

***REAL ESTATE INSURANCE BASICS
& HOT TIPS***

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I. Definition of Retention of Risk

A. Although the concept of retention of risk is difficult to define, it is essentially a risk management technique by which an entity uses its own financial resources to pay for all or some of its losses.

B. Risk management contributes to an entity's overall profitability by planning, organizing, directing and controlling the sources and uses of funds with which an entity may finance its recovery from losses it may suffer.

1. The goal is to minimize the adverse effects that the losses might have on an entity's ability to achieve its business objectives.

2. The goal is achieved by reliably and cost-effectively providing funds to the entity to pay for and restore its losses.

C. All types of losses may be covered through risk management techniques, e.g., workers compensation, physical damage to property and injury to persons. This Article will not address issues relating to workers compensation and it will focus on property insurance and liability insurance issues primarily in the landlord and tenant relationship.

II. Risk Management Process

A. When the risk management process is not used by an entity, that is, where there is no conscious decision-making process by which the entity determines whether or not to insure against a particular loss, that entity is deemed to have retained the risk of such loss. This is a risk financing alternative which is called RETENTION, because the entity will have to use its own funds to finance recovery from its losses.

B. On the other hand, where an entity engages in a conscious decision-making process to determine whether the purchase of insurance is in the best interests of that entity to protect it against particular losses, and through that decision-making process the entity concludes that it is in the best interests of that entity not to purchase insurance to cover all or any portion of a particular loss, the entity is deemed to be self-insuring the portion of the loss not so covered. As such, self-insurance is a form of retention for the portion of the loss not insured and that portion is often referred to as "SIR" or "Self-Insured Retention".

C. The other basic risk financing alternative is called TRANSFER, because the entity will use funds originally coming from an outside source to pay for its losses.

III. Basic Retention and Transfer Options

A. The most basic retention options are:

1. Paying for losses out of cash flow.
2. Using unfunded reserves.
3. Using funded reserves.
4. Borrowing.
5. Loss control or loss avoidance measures, such as safety programs and other practices intended to avoid or reduce the possibility of property and/or casualty losses and injury to persons.

B. The most common basic transfer options are:

1. Insurance.
2. Contractual transfers (such as hold harmless, indemnity and exculpatory agreements in leases; lease requirements that the other party maintain insurance protection that also protects the self-insured party; and lease requirements for (i) waiver of subrogation endorsements to insurance policies or (ii) naming particular parties as additional insureds, both of which measures prevent a negligent party from being sued by an insurer for the recovery of losses paid by that insurer resulting from the negligent party's actions).

C. An entity may employ a combination of retention and transfer options.

IV. Selecting the Best Risk Financing Technique

A. An entity should choose the combination of risk financing techniques which maximizes either the present value of its differential expected annual net cash flows or the time-adjusted rate of return on its resources, making the best use of an entity's funds matching the amounts and timing of its needs for cash.

B. In making such choice and determining the actual retention level the entity should maintain, the entity should take into account:

1. The cost of those claims which can statistically be anticipated over time based on operations and exposures to risk and the point at which predictability of losses significantly drops off and at which the loss severity potential greatly increases.
2. The financial strength of the entity and its need or desire for financial security (which may lead its managers or owners to choose the relatively more expensive technique of

insuring rather than self-insuring even though self-insurance could generate a higher expected present value future net cash flow).

3. Legal requirements, such as provisions in loan documents which require the maintenance of certain insurance and/or certain minimum assets to liabilities or the ratios or balance sheet requirements which might be violated upon a casualty or liability loss.

4. Budget constraints, which may restrict an entity's ability consistently to retain sufficient amounts of money to cover its loss exposures and for which the purchase of insurance is more prudent.

5. The relative economic benefit of transferring risk to an insurer in the prevailing market climate. In a soft insurance market, insurance is usually purchased with lower SIR or deductibles. In a hard insurance market, an entity is more likely to choose self-insurance or increase the SIR or deductible.

C. Choosing and implementing the selected risk financing measure involves input from many different sources, including:

1. Risk management professionals, who have the responsibility for identifying and analyzing the potential losses to which the entity is subject and the maximum possible loss in dollars.

2. Insurance professionals, who can assist with pricing of premiums for the insurance coverages identified by risk managers as being essential or desirable.

3. Senior management, who can implement loss control measures designed to decrease the potential for losses (such as the implementation of safety programs or the installation of an automatic fire suppression system in a building) and who can make other business decisions relating to retention reserves and the purchase of insurance.

V. *Property Coverage*

A. Coverage Forms.

The standard in the insurance industry is a policy form issued by the Insurance Services Offices (ISO). An insurance company or an agent or broker representing that insurance company may develop its own policy forms. These forms are commonly referred to as "manuscript policies." These forms are usually broader than the standard ISO forms. Reference to coverage "at least as broad as ISO form . . ." should set the minimum requirement and not preclude coverage under a broader form. *Do not use "equal to," as some forms are broader than ISO.*

1. Basic Form (Fire and Extended Coverage).

The ISO form *CP 10 10* covers the following **14 basic causes of loss**:

- i. Fire
- ii. Lightning
- iii. Explosion
- iv. Smoke
- v. Windstorm
- vi. Hail
- vii. Riot
- viii. Civil Commotion
- ix. Aircraft
- x. Vehicles
- xi. Vandalism
- xii. Sprinkler Leakage
- xiii. Sinkhole Collapse
- xiv. Volcanic Eruption

This coverage is commonly known as “Fire and Extended Coverage,” although it is properly named “Basic Form” Coverage.

2. Broad Form (Specified Perils).

The ISO form *CF 10 20* provides **named perils** coverage for the perils insured under the basic form **plus** 5 other causes of loss: breakage of glass, falling objects, weight of snow, ice, or sleet, water damage (in the form of sudden leakage from appliances), collapse from specified causes. This form is not written very often. For very little additional premium, Special Form Coverage is available.

3. Special Form (formerly known as “all-risks”).

The ISO form *CF 10 30* provides coverage for loss from all causes not specifically excluded. It is sometimes referred to as Special Extended Coverage. This form is the form most commonly written. It is no longer called “all-risks” due to problems in interpretation of coverage under that definition. This form provides coverage for “**direct damage from...except as otherwise excluded....**” These are **specific exclusions** for the following perils:

- i. Ordinance or Law
- ii. Earth Movement
- iii. Governmental Action
- iv. Nuclear Hazard
- v. Utility Services
- vi. War and Military Action
- vii. Water
- viii. Boiler and Machinery Failure
- ix. Wear and Tear or Lack of Maintenance
- x. Continuous Seepage or Leakage Over a Period of 14 Days or More
- xi. Dishonest Acts
- xii. Pollutants
- xiii. Faculty Design or Workmanship

Resulting damage from fire or explosion is covered for some of these excluded perils. Examples are Earth Movement (fire and explosion) and Nuclear Hazard (fire).

The **water exclusion** addresses damage caused by:

- i. Flood, surface water, waves, tides
- ii. Mudslide or mudflow
- iii. Water that backs up or overflows from a sewer, drain or sump
- iv. Water under the ground surface pressing on, or flowing or seeping through: foundations, walls, floors or paved surfaces; basements; doors, windows or other openings

However, resulting damage from fire, explosion or sprinkler leakage is covered if caused by **water damage**.

4. Earthquake or Flood.

Although there are ISO forms available to endorse these coverages onto the property policy, these coverages are usually written under separate policies. Earthquake

and/or Flood may be written separately or combined under a DIC (Difference in Conditions) policy, a “property umbrella” type of coverage.

Flood insurance is frequently written under the National Flood Insurance Program (NFIP), a federally funded program which makes flood insurance available at a reasonable cost for properties in flood zone areas. These properties must be located in communities which participate in flood prevention programs as required by the federal government. \$500,000 of coverage is available for direct damage to building and contents only. (There is no coverage under this program for business income.)

Frequently there are several policies provided in layers (excess over the primary layer) to obtain the total limits desired for either earthquake or flood insurance. For example, excess flood insurance can be written over the NFIP program. Earthquake policies are usually written in layers up to, or exceeding, the “probable maximum loss” (PML) of the property or the portfolio of properties insured.

These coverages are subject to higher deductibles than the standard deductibles for other direct damage coverage. Earthquake coverage deductibles range from 5% to 20%. Flood may be a 2% or flat dollar deductible of \$10,000 to \$25,000 or higher.

5. Endorsements Which Expand Coverage.

i. **Business Income** - ISO form *CF 00 30* provides business income and **extra expense coverage**. ISO form *CF 00 32* provides business income **without** extra expense. Coverage is usually written for 6 or 12 months and it can insure a longer period.

(a) Both forms cover loss of income suffered by a business as a result of not being able to use property damaged by a **covered cause of loss**, during the time required to repair or replace it.

(b) **Extra Expense** covers expenses in excess of normal operating expense that are incurred to continue operations after a direct damage loss (such as the cost of operating from a temporary location).

(c) If a Tenant is required to **continue rent payments**, this continuing expense is covered under the Tenant’s business income insurance.

(d) Both ISO forms also offer coverage for **rents insurance** (also known as rental value or loss of rents) to reimburse the owner of a building for loss of rents. Coverage is also provided for fair rental value of the premises occupied by the insured. Coverage for rents insurance is elected by checking a box on the Business Income policy form.

(e) Other, non-ISO, forms providing this protection may be called “business interruption”, “loss of earnings”, “gross earnings”, “time element”, or “use and occupancy” coverage. Extra expense and rental value may be included in or written separately from these forms.

(f) **Contingent Business Income** provides coverage for loss of income due to damage from a covered cause of loss to the property of a key supplier, customer, or leader location (anchor store) that attracts business to the insured's store.

(g) **Extended Period of Indemnity** extends coverage for loss of income from the 30 day period provided under the standard ISO forms to a longer, specified period of time (which could be as long as 180 or 360 days) after the damaged property has been repaired. This allows time for the property to "rent up" or for the store to regain its clientele after it reopens.

(h) **Service Interruption** coverage provides protection for loss due to lack of services from incoming utilities, such as electrical, water or telecommunications caused by a covered cause of loss to property of the utility away from the insured's premises. This coverage is also known as "off-premises power".

ii. **Ordinance or Law** - ISO form *CF 04 05* provides coverage for loss caused by the enforcement of ordinances or laws regulating construction and repair of damaged buildings.

(a) Without this endorsement, **standard property policies do not cover**: the loss of the undamaged portion of the building (which might need to be demolished); the cost of demolishing that undamaged portion of the building; or the increased cost of rebuilding the entire structure to conform with current building codes.

(b) This coverage is usually written for a **specific limit** determined to be sufficient to meet these additional costs.

iii. **Boiler and Machinery** - covers loss caused by mechanical or electrical equipment breakdown, including damage to the equipment, damage to other property of the insured, and damage to property of others.

(a) Examples of exposures are: steam boiler, high rise office buildings with extensive "smart building systems" and other HVAC systems.

(b) **Separate coverage for business income** must be written in conjunction with this coverage. It is not included in the standard Business Income policy form.

(c) Coverage may be attached to an ISO property policy and it is more frequently written as a separate policy.

iv. **Leasehold Interest** - covers loss suffered by Tenant due to **cancellation** of a favorable lease because of damage to the leased premises by a covered cause of loss.

(a) Tenant's net leasehold interest is represented by the difference between the rent Tenant was paying and the current rental value of Tenant premises.

(b) Coverage may also be provided for the unauthorized portion of prepaid rent, bonus payments or improvements and betterments.

v. **Legal Liability** - ISO form *CF 00 40* provides coverage for sums the insured is obligated to pay as a result of accidental damage from a covered cause of loss to property of others in the insured's care, custody or control.

(a) Coverage applies to Tenant's **negligent damage** to premises if such damage is covered under Tenant's policy.

(b) Coverage does not extend to other damage for which Tenant would not be liable in tort.

(c) This coverage is not a substitute for first party property insurance and it would not protect Tenant against **all** contractually assumed liabilities.

vi. **Coverage Conditions or Limitations to Coverage**

(a) **Blanket Limit** - a single limit of insurance that applies over more than one location or more than one subject of insurance - such as building **and** personal property. A blanket limit provides better protection against underinsurance as the full limit can be applied to any one location.

(b) **Stop Loss Limit** - defines the limit of insurance as the largest possible loss at any one location. (Assumes only one location will be damaged in a single loss. Earthquake insurance is usually written for a stop loss limit to insure, as closely as possible, the PML [probable maximum loss] of the insured property.)

(c) **Replacement Cost** - pays the full value of replacing the damaged property up to and not exceeding the limit shown on the policy. Property must be repaired or replaced.

(d) **Actual Cash Value (ACV)** - commonly defined as replacement cost less depreciation or, in some jurisdictions, fair market value.

(e) **Coinsurance Clause** - provides penalty if the insured does not purchase a limit of insurance at least equal to the percentage stated on the declarations page - usually 80%, 90% or 100% of the value of the insured property.

(f) **Agreed Amount** - waives coinsurance penalty by stating that the insurance amount is agreed to be equal to the percentage of value required by the coinsurance provision. The same result may be obtained by providing for "no coinsurance clause."

(g) **Waiver of Subrogation** - the insured party is obligated to have his insurer waive the insurer's rights of recovery against the other party for damage to insured's property.

6. Acknowledgements. The materials contained in this Article V were prepared by Roberta McCreary, Editor and Publisher of McCreary's Real Estate Insurance Review.

VI. Liability Coverage

A. Liability Forms

1. Commercial General Liability Coverage (primary coverage)

i. The ISO form *CG 00 01* is commonly referred to as the "CGL".

ii. In 1986 this form replaced the older ISO form named "Comprehensive General Liability."

iii. This form provides coverage against liability claims for **bodily injury and property damage arising out of:**

- (a) premises and operations
- (b) products and completed operations
- (c) advertising and personal injury

iv. Coverage for **contractual liability** is provided **as an exception to an exclusion** for damages which result from the assumption of liability in a contract or agreement.

(a) The policy form states that the exclusion **does not apply** [therefore coverage does apply] to liability the insured would have:

- (1) in absence of the contract or agreement
- (2) under an "insured contract" provided that "bodily injury" or "property damage" occurs subsequent to the execution of the contract or agreement

(b) "**Insured contract**" (as defined in the 1988 ISO form) includes:

- (1) a contract for lease of premises (but **not including damage by fire** to premises rented to or occupied by insured)
- (2) a sidetrack agreement
- (3) any easement or license agreement (but not including construction or demolition operations on or within 50 feet of a railroad)

- (4) an obligation to indemnify a municipality (but not in connection with work for that municipality)
- (5) an elevator maintenance agreement
- (6) that part of any other contract or agreement pertaining to the insured's business under which the insured assumes the tort liability of another party to pay for "bodily injury" or "property damage" to a third person or organization. (Tort liability means the liability that would be imposed by law in the absence of any contract or agreement.)

v. **Fire Legal Liability** coverage is included for a limit of \$50,000 under the 1986 ISO Commercial General Liability policy form.

(a) Coverage may be increased to a higher limit for an additional premium.

(b) Coverage for **negligent damage** to property in the care, custody or control of insured can also be provided under the property policy through a legal liability form.

2. Coverage Triggers

i. **Occurrence basis** policy coverage is triggered by an incident which **occurs** while the policy is in force regardless of when the claims arising out of that incident is filed.

ii. **Claims made** basis policy coverage is triggered by **claims made** (reported or filed) during the year the policy is in force for any incidents that occur that year or during any previous period during which the insured was covered under a "claims-made" contract.

iii. **Nose Coverage** provides coverage under a claims-made policy back to a **retroactive date** which is prior to the inception of the current policy. The retroactive date is established by an underwriter to restrict how far back the claims-made policy will apply.

iv. **Tail Coverage** provides an extended period of time under a claims-made policy for claims to be made that occurred during the policy period but which were not reported until after the policy period. An **extended reporting period** is purchased, usually for one or two years after the expiration of the claims-made policy.

3. Endorsements Which Expand Coverage

i. **Liquor Liability** - provides protection for the common law liability imposed on those selling alcoholic beverages.

(a) **Host liquor liability** coverage for the incidental serving of alcoholic beverages is automatically included under the ISO CGL form.

(b) **Liquor liability** is often written as a separate policy or as part of a special program for restaurants and bars.

ii. **Pollution Liability** - is usually written under separate non-standard environmental liability policies although endorsements to the ISO CGL do exist.

(a) There are two common coverages:

(1) **Environmental impairment** liability which covers liability arising from accidental release or discharge of pollutants.

(2) **Environmental remediation** liability which covers the cost to clean-up a site after release or discharge of pollutants.

(b) Coverage is more affordable and available now than it was several years ago.

(c) Underwriters may require Phase One and/or Phase Two environmental audits to write this insurance.

(d) Other coverages are available now or are under development including: Lender's Secured Credit (covering entire portfolio), Depreciation (dovetails with remediation), Business Interruption for on-site pollution, Cost Cap Coverage (for new conditions discovered), Underground Storage Tank liability.

iii. **Garagekeepers Liability** – Also known as garagekeepers legal liability, provides coverage to owners of garages, parking lots, etc. for their liability as bailees when customers' vehicles are negligently damaged when left in custody of the insured.

4. Other Coverage Conditions - CGL

i. **Limit per Occurrence and Aggregate** – general liability policies are now written with a **single limit per occurrence** for all bodily injury and property damage liability claims and an **annual aggregate** for all claims arising during the policy year.

ii. **Limit per Location** - used under a blanket policy covering multiple locations to provide that the full policy limit will be available for claims arising from a single location. Avoids depletion of policy limit by claims from other locations.

iii. **Deductible** - amount the insured must reimburse to the insurer after the insurer pays the claim. Usually applies only to indemnity payments, not the costs of defense.

iv. **Self-insured Retention (SIR)** – amount the insured is responsible to pay **before** the insurance policy will pay. Frequently applies to both indemnity and defense costs incurred.

v. **Additional Insured** - coverage may be extended to a third party under the insured's liability policy by endorsement naming the third party as additional insured.

(a) Additional insureds **must be added by endorsement** unless there is a blanket additional insured provision providing automatic coverage for any additional insured status granted.

(b) Additional insured endorsements **may exclude** the negligent actions of the additional insured or may not apply to claims alleging *personal injury*.

(c) Proposed changes to commercial general liability coverage policies intended to curb the scope of coverage under the additional insured endorsement are being welcomed by insurers but criticized by insureds. This is especially true in the construction industry where insurers are seeking to limit coverage for additional insureds to liabilities associated with the principal policyholder. Currently, the endorsement provides coverage for liabilities arising from actions by additional insureds that have little or no connection with the principal policyholder.

vi. **Primary Insurance** - an endorsement which provides that the insured's policy will be the **primary** source of insurance for the additional insured.

(a) The additional insured's coverage will be secondary and will not contribute with the primary insured's coverage to pay a loss.

(b) When the primary insured's policy limits are depleted, the additional insured's coverage will respond.

5. Acknowledgements. The materials contained in this Article VI were prepared by Roberta McCreary, McCreary's Real Estate Insurance Review.

VII. Basic Insurance Concepts Relevant to Risk Financing Alternatives

A. Deductibles.

Deductibles represent a way for insureds to reduce insurance premiums by retaining predictable, frequent losses. In determining how much risk is being assumed, it is important to understand how deductibles are applied when a loss occurs. Property deductibles vary from policy to policy and in how they may be applied. For example, the deductible is applied “per event” or “per occurrence”. If a building and contents are both insured, the deductible applies only once. If only contents are insured, the deductible very likely applies separately to the contents of each building that is insured. Annual aggregate deductibles limit the aggregate amount an insured will have to pay out-of-pocket in a given year. Aggregate deductibles will be at least twice the amount of the “per occurrence” deductible. Policies will either have a “per occurrence” deductible or will have both a “per occurrence” and an annual aggregate deductible. They will not have only an annual aggregate deductible.

B. Deductible Compared to SIR.

Generally third, deductibles and SIRs may be used interchangeably by an insured, but to an insurer and to parties and named or additional insureds, there is an important difference.

1. In an insurance policy which is an SIR policy, the insured pays the SIR entirely upon a claim under the policy, and the insurer has no obligation or responsibility whatsoever to pay the SIR to third parties or named or additional insureds.

2. In an insurance policy which is a deductible policy, upon a claim under the policy, the insurer “fronts” the payment of the deductible to third parties and named and additional insureds and gets reimbursed by the insured. This is generally preferable where the creditworthiness of the insured may be in doubt. The premium for a deductible insurance policy is more than for an SIR insurance policy.

C. Blanket Property Coverage.

The formal description of blanket coverage is a policy that covers under one amount:

1. One type of property in more than one separately rated building.
2. Two or more types of property in one or more separately rated buildings.

The types of property that might be insured under blanket coverage include: buildings, personal property of the insured, personal property of others, and tenants’ improvements and betterments. Blanket coverage is often preferable to specific coverage because the entire policy limit is available to apply to a given loss. For example, if three buildings are insured under specific coverage for \$1 million each, \$1 million would then be the insurer’s maximum responsibility even if a loss at a given building were \$1.2 million. Under blanket coverage, the three buildings could be covered for a total of \$3 million and when a loss occurs in one building, the entire \$3 million is available to respond to the loss.

D. Co-insurance Clause.

The co-insurance clause in a property policy is designed to protect insurers against their insureds' tendency to understate the value of property in order to reduce insurance premiums. It is actually a penalty that is applied when a loss occurs if the property was not insured within 90% or 80% of the property value (depending on the percentage indicated in the co-insurance clause in the policy).

It is difficult to describe how a co-insurance clause is applied. The insurance industry describes it as "did over should" because insurers apply the co-insurance percentage to the actual value of the property and then divide the amount that the insured did insure, by the amount that should have been insured. This determines a multiplier that is then applied to the value of the loss. The following is an example from a standard insurance policy:

When:

The value of the property is \$250,000

The co-insurance percentage for the property under the insurance policy is 80%

The limit of insurance for it is \$100,000

The deductible is \$250

The amount of loss is \$40,000

Step (1): $\$250,000 \times 80\% = \$200,000$ (This is the minimum amount required to meet the co-insurance requirement)

Step (2): $\$100,000 / \$200,000 = .50$ ("did over should")

Step (3): $\$40,000 \times .50 = \$20,000$

Step (4): $\$20,000 - \$250 = \$19,750$

The insurer will pay no more than \$19,750. The remaining \$20,250 is not covered, or could be considered "self-insured". Because of this risk, many insureds prefer to purchase "agreed value" coverage that eliminates co-insurance penalties.

E. Agreed Value.

At the inception of the coverage year, the insured and the insurer agree on a property value, called the “agreed value”. On a blanket coverage policy, the insured is then required to carry coverage for at least 90% of the agreed value. Claims are then paid up to the full policy limits. Quere: What happens if the insured and the insurer cannot agree on the “agreed value”?

F. Amount of Coverage.

The amount of coverage may also be called the “limit of liability”. As with a deductible, the limit may be on the basis of “per occurrence” or may be “per occurrence” with an annual aggregate limit. The limits represent the maximum amount an insurer is required to pay under the policy terms. As with deductibles, it is important to understand how the limits are applied. For example, liability claims may result in legal expenses as well as settlement amounts. Some policies include legal expenses within the policy limits, thus eroding the amount available to pay a claim. Other policies may pay these expenses in addition to policy limits.

G. Replacement Cost (Replacement Value) Property Coverage.

Replacement cost (or replacement value) coverage pays for the cost of replacing damaged property with property of like-kind and quality. Property coverage is also available on an “actual cash value” basis that pays the depreciated value of property. Often, the depreciated value would not be enough to replace the property. Replacement cost policies have higher limits, or property values, than actual cash value policies. Co-insurance percentages, if applicable, are applied to the replacement value, not the actual cash value.

It is not the intent of replacement value coverage to improve the property to be replaced. Therefore, if building codes have changed since the property was originally built and the codes require an upgrade (e.g., sprinklers), replacement cost coverage would not pay for the cost of the upgrade unless the policy specifically indicates that it covers the increased cost of construction due to statutes or ordinances.

H. Excess Insurance.

This provides coverage above an entity’s SIR or deductible, and may provide broader protection than any underlying insurance coverage or SIR. Excess insurance can be written to cover liability and property losses. (See paragraph J., infra.)

I. Umbrella Insurance.

This provides excess layers of protection over underlying policy limits or over the SIR and generally “follows form”, that is, it provides coverage “as broad as” the underlying insurance coverage. (See paragraph J., infra.)

J. Excess Insurance Compared to Umbrella Insurance.

Excess Coverage	May provide broader coverage than Primary Coverage and Umbrella Insurance
Umbrella Coverage	“Following Form”
Primary Coverage	
Deductible SIR	

Excess and Umbrella coverage can strengthen an entity’s risk financing program by providing a means to protect against any loss which exceeds the primary limits of coverage and/or a deductible or SIR.

K. Insurance Premiums. After a number of years during which insurance premiums were declining and insurance companies were fiercely competing against each other for premium dollars to invest to earn large double digit returns, the insurance market has been “hardening” and insurance premiums for real estate have been significantly increasing. Indeed, property and casualty insurance for multifamily projects has gotten quite expensive as a number of insurers got out of that market, and insurance premiums for “trophy” properties have become prohibitive after 9/11. At the same time, a softening of the market may again be in the horizon, because a number of new off-share insurers are re-insurers are cropping up, which are not plagued by past losses and claims. They are able to undercut the premiums of older insurers and to invest their premium dollars in a rising stock market and economy.

VIII. Determining Which Property and Liability Losses May Be Handled Better Through a Non-Insurance Method.

After the risk manager has determined the potential losses that may be suffered by an entity, a determination must be made as to which losses could be better absorbed without the purchase of insurance.

A. Property Insurance Coverage.

Total self-insurance is generally not common for property losses because the maximum possible losses that may be incurred could be much more than current budget constraints will allow (i.e., even a Fortune 500 company might not easily absorb the total loss of a \$20,000,000 plant). In addition, since property losses are usually payable at once (as opposed to liability losses, which may be litigated for years), there is less incentive to self-insure property losses. Through loss control and safety programs (e.g., fire suppression systems, security systems, maintenance requirements, etc.), events which may cause a fire or other casualty may be reduced, thereby reducing the property insurance premium.

Further insurance premium reductions may be realized by increasing the SIR or deductible. However, the savings may not be as significant as one may expect. With an SIR, the

insured handles the claims adjustment. With a deductible, the insurer handles the claims adjustment.

In a hardening insurance market, many entities may maintain the same limits of liability and increase the deductibles and SIR to minimize premium increases. A rule of thumb is that if an entity can save more in premiums than it assumes by increasing the amount of its deductible, then an increased deductible may be worth considering.

The following is a true example of premium quotes recently given by an insurer in Richmond, Virginia, for a hotel having a replacement value of \$40,000,000, which quotes are probably not applicable in today's market, but should provide a glimpse of what the relative premiums might be during a "soft" insurance market. In a hardening insurance market, the premiums will be higher and the spreads between the premiums may be greater.

<u>DEDUCTIBLE EACH LOSS</u>	<u>PROPERTY LIMIT</u>	<u>ANNUAL PREMIUM</u>
(1) \$250	\$40,000,000 (Full Value Policy)	\$100,000
(2) \$25,000	*\$20,000,000 (Loss Limit Policy)	\$52,865
(3) \$50,000	*\$20,000,000 (Loss Limit Policy)	\$43,600
(4) \$100,000	*\$20,000,000 (Loss Limit Policy)	\$37,615

*Excess layers of insurance (above the PML [Probable Maximum Loss]) are available: The excess premium (above \$15,000,000) for a \$40,000,000 fire resistant hotel in Richmond is approximately \$300 premium per \$1,000,000 of coverage, subject to \$5,000 minimum premium on options (2) and (3); option (4) already includes minimum premium charge. (As the amount of primary insurance increases, the pricing for excess layers decreases.) Note, however, that this example may result in a co-insurance penalty unless the co-insurance provision is eliminated. But note that if the hotel were located in a city such as Hilton Head, South Carolina, where windstorm damage is more likely, the property insurance could cost ten (10) times more.

There are many ways to perform a risk analysis on the foregoing example, but note that the deductible is for each loss. This means that where there are high deductibles, multiple losses within any year could wipe out any premium savings achieved by such a high deductible. In addition, in the \$20,000,000 loss limit policy, an increase in the deductible of \$25,000 will save less than \$25,000 in annual premium. SIR/deductible is often used to minimize rate increases or to make a risk acceptable to underwriters. Some underwriters allow an annual aggregate on the deductible to limit the insured's "out-of-pocket" expenses. The annual aggregate is expressed as a multiple of the per occurrence deductible. For example, the \$40,000,000 hotel could have a \$25,000 deductible with an annual aggregate of \$100,000 (four times the deductible).

1. Additional premium savings might be available by purchasing 80% or 90% replacement value insurance and, if the entity has multiple locations, insuring all locations under a blanket policy, on the assumption that a fire or other casualty will not damage or destroy all of the separate locations. Although this increases the SIR of an entity, depending on the proximity of each location to the others and other factors, this is a common SIR technique for reducing total insurance premium costs.

2. Loss control measures, which can reduce both the frequency and severity of a loss. For example, good housekeeping can reduce the frequency of claims and a sprinkler system can reduce the severity of a loss.

3. Shifting of risks of casualty losses to another party, e.g., a landlord requiring a tenant to maintain fire and extended coverage insurance.

4. Waiver of subrogation provisions in leases and endorsements in insurance policies, which prevent the insurance company from suing the party that caused the loss after the claim has been paid.

B. Boiler and Machinery Insurance.

This is generally regarded as essential coverage and the use of deductibles to retain small losses should be considered.

C. Commercial General Liability.

This is generally regarded as essential coverage, but SIR and deductibles may be used advantageously.

1. Many of the same considerations are present in the analysis of liability risks as are present with the analysis of property risks. However, the maximum losses and the predictability of such losses are much more uncertain. There are many more variables involved in liability losses, and liability losses may have an unlimited potential. Indeed, every customer of a retailer is a potential third-party claimant of that entity. This results in much higher premiums for liability insurance than for property insurance.

2. There are so many variables in commercial general liability that it is not possible to give an accurate example showing pure premiums and deductibles. Each class of business has its own rate, based on large numbers of statistics gathered over many years to promulgate a rate for a typical risk within a class.

3. Although the following example may be misleading, it is useful to put into perspective insurance company pricing for higher commercial general liability limits:

Consider a \$40,000,000 hotel in the City of Richmond. A \$1,000,000 general liability policy may have a premium of \$100,000. An additional \$1,000,000 purchased through an umbrella liability policy is \$20,000. Each additional \$1,000,000 is

priced at \$15,000 per million. Limits above \$5,000,000 have a lower rate.

4. Present value analysis is used to calculate the amounts that need to be set aside for anticipated future claims. For example:

An organization which expects to incur \$1 million of losses for a specific type of products liability exposure may decide to retain \$1 million and purchase aggregate excess liability coverage above \$1 million. If the organization wants to prefund the expected \$1 million in losses, it may be possible for that entity to invest only approximately \$827,800 today to have the funds necessary to pay out \$1 million assuming that the payout may be made in three equal annual installments of \$333,000, a 10% interest rate, compounded annually and that no income taxes will be payable on the investment income.

5. From the perspective of an insured, it is most advantageous to retain predictable, and therefore, budgetable liability losses (also referred to as “normal losses” or “expected losses”) which have a low potential severity and to transfer all other losses to insurance companies. Normal or expected losses have a high frequency of occurrence and, therefore, are statistically predictable.

6. In order to address the potentially adverse impact on an entity where a larger than expected number of losses increases the actual dollar amount retained beyond that which was originally anticipated, an organization, especially a small business, may join with other small organizations in a “pool” or “association group”. A “pool” or “association group” is generally composed of insureds having similar exposures which, by coming together, spread their risk to such exposures; reduce the costs of settling claims, as compared to the costs incurred by commercial liability insurers; and coordinate a strong safety and loss control program to meet the group’s specific needs.

D. Desirable or Available Coverages - The risk manager may determine that certain insurance coverages may be desirable (i.e., coverage against losses that would cause the entity serious economic distress but would probably not force the entity to cease its operations, such as vandalism insurance and fire legal liability insurance) or available (i.e., coverages against losses that may be of some value but deal with losses that are likely to be small or happen very infrequently, such as earthquake insurance, flood insurance, glass insurance or water damage insurance). The case may be made that an entity’s loss control activities can be effective enough in these areas to make retention attractive because the resulting maximum loss or the loss frequency is so small.

E. Acknowledgments. The author is indebted to Sam Graham of DeJarnette & Paul Insurance, Richmond, Virginia, a subsidiary of BB&T Insurance Services, Inc., for his contributions to this Article VIII.

IX. Landlord and Tenant Insurance Considerations

A. Common Law. Under common law, neither the landlord nor the tenant was obligated to repair physical damage to property and the tenant remained liable for the rent payments, unless the lease provided otherwise. Crow Lumber & Bldg. Materials Co. v. Washington Cty. Library Board, 428 S.W.2d 758 (Mo. App. 1968) (collecting cases which maintain tenant obligation to pay rent notwithstanding casualty loss); Morris v. Durham, 443 S.W.2d 642 (Ky. App. 1969). However, if the damage was caused by the negligence of a party, then, except as otherwise provided in the lease, the negligent party might be liable to repair the damage. National Motels, Inc. v. Howard Johnson Inc. of Washington, 373 F.2d 375 (4th Cir. 1967); Mabrey v. McNeil, 534 A.2d 1256 (Conn. App. 1987).

B. Insurable Interests. A landlord and a tenant each has its own insurable interests and, unless otherwise in the lease, neither has a right to claim an interest in insurance proceeds received from the separate property of the other. However, a lease may provide various arrangements for insurance:

1. Each party can be required to insure its own property interests and each may recover for its own interests. A tenant's interest is the value of its improvements and betterments for the unexpired term of the lease. A tenant may obtain improvements and betterments insurance.

2. Either the landlord or the tenant may be required to obtain property insurance for the interests of both parties and, in such case, each party would also be entitled to recover for property loss or damage to its own respective interests: the landlord for the building and the tenant for the value of its improvements and betterments for the unexpired term, unless otherwise provided.

3. Suppose a tenant is required to restore damage to the premises and is only entitled to reimbursement from the landlord's insurance and not from the landlord. Loving v. Ponderosa Systems, Inc., 479 N.E.2d 531 (Ind. 1985). If the mortgagee takes the proceeds to satisfy the mortgage, then, unless the lease and the tenant's insurance policy contain a waiver of subrogation therefor, the tenant should be subrogated to the rights of the mortgagee under the mortgage to recover from the landlord so much as the tenant may have paid for restoration, up to the amount of insurance.

4. What if a landlord or a tenant fails to supply insurance required under the terms of the lease and a loss occurs? Would the party that failed to provide the insurance be liable for the amount of the loss up to the amount of insurance agreed to be obtained? Stefani v. Capital Tire, Inc., 425 N.W.2d 500 (Mich. App. 1988). That would be the normal measure of damages unless the other party knew or should have known that there was no insurance obtained by the party required to do so and then liability would be limited to the cost of premiums since the other party could have mitigated damages by obtaining the insurance. Rodriguez v. Nachamie, 395 N.Y.S.2d 51 (App. Div. 1977).

C. Self-Insurance may affect property insurance and liability insurance and the deductible portions of both; rental insurance and uninsured events.

1. Property insurance insures against loss or damage resulting from fire or other perils. In multi-tenant shopping centers, warehouses, office buildings and the like, the landlord generally carries the property insurance on the building and common area improvements, although the tenants may be required to make payment for same under the terms of the leases. Many single occupancy buildings or buildings in which a single tenant occupies substantial space are required to be insured by the tenant and, in the event of damage or destruction, the tenant is required to repair or restore the property.

i. It is not usual, although it is possible, for a landlord to self-insure its entire risk. Normally, the self-insurance risk is taken by the landlord by increasing the amount of the deductible under the property policy.

ii. From time to time, the tenant may, based on the tenant's financial strength, be permitted to self-insure its obligation to restore the landlord's property, either by way of a large deductible or by way of no insurance at all.

iii. Co-insurance problems may arise where property is insured for less than the full insurable value. Is this a risk where one party agrees to self-insure the entire value of the property? If there is a risk, then who bears it? This would depend on the provisions of the lease.

2. Liability Insurance and Indemnification. Most leases attempt to allocate liability for negligence between landlord and tenant.

i. A landlord often requests a complete indemnity by a tenant for any act occurring on the premises or in the common areas, regardless of who is negligent. Tenants often refuse to bear such entire responsibility.

(a) A common compromise requires the tenant to be responsible for events occurring in the tenant's premises of a multi-tenant building and for the landlord to be responsible for events occurring in the common areas of a multi-tenant building. Responsibility is thus allocated based on the place where the events occur and not on who was negligent. Thus, each party indemnifies the other for events occurring in the agreed areas. If such indemnification obligation is insured, then the risk is shifted to the insurance company. In a single occupant building, the determination of whether the tenant bears the entire risk depends on the lease agreement.

(b) In many cases, however, leases may contain a reciprocal "hold harmless" provision for the premises and the common areas. In such a case, if the landlord's insurance company can prove the tenant's negligence, then the landlord's insurance company will be subrogated to the landlord's right to recover against the tenant's insurer, unless the lease or the insurance policy provides otherwise. (See also Paragraph VIII. D.)

ii. Although most jurisdictions enforce indemnification provisions in leases (see, 1 Milton R. Friedman, Friedman on Leases §9.10 (3rd ed. 1990)), some, such as New York and Illinois, have statutes which limit or prohibit indemnification against a party's own negligence.

3. The allocation of risk for rent during the period of time during which the premises are unusable by reason of damage or destruction is usually provided in the lease. If no provision is made for insuring loss of rents during such period, then if the tenant is, nevertheless, responsible to continue to pay rent (as in a "triple net" lease), the tenant would be self-insuring such obligation. Similarly, if rent abates during such a period, the landlord will be self-insuring the rent which the landlord would otherwise receive and which is ordinarily required to pay operating expenses, taxes and mortgage payments. Taxes and mortgage payments do not abate during periods when the premises cannot be occupied by reason of damage or destruction, so the parties must consider the source of the funds to pay same while the property is being repaired. Business interruption/extra expense coverage can be purchased to cover this exposure.

D. Subrogation - Does it Apply To Self-Insurance?

1. Subrogation permits one party to stand "in the shoes of another". Thus, where a fire is caused by the negligence of a tenant and a landlord's building is destroyed, if the landlord's insurance company pays the cost of restoration, it is subrogated to the landlord's right to collect from the tenant because of the negligence of the tenant in causing the fire. Likewise, if the landlord caused the fire and the tenant's inventory was destroyed, then the landlord might face a subrogation claim from the company insuring the tenant's inventory.

2. Leases have traditionally dealt with the subrogation problem by providing for a mutual waiver of subrogation so that neither the landlord nor the tenant would be subjected to claims from the other's insurance company. Often, leases do not provide for a waiver by each tenant of subrogation claims against other tenants. What happens in that situation is a discussion beyond the scope of this article.

3. If the landlord self-insures or the tenant self-insures, then a mutual waiver of subrogation prevents a claim against the negligent party. However, even without a mutual waiver of subrogation, a self-insured landlord or tenant obligated to provide amounts equivalent to insurance proceeds to repair or replace may be deemed to have waived its subrogation claim, if any, since it is acting as an insurance company.

E. Rights of the Mortgagee with Respect to Self-Insurance.

1. Requirements for providing insurance and whether and to what extent self-insurance will suffice will generally be addressed in the mortgage document.

2. The mortgagee may require the proceeds of self-insurance to be applied to the mortgage balance. In such an event, the self-insured landlord or tenant may have a subrogation right against the other, if not waived, to require the damage to be repaired.

F. Insurance Certificate.

1. In the event of self-insurance, the tenant should be required to provide an insurance certificate from the primary or excess carrier to the landlord and to the landlord's mortgagee specifying the self-insurance deductible retained by the tenant. For example, the certificate should specify the type of property coverage (e.g., replacement cost with agreed value endorsement) and the amount thereof. Such insurance coverage should name the mortgagee under a standard mortgagee clause which will provide that mortgagee is not subject to any defenses that the tenant may have with respect to payment.

2. Care must be taken to be sure that the landlord's mortgagee approves self-insurance by the tenant.

3. The lease should require that the insurance certificate confirm that the tenant permits and has waived subrogation.

4. Adequate assurance of the tenant's financial responsibility through a letter of credit or some other form of financial instrument should be required under the terms of the lease. The tenant is to maintain any reserves agreed to cover the risk insured. The tenant is to provide annual statements to landlord and landlord's mortgagee to confirm the required net worth to permit it to self-insure; otherwise, the right will be lost.

5. If, under the provisions of the damage or destruction lease provisions, the lease would terminate in the event of a property loss because the period required to restore would be longer than that provided by the lease, then the tenant should be required to deliver to the landlord [and landlord's mortgagee] an amount equal to the insurance proceeds otherwise payable to the landlord under the terms of the insurance policies that would be maintained absent the self-insurance.

6. If the tenant self-insures its liability coverage, it must bear the cost of the defense of any claim, including the defense of the landlord, as well as the obligation to pay any judgment or settlement. However, it is very unlikely that any entity would self-insure or be permitted to self-insure the entire liability risk.

7. If the lease does not contain an operating covenant and the premises are destroyed by damage or destruction and the tenant determines that it will not reopen, then the landlord [and landlord's mortgagee] should have the alternatives to require the self-insurance proceeds to be paid directly to it (i) to be used for restoration in such form and condition as the landlord and/or the lease may require, and the lease will remain in full force and effect, or (ii) without the obligation to restore, in which event the lease will terminate. Of course, there are many variations to these choices which may be included in a lease.

G. Establish the Responsibilities of the Parties in the Event of a Loss.

1. If the landlord is carrying the property insurance, then the landlord would have the obligation to rebuild provided it could do so within 120 days (for example), and if the damage or destruction could not be repaired within 120 days, then either the landlord or the tenant could terminate the lease. Once the landlord commences to rebuild, the lease cannot be

terminated provided the landlord diligently prosecutes the reconstruction to completion, subject to force majeure.

2. If the tenant is the sole occupant of the premises, and the landlord chooses to rebuild, then the tenant might be obligated to rebuild using the proceeds of insurance. If the tenant self-insures, then the tenant would be obligated to rebuild using funds provided by the tenant.

3. The lease should provide who bears the risk of rent loss during the period of rebuilding in the event of casualty. If it is the tenant, then the tenant should be obligated to carry insurance to provide rental payments during the reconstruction phase. However, the tenant might be permitted to self-insure such risk. If the landlord bears the risk, it may choose to self-insure or purchase business interruption or extra expense coverage.

H. Insurance Company Ratings.

Best's Insurance Reports (Best's) compiles information on insurance companies and provides ratings that are typically used by consumers to evaluate insurance companies. Best's ratings include an alpha component (from A++ to F) and a numeric component (I through XV).

The alpha component represents Best's qualitative and quantitative analysis of each company's financial condition and operating performance. The numeric component represents each company's policyholders' surplus (equity) and conditional reserve funds, i.e., the company's financial size.

Best's interprets its ratings as follows:

Secure Ratings:

A++, A+	Superior
A, A-	Excellent
B++, B+	Very Good

Vulnerable Ratings:

B, B-	Adequate
C++, C+	Fair
C, C-	Marginal
D	Very Vulnerable
E	Under State Supervision
F	In Liquidation

There are also miscellaneous codes for "not rated" categories, e.g., NR-2 is Insufficient Size and/or Operating Experience.

Financial Size (in \$ millions):

Class I	up to 1
Class II	1 to 2
Class III	2 to 5
Class IV	5 to 10
Class V	10 to 25
Class VI	25 to 50
Class VII	50 to 100
Class VIII	100 to 250
Class IX	250 to 500
Class X	500 to 750
Class XI	750 to 1,000
Class XII	1,000 to 1,250
Class XIII	1,250 to 1,500
Class XIV	1,500 to 2,000
Class XV	2,000 or greater

Various “rules of thumb” are used to identify “safe” companies. A common rule is “equal to or greater than A-VIII”. In negotiating as to the acceptability of a carrier, greater emphasis is put on making sure that it falls into the Secure Rating status (at least B+) than demanding the highest levels of financial size.

I. Model Self-Insurance Lease Provisions.

1. Tenant shall pay for and maintain or cause to be paid for and maintained, from the date of commencement of the construction of the Leasehold Improvements through the end of the term, the following policies of insurance covering the premises, which insurance shall be obtained from companies currently rated “A-VIII” or better as defined in the then current edition of Best’s Insurance Reports (or the equivalent thereof if Best’s Insurance Reports is no longer published) and is licensed to do business in the State where the premises are located:

(i) Workers’ Compensation Insurance covering tenant and its employees for all costs, statutory benefits and liabilities under State Workers’ Compensation and similar laws for employees of landlord, and Employer’s Liability Insurance with limits of Five Hundred Thousand Dollars (\$500,000.00) per accident or disease.

(ii) Commercial General Liability Insurance covering the premises with combined single limits of not less than _____ Dollars (\$_____) per occurrence for death, bodily injury or property damage.

(iii) All Risk” Property Insurance (now known as Special Perils Insurance) upon all buildings, building improvements, personal property owned

by tenant and alterations on the premises (i) against loss or damage by fire, lightning, windstorm, tornado, hail and such other further and additional hazards of whatever kind or nature as are now or hereafter may be covered by standard extended coverage, (ii) with “all risk” endorsements (including, but without limiting the generality of the foregoing, vandalism, malicious mischief and damage by water), (iii) against war risk as, when and to the extent such insurance is obtainable from the United States of America or an agency thereof, (iv) against flood disaster pursuant to the Flood Disaster Protection Act of 1973, 84 Stat. 572, 42 U.S.C. SS. 4001, if the premises is located in an area identified by the United States Department of Housing and Urban Development as a flood hazard area, (v) against earthquakes (including subsidence), (vi) against any other risk commonly insured against by persons operating properties similar to the premises and located in the vicinity of the premises or conducting operations similar to the operations conducted at the premises, (vii) containing demolition and increased cost of construction coverage; and (viii) if a sprinkler system is located in the buildings, sprinkler leakage insurance and all of which insurance shall be in the full replacement cost of the buildings, building improvements, personal property and alterations on the premises and with an “agreed value” endorsement and all other endorsements reasonably requested by landlord from time to time. The maximum “deductible” permitted under such insurance will be \$_____.

(iv) Rental Interruption Insurance coverage, in adequate amounts to avoid co-insurance provisions, for an adequate period of time of not less than 12 months, taking into consideration the reasonable time period required to rebuild and/or replace the insured property; including coverage for, but not limited to, loss and loss of use of Tenant’s leasehold improvements, business fixtures, stock-in-trade and for “extra expense” as well as all Rent and Additional Rent required of tenant under the lease.

2. The specified limits of insurance may be satisfied by any combination of primary or excess/umbrella liability insurance policies. At the end of each five (5) years of the initial term, and at the beginning of each extension period tenant shall review with landlord the coverages and limits of any or all of the policies required above and, at that time, shall cause such coverages and liability limits to be increased as reasonably required by landlord in view of inflation and other relevant factors.

3. Each policy shall expressly provide that it shall not be subject to cancellation, modification or change without at least thirty (30) days’ prior written notice to landlord, that the coverage provided by such policy shall be deemed primary insurance and that any insurance provided by or on behalf of landlord shall be in excess of any insurance provided by such policy. Tenant shall furnish landlord, or cause to be furnished to landlord, currently with the execution of this lease, and prior to the inception of each successive policy period, insurance certificates and, upon request by landlord, copies of such policies required to be maintained hereunder naming landlord as an additional insured thereunder. Upon request of landlord, tenant shall also provide

coverage under such insurance (or so much thereof as landlord may require) for the benefit of the landlord's mortgagee holding a lien on the premises and shall name such mortgagee under a standard mortgagee provision. All policies required to be provided by tenant hereunder shall include an endorsement or other provision whereby such insurance carrier acknowledges and accepts the waiver of subrogation in favor of landlord contained in paragraph ___ below.

4. [Subject to approval by the holder of any first mortgage on the premises] tenant shall have the right to self-insurance for the insurance required above, on the following terms and conditions and subject to:

(i) "Self-insure" shall mean that tenant is itself acting as though it were the insurance company providing the insurance required under the provisions hereof and tenant shall pay any amounts due in lieu of insurance proceeds which would have been payable if the insurance policies had been carried, which amounts shall be treated as insurance proceeds for all purposes under this lease.

(ii) All amounts which Tenant pays or is required to pay and all loss or damages resulting from risks for which Tenant has elected to self-insure shall be subject to the waiver of subrogation provisions of paragraph ___ hereof and shall not limit tenant's indemnification obligations set forth in paragraph ___ hereof.

(iii) Tenant's right to self-insure and to continue to self-insure is conditioned upon and subject to:

(a) The tenant now having and hereafter maintaining a tangible net worth of at least _____ Dollars (\$_____). The amount of Tenant's net worth requirement shall be increased by _____ Dollars (\$_____) at the end of each five (5) years of the initial term and at the beginning of each extension term of the lease [or tenant maintaining a rating of "A" or better by Standard and Poor];

(b) The tenant providing an audited financial statement, prepared in accordance with generally accepted accounting principles, to landlord [and landlord's mortgagee] by May 1 of every year which establishes and confirms that tenant has the required net worth;

(c) No events occurring that make it apparent that such net worth has been diminished below the required level (such as the bankruptcy of tenant); and

(d) The tenant maintaining appropriate loss reserves for the amount of its self-insurance obligations under the lease and

otherwise which are actuarially derived in accordance with accepted standards of the insurance industry and accrued (i.e., charged against earnings) or otherwise funded.

(iv) In the event tenant fails to fulfill the requirements of 4(c), then tenant shall immediately lose the right to self-insure and shall be required to provide the insurance specified in paragraphs 1, 2 and 3, provided, however that tenant's self-insurance shall continue in full force and effect until the insurance specified in paragraphs 1, 2 and 3 is issued by a qualifying insurance company.

5. In the event that tenant elects to self-insure and an event or claim occurs for which a defense and/or coverage would have been available from the insurance company, tenant shall:

(i) undertake the defense of any such claim, including a defense of landlord, at tenant's sole cost and expense, and

(ii) use its own funds to pay any claim or replace any property or otherwise provide the funding which would have been available from insurance proceeds but for such election by tenant to self-insure.

6. In the event tenant has the right to and elects not to operate its business in the premises after reconstruction, or fails to commence reconstruction within _____ days after requested by landlord, landlord shall have the right to determine that the self-insurance proceeds either be paid to landlord:

(i) for restoration of the premises to such form and condition as landlord may reasonably require, and the tenant's other obligations under the lease shall continue in full force and effect, or

(ii) such proceeds be paid to landlord or landlord's mortgagee and the lease shall thereupon terminate.

7. In the event that tenant elects to self-insure a deductible or self-insured retention, tenant shall provide landlord [and landlord's mortgagee] with certificates of insurance from the primary, umbrella and excess carriers specifying the extent of self-insurance coverage hereunder and containing a waiver of subrogation and/or release of right of recovery provision reasonably satisfactory to landlord. Any insurance coverage provided by tenant shall be for the benefit of tenant, landlord [and the first mortgagee], as their respective interests may appear [and, shall name the mortgagee under a standard mortgage provision].

8. The obligations of tenant under this [insurance paragraph] are independent and shall remain in full force and effect notwithstanding any breach of any provision of the lease by landlord.

J. Model Letter from Self-Insured Tenant to Mortgagee.

To Lender:

_____ (the "Tenant") is the lessee under a certain Lease dated _____, 200__, between _____, as lessor (the "Borrower"), and the Tenant, as lessee (the "Lease"). We understand that _____ Insurance Company (the "Lender") is making a mortgage loan to the Borrower (the "Loan") to be secured by the real estate which is the subject of the Lease (the "Property").

Pursuant to your request, this is to confirm that the Tenant will provide the insurance required by paragraph ___ of the Lease by self-insuring against the risks required by the Lease. This also confirms that the Tenant and its parent, (the "Parent"), which has guaranteed the Lease, have a combined tangible net worth as of _____ of _____ Dollars (\$_____).

Loss or damage, if any, payable under the self-insurance shall be payable to the Lender, as its interests may appear, and such insurance shall not be invalidated by (i) any, default, act, omission or negligence of the Lender or the Borrower, (ii) by any foreclosure or other proceedings relating to the sale or other transfer of the Property, (iii) by any change in the title or ownership of the Property or, (iv) by the occupation of the Property for purposes more hazardous than are permitted by the Lease.

The self-insurance is subject to the waiver of subrogation and release provisions of paragraph ___ of the Lease and shall not limit the Tenant's indemnification obligations under paragraph ___ of the Lease.

You are authorized to rely upon the representations provided herein in making the Loan to the Borrower. The Tenant understands that if the Lender determines that the Tenant and the Parent do not have the financial capacity to cover such risks, the Lender may require the Borrower to obtain insurance policies insuring against such risks, the failure of which will constitute an event of default by the Borrower under the Loan. However, nothing herein shall impose any liability on the Tenant to pay for such insurance so long as it meets the requirements under the Lease of the conditions of Tenant's right to self-insure.

The Tenant hereby confirms that its insurance obligation under paragraph ___ of the Lease is independent and shall remain in full force and effect notwithstanding any breach of any provision of the Lease by Landlord.

X. *Certificates of Insurance*

A. A certificate of insurance is a writing which evidences the existence of an insurance policy. It is not the policy. It is used in instances where it may be impractical to provide the complete policy for review and analysis. It may be called “Evidence of Insurance” or “Proof of Insurance”, but the term “Certificate of Insurance” is most commonly used by practitioners.

1. ACORD 25-S (titled “Certificate of Insurance”) relates to liability insurance. However, (i) it confers no rights upon the recipient of the certificate and (ii) it does not obligate the insurer to give the certificate holder notice of cancellation or amendment of the underlying policy.

2. ACORD 27 (titled “Evidence of Property Insurance”) relates to property insurance. Because it conveys all of the rights and privileges afforded under the underlying policy (thereby becoming part of the underlying policy), and because it unconditionally obligates the insurer to give the certificate holder notice of cancellation of the underlying policy, ACORD 27 comes close to fulfilling the expectations of most people who require insurance in real estate transactions, be they mortgagees, loss payees or named insureds. Although ACORD 27 is not to be used to evidence policies of liability insurance, it is adaptable to that purpose.

3. ACORD 28 (titled “Evidence of Commercial Property Insurance”) is a new property form of certificate of insurance designed to correct a number of deficiencies found in existing certificates. It is still in the process of being revised and a number of insurance agents are not yet familiar with it. Since it deals with real and personal property losses and contains many of the modifications that practitioners have had to fight for on many occasions, it would be prudent to be as persistent as possible to require this form of Certificate of Insurance. A copy of the Certificate is attached at the end of this article.

B. The Dancing Bear Case.

The misfortune that can result from relying on a Certificate of Insurance similar to ACORD 25-S is illustrated by T.H.E. Insurance Co. v. Naghtin, 916 F.2d 1082 (6th Cir. 1990). After a performance at a shopping center by a traveling bear show, members of two families were apparently injured during a photo opportunity with Fluffy, a 7-year old bear. Naghtin, the operator of the bear show, had obtained general liability insurance covering “Bears in Cages, Display, Bear Acts and Photos with Bear Cubs”. Id. at 1084. Prior to the incident at the shopping center, the insurance company’s agent issued a certificate of insurance to the shopping center owner (“Mansfield”), which certified that insurance existed for “Animal Display, Photos, etc....”. Id. at 1084. T.H.E. Insurance Company (“T.H.E.”), which had issued the policy, brought a declaratory judgment action seeking a determination that it had no obligation to defend claims resulting from the incident. The District Court for the Northern District of Ohio agreed with T.H.E. and held (i) its policy did not cover the incident because it did not cover photo opportunities with adult bears, and (ii) the Certificate did not estop T.H.E. to deny coverage. Only Mansfield appealed.

The first issue discussed on appeal with Mansfield's standing to appeal. Apparently, Mansfield was not a named insured under the policy. However, the Court held that Mansfield had a sufficient personal stake in the outcome of the controversy to warrant invocation of Federal Court jurisdiction and to justify exercise of the Court's remedial powers on Mansfield's behalf (cit. omitted). The Court noted that Mansfield was the only party capable of arguing that it was induced to rely on the certificate and that, if it prevailed on its estoppel theory, it would benefit from T.H.E.'s contribution should Mansfield and Naghtin be held jointly and severally liable for the injuries that Fluffy caused.

However, on the issue of whether Mansfield was entitled to rely on the certificate, the Sixth Circuit held that in view of the disclaimer [25-S-type language] in the certificate, Mansfield was not entitled to rely on it. Thus, notwithstanding that (i) Mansfield had been issued a certificate which was wrong, (ii) common sense indicates that the inevitability of Mansfield's reliance in fact on that Certificate and (iii) the reliance was induced by T.H.E.'s agent, T.H.E. was not estopped to deny coverage.

C. The materials contained in this Article X were prepared by Joel V. Volker.

XI. Parties to Insurance Policies

A. General Rule.

Under property policies, additional parties are handled as "insured as their interests may appear," "additional insureds" or "loss payees"; under liability policies, additional parties are "additional insureds" or "additional named insureds" (although "additional named insureds" is obsolete).

B. Named Insured.

This terminology is used for both property and liability policies. The named insured is the party that can enforce the policy. This is the party who pays the premiums and whose risk history is studied to determine the amount of premiums. The failure of the named insured to pay the premiums and fulfill the conditions of the insurance contract could result in a defense for the insurance company.

C. Additional Named Insured.

This terminology is obsolete although it is sometimes referenced in situations where a company is the "named insured" and its subsidiaries are "additional named insureds."

D. Additional Insured.

This terminology is commonly used for liability policies although a party may be named as an additional insured on a property policy if they have an insurable interest in the property insured. An additional insured is not provided the same protection as is provided to the named insured. Coverage is provided to the additional insured only to the extent stipulated on the additional insured endorsement. However, if an additional insured endorsement is coupled with well written indemnities and waivers, the additional insured may, in fact, have broader protection than the named insured. The policy premium is not adjusted for an additional insured's risk history. An additional insured has no obligation to pay the premium for the policy.

1. Cost. An additional insured endorsement is available at no or nominal cost (\$25-\$75) to the named insured.

2. Evidence. The additional insured must get a copy of the endorsement effecting status. The certificate of insurance form used most often, ACORD Form 25-S, states in the upper right hand corner, "This certificate does not amend, extend, or alter the coverage afforded by the policies below". If the insurance company does not actually issue the endorsement, a party is not an additional insured even if the certificate shows the party as an additional insured. (Another form, ACORD Form 27 entitled "Evidence of Property Insurance", is enforceable but applies only to property insurance unless modified.)

3. Advantages of additional insured status.

i. Additional insured status provides a safety net to the additional insured should the indemnification clause be held to be unenforceable.

ii. The additional insured is provided direct policy rights to defense within the primary insured's policy, without having to depend upon indemnification, subject to the scope of the insurance coverage provided. Additionally, liability policies treat named and additional insureds as if each is insured under a separate policy. Hence, each additional insured is entitled to a separate defense.

iii. An additional insured is not subject to all of the defenses against the named insured or the same obligations as the named insured. Additional insured status may therefore actually afford better protection than being a named insured.

iv. An additional insured is entitled to coverage for personal injuries, as defined within the policy.

v. Additional insured status may enable the additional insured to circumvent statutes prohibiting the transfer of sole negligence, to the degree to which the additional insured endorsement does not exclude such coverage.

vi. Additional insured status may automatically entitle the additional insured to the excess liability or umbrella coverage of the other party because such policies frequently cover all insureds also covered under the primary liability policy.

vii. Subrogation may be avoided, but only to the extent that coverage is provided by the additional insured endorsement.

viii. Other coverages may be provided to the additional insured that were otherwise unavailable to it.

As a result, the additional insured is provided substantial cost-free protection, and reduces the likelihood of claims against its own insurance program. Thus, the additional insured is able to reduce future insurance costs.

4. Potential pitfalls. Potential hazards with regard to additional insured requirements are frequently overlooked. This oversight can create problems for the drafting counsel.

i. Additional insured endorsements do not usually include the additional insured's employees, officers, directors, etc., as is often required by the contract.

ii. Each form granting coverage also restricts that coverage to a specified scope.

iii. No standard form may offer the scope of coverage desired. In such case, additional wording should be added to the form being used, or a so-called "manuscripted" form submitted to the insurance company.

iv. In many cases, provision of additional insured coverage triggers the other insurance clause for the recipient of the coverage.

v. The aggregate limit may be impaired or exhausted. This should be handled by application of an "aggregate limit per location", "aggregate limit per project", or similar endorsement.

vi. When evidenced only by an ACORD Form 25-S Certificate of Insurance, there is no guarantee of coverage. A copy of the additional insured endorsement should be obtained and carefully reviewed.

vii. The policy providing the additional insured status may be canceled or the insurance company involved may become insolvent.

viii. In spite of all precautions, the additional insured's own insurance coverage may still be involved in a claim for a variety of reasons, not the least of which is that insurance companies frequently challenge additional insured status at the time of a claim.

5. Landlord forms. The most common form of additional insured endorsement requested by landlords is ISO Form 20 11.

i. Coverage under ISO Form 20 11 is restricted to "liability arising out of the ownership, maintenance or use of the part of the premises leased". If the term

“premises” is restrictively described in an agreement, coverage may be similarly restricted. For example, one case held that the negligent employee of a tenant who injured a third party while in the alley behind the store was not in the premises. Hence, the additional coverage endorsement on the tenant’s policy did not protect the landlord in this situation. A landlord may consider a broader definition of “premises” for insurance purposes only.

ii. Coverage under ISO Form 20 11 does not apply to occurrences taking place after the tenant vacates. This can be a problem if the tenant leaves a dangerous situation in the premises. This exclusion should be deleted from the endorsement.

iii. Also excluded under ISO Form 20 11 is construction or demolition on behalf of a landlord. Since a landlord would be the owner of alterations, alterations could be characterized as being constructed on the landlord’s behalf. This ambiguity could become a possible avenue for an insurance carrier to deny coverage. Again, the exclusion should be deleted.

iv. If ISO Form 20 11 is used, the landlord should resist alterations to the form which attempt to limit coverage to the vicarious liability of a landlord, since the limitation would restrict coverage to situations where the landlord is either not negligent or only partially negligent. A landlord’s sole negligence would not be covered.

v. A better approach would be for the landlord to request ISO Form 20 26 and resist any changes to the form.

6. Tenant/owner forms. The most common additional insured endorsements requested by lessees from lessors (and by owners from contractors) are ISO Forms 20 09 and 20 10.

i. ISO Form 20 09 is a vicarious liability form and should not be accepted.

ii. ISO Form 20 10 refers only to “ongoing operations”, not “completed operations”. The term “ongoing” should be deleted or the phrase “and completed” inserted before the word “operations”.

iii. The better approach is for lessees to obtain from landlords (or for owners to obtain from contractors) ISO Form 20 26, without modification.

Some insurance companies may attempt to deny coverage on the basis that the additional insured failed to notify the insurance carrier of the claim independently of the named insured.

7. Loss payees. The interests of these parties are protected only if the named insureds choose to enforce the protection. A loss payee has no independent right to enforce the policy. A loss payee has neither the benefits nor obligations of named or additional insureds, but is simply the recipient of payments.

8. Mortgagees. Mortgagees are handled by a special “**mortgagee clause**”. A mortgagee clause relieves mortgagee of the obligation to pay premiums and thus assures the mortgagee that the mortgagee will be paid even if the insured violated the terms of the policy. A mortgagee clause normally gives the mortgagee 30 days’ notice of cancellation rather than the standard 10 days.

9. Acknowledgements. The materials contained in this Article XI were prepared by Aaron Johnston, Jr. and Charles E. Comisky.

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