to participate in the wrap up insurance policy, because their professional malpractice liability is viewed as different in nature than the product liability of the construction contractors. This statute was followed a decade later by a successor which allows insurance companies to issue "wrap-up" insurance in Oregon by authorizing them to issue:

“ . . . a policy of insurance or a guaranty contract covering and insuring any public body, the prime contractor under a contract with the public body for the construction of any project of a public body and any contractors or subcontractors with whom the prime contractor may enter into contracts for the purpose of fulfilling its contractual obligations to the public body, or any combination thereof. See Oregon Laws 1991, Chapter 581, Sections 1, 3 and 4(2).”

This statute, however, was limited to projects having an estimated construction cost in excess of \$100 million. Oregon Laws 1991, Chapter 581, Section 3. This legislation is codified as a legislative counsel note following ORS 737.346.

Oregon’s “fictitious grouping” statute does except liability and casualty insurance for commercial risks if: a) the policy requires active participation in a plan of risk management which has established measures and procedures to minimize both the frequency and severity of losses; b) the policy passes on the benefits of reduced losses to plan participants; and c) rates are actuarially measurable and credible and sufficiently related to actual and expected loss and expense experience of the group so as to assure that non-members of the group are not unfairly discriminated against. ORS 737.600(3)(f). To fall within the statutory exception to “fictitious groupings”, contractors may use what is generically called a “project insurance program”. In many ways, these programs are very similar to owner-controlled insurance and contractor-controlled insurance programs, including the requirement for all contractors to actively participate in a plan of risk management (i.e., safety program).

DEFECTS: THE ROOT OF THE PROBLEM

The obvious question this development liability insurance crisis begs is why the development teams cannot seem to avoid defects by quality control systems and processes. There are many reasons defects ubiquitous on new housing construction. The constant innovation of new synthetic and composite building materials and systems often have latent defects that only exhibit themselves after years of installation and use such as LP siding or synthetic Stucco. The best plans and specifications and the best materials in the world will not help if low paid construction workers do not understand how, or are in too much of a hurry, to properly assemble the materials.

Both developers and insurance carriers are innovating new ways to try and solve these seemingly intractable problems. One recent trend is the use of a “building envelope consultant” to focus on avoidance of water infiltration through the building envelope. Another recent remedy is to prepare on site mock-ups of the important assemblies like windows, to give workers a visual example instead of specifications they may never read or understand. Infrared cameras are also giving developers and insurers the ability to see through the walls to provide early detection of leaks and avoid consequential damage to the structure. Some insurers are requiring ongoing maintenance programs and manuals for residential projects. About the only certainty is that there will be major changes and continued uncertainty on insurance for residential developers.

SCOPE OF COVERAGE DISPUTES FOR PROPERTY DAMAGE

In the context of a property insurance policy, the word "decay" was recently held to include not only weakness caused by organic processes, but to include simple failure of structural elements due to stress and temperature changes over a fifty year period. As a result the damage was held not covered by the insurance. *Stamm Theatres, Inc. v. Hartford Casualty Insurance Co.*, 2001 WL 1337599 (Cal.App. 1 Dist. 10/31/2001). Similarly the scope of indemnity provisions are a continuing source of dispute. For example it was recently held that under terms of a broad indemnification agreement, a tenant whose underground tanks polluted the leasehold premises is liable to the landlord not only for damages to the leased premises, but also for loss of access to adjacent premises owned by landlord during the remediation period. *NRC Corp. v. Amoco Oil Co.*, 2000 WL 260635 (March 9, 2000).

In a similar geographic coverage type case, it was held that liability insurance coverage for claims arising from "operation, maintenance or use of the insured premises and all operations necessary or incidental to the business of the . . . insured conducted from or at the insured premises: covers off-site damage resulting from the business conducted on the insured premise. *Cycle Chem, Inc. v. Lumbermens Mutual Casualty Company*, 2003 WL 23111986 (N.J. Super. App. Div. 2003); December 30, 2003. In a somewhat contrary result, a shopping mall owner was held to owe no duty to a shopper to remedy an icy condition in an adjacent municipal parking lot, in which shopper slipped and fell while on his way to the mall, when the mall owner did not install or maintain the parking lot, where the mall owner provided twenty five parking spaces for its customers on its own property, and where the municipal lot served many other businesses and establishments, and the mall owner did not cause the parking lot condition. *Puterman v. City of Long Branch*, 2004 WL 2534376 (N.J. Super) (2004).