PROPERTY AND LIABILITY INSURANCE IN REAL ESTATE TRANSACTIONS

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I. INTRODUCTION

A. General Overview.²

Property and liability insurance play an important role in many types of real estate transactions. Not surprisingly, the risks that are covered by property and liability insurance are also important considerations in real estate transactions.

The context of this presentation is real estate transactions. The focus, accordingly, is on handling insurance and insurable risks in a two party setting, where each of the parties has a different role and interest relative to the insurance coverages.

The fundamental premise of this presentation is that the real estate attorney's objective should be:

- 1. To understand the essential elements of property insurance and liability insurance, and
- 2. To consider insurance coverages as one of the primary factors in the allocation of the types of risks that are coverable by insurance.

Although this may seem self-evident as so stated (and is in fact a premise many of you share), we find more confusion in this area than in any other, both in the documents we encounter and in the course of negotiations.

The rationale for making insurance coverages a primary factor in risk allocation is:

- 1. Obviously you do not want your client to bear a risk which is difficult, expensive or impossible to insure, when the other party could more readily insure the risk.
- 2. The other party to the transaction is likely to have the same outlook, and

¹ Thanks to Jeff Isenberg, Risk Management Resources, for substantial contributions to this presentation.

² References to "standard" policy forms and coverage treatment contemplate the policy forms and language developed by "ISO", the Insurance Services Office, Inc., which includes the development of standard insurance policy forms among the services it provides to its several thousand insurance organization customers. Note, however, that (a) ISO forms undergo various degrees of modification from time to time; (b) different versions of ISO forms can be approved for use, or be in use, in different states; (c) different editions of the same "standard" ISO forms might be issued by various insurers at the same time; and (d) some insurers issue coverage forms that include some, but not all, of ISO's "standard" policy language. Use of ISO coverage forms is expected to be subject to ISO copyrights.

References to standard "ACORDTM" Certificates of Insurance contemplate those certificates of insurance forms promulgated by the ACORD Corporation. ACORD Certificate of Insurance forms also undergo modification from time to time, and their use is expected to be subject to ACORD copyrights.

consequently any attempt to impose a risk that is difficult to insure will add delay and cost to the transaction.

3. An insured risk is generally a better credit risk than an indemnified, but uninsured risk. It is also generally (but not always) less trouble to collect.

Our premise is not that insurance coverages are the only pertinent factor. Fault, ability to pay, ability to spread the cost, and bargaining strength remain important factors.

B. Overview of Insurance Coverages.

This presentation addresses property insurance and liability insurance. It does not address, among other things, title insurance, workers compensation, management, or professional liability insurance.

Property insurance is known variously as fire insurance, fire and extended coverage insurance, and "all risk" insurance. Property insurance also includes more specialized types of coverages such as boiler and machinery insurance and EDP (computer related) insurance. Property insurance pays a claim directly to its insured -- it is "first party" insurance. Regardless of whether written in "all risk" or more limited specified peril form, the policy pays only for losses resulting from the perils covered by the policy. Some policy limitations are straightforward and readily understood in a loss exposure context. Others are not.

Liability insurance is known variously as commercial general liability ("CGL"), comprehensive general liability and public liability insurance. Liability insurance does not pay the insured like property insurance; it provides a defense to the insured and pays claims to the injured party asserting a claim against the insured -- it is "third party" insurance.

II. COMMERCIAL PROPERTY COVERAGE

A. Framework For Analysis. Ask:

1. What Property is covered?

- 2. What Events ("Perils") trigger coverage?
- 3. What Measure of Recovery applies?
- 4. What other limitations will or might apply to the insurance recovery?

If the property coverage falls short in any of these areas, the insurance recovery may not

³ As will be discussed below, both of these familiar terms have fallen out of favor with the U.S. insurance industry.

be satisfactory.

B. <u>Basics</u>. Although there are "standard" Insurance Services Office (ISO) property coverage forms, there is not nearly the standardization in the property insurance area that is reflected by the predominance of the standard ISO Commercial General Liability Policy in the liability insurance area. As a general matter, it is the smaller Insureds, and Insureds that have less insurance sophistication (or have less sophisticated agents), that tend to have unmodified standard ISO property policies. There are so many variables in a more complex property insurance program, and so many Insureds that will maintain other than unmodified standard ISO programs, that we believe it more appropriate here to focus on the problem variables than on the standard policy. The intent is to identify the property insurance areas that are most likely to cause your clients problems in a real estate transaction setting.

Main points: (1) it is important to consider the particulars of the property loss exposures and property insurance program in handling a real estate transaction, and (2) be specific with respect to property insurance variables when drafting the property insurance requirements that will apply to the other party.

1. <u>Covered Property</u>. The basic coverage applies to "the building or structure" (standard ISO form language) either described on the policy Declarations page or in a separate endorsement, or by reference to a Schedule on file with the insurer, and to the "Contents" within those described premises (and probably also in the open or in a vehicle within a stated distance, usually 100 feet, of such premises). Many Insureds also need a cushion of automatic coverage for additional properties, real or personal, they acquire during the policy term. The automatic limits for "newly acquired property" in standard policies are not sufficient for significant "newly acquired" exposures.

Policies can vary substantially with respect to what types of property are included in "Contents". Two main points here: First, unless revisions have been negotiated, the coverage for personal property belonging to others, *e.g.*, customers, lessors or employees, will likely be quite restricted, both in terms of the amount of coverage, and with respect to measure of recovery. As to the latter, coverage is often provided to the extent of the Insured's legal liability for the damage, rather than on a direct, "first party", coverage basis. The legal liability measure of recovery may not be appropriate to the Insured's customer relations objectives. That is, the Insured may want its customer to be made whole, without any condition of legal liability.

Second, the Contents coverage may or may not include "Tenant's Improvements", although the likelihood today is that it will. This is obviously an important issue if your client is a Tenant assuming the exposure, or the obligation to insure the exposure, for leasehold improvements under a Lease. Moreover, Tenants do not

⁴ Note that many policies no longer use the term "Contents", but rather refer to "Business Personal Property" or merely "Personal Property."

always consider their Tenant's Improvement exposures when establishing their property insurance limits. That is, the loss to Improvements may be covered, but for an inadequate amount. Finally, with respect to such coverage it is important to recognize that there may be a "use interest" measure of recovery which may be unsatisfactory if lease term extension options are not taken into consideration. This is discussed below.

Some other quick points on "Covered Property":

- a. "Valuable Papers and Records" will probably be included as covered property, but an insufficient measure of recovery will likely apply. This is discussed in the Measure of Recovery section, below.
- b. Computer Equipment and Electronic Data will be subject to excluded perils and measure of recovery limits, both of which are discussed below. Also as discussed below, the absence of a covered direct damage loss to EDP property will likely prevent recovery for any resulting Business Income or other indirect loss.
- d. Money and Securities are expected to be among the excluded types of property, or only a modest amount of coverage will be provided. Separate Crime coverage should be considered to address any significant exposures. The Crime policy can also cover loss from employee dishonesty, as well as other types of crime loss that are similarly expected to be excluded under a property policy.
- e. Building foundations and underground pipes, flues or drains are often excluded. Coverage will generally have to be specifically negotiated where it is viewed as appropriate.

Each category of property with special limitations on insurance coverage necessitates particular attention to risk allocation in a real estate transaction, particularly in a lease.

2. <u>Indirect Loss.</u>⁵ The general Insuring Agreement will usually restrict coverage to direct physical loss or damage. The corollary is that there is usually no coverage for the indirect consequences of the direct loss, such as loss of business income, extra expenses that must be incurred, or the Tenant's loss of the value of a favorable Lease that is terminated following the direct damage. However, such indirect loss coverage can usually be purchased when desired.

It takes a covered direct loss to trigger the indirect loss coverage. This

⁵ "Consequential loss" is an appropriate alternative, and the insurance industry tends to favor a third term, "time element loss", to describe the types of damages that can result over time following the direct property damage. For purposes of consistency, and also to emphasize the "direct vs. indirect" distinction, the term "indirect loss" is used throughout this discussion.

general rule can be a problem in view of the fact that the direct damage coverage is largely restricted to **owned property** located at a **scheduled premises**. There are circumstances where the client's indirect loss exposures are tied to direct damage to **non-owned** and/or **off-premises** properties.

Example #1:

Your client operates a retail store in a large shopping mall. The lead tenant in the Mall has a fire, and it will be 120 days or more before the substantial customer traffic attributed to that lead tenant is reestablished. Your client is going to sustain a significant loss of revenues as a result. Unless your client has negotiated for "Contingent Business Income" coverage, it will not likely recover for its revenue loss. (Note that a Landlord with a Base Rent + percentage of revenues" rent structure could also sustain a revenue loss here.)

Example #2:

There is no loss to your retail store client, or to any other tenant in the Mall, but electrical arcing in a utility company substation results in your client being unable to conduct business for several days during the critical Holiday Season. In this example, your client would have had to add the "Contingent Business Income" coverage under its Mechanical Breakdown/Boiler & Machinery⁶ policy in order to recover its revenue loss. If, however, the damage to the substation occurs as a result of a Special Form/All Risk⁷ peril, *e.g.*, fire or lightning, there would be no recovery unless the Contingent Business Income coverage (usually in the form of a "Utility Service Interruption" coverage extension) was added to the client's Special Form Perils/All Risk policy.

<u>Indirect Losses – Mortgages</u>. From the credit and cash flow viewpoint of a Mortgagee, indirect loss exposures may be very significant. Unfortunately, analysis of the type and scope of the exposures and the possible insurance solutions must be handled on a case-by-case basis.

<u>Indirect Loss – Leases</u>. There are at least four types of indirect loss coverage that should be considered in the context of Lease and Mortgage transactions:

- a. Business Income (also known by its earlier name, "Business Interruption" insurance),
- b. Extra Expense,
- c. Rental Income (or "Rental Value", or just "Rents" coverage), and
- d. Leasehold Interest.

⁶ Regarding terminology, see footnote 10.

⁷ See footnote 8.

From the perspective of a Landlord or Mortgagee, either the Business Income or the Rental Income coverage approach can be used to address the potential for lost rental income. The exposure to lost rental income would exist whenever the Lease presents loss scenarios where Tenant's rent would abate. Business Income exposure values can be difficult for some insureds to determine, and Business Income loss adjustments can become quite complex, with somewhat uncertain results. For these reasons, a Rental Income coverage approach, which contemplates specific coverage for lost rental income, may be preferred. Where Tenant's rent does not abate, Landlords sometimes require Tenant to carry the Rental Income coverage for the benefit of Landlord. Landlord would obviously have an interest in monitoring Tenant's compliance with this insurance requirement.

From Tenant's perspective, Extra Expense coverage is expected to be responsive to the duplication of rent expense that would result if substitute premises had to be leased at the same time that the rent under the subject Lease also continued because there was no abatement of that rent. (Tenant should obviously contemplate that it may need Extra Expense dollars to fund considerably more than just the duplicate rent expense.)

It is important, for both Landlord and Tenant (and Mortgagee), that the insurance maintained to respond to these exposures involving rent contemplate all of the variables that go into "Rent" under the Lease. For example, "Rent" under most net leases includes Tenant's proportionate share of the Common Area expense, real estate taxes, specific maintenance and repair expense, and a variety of other Operating Costs, including insurance expense. Tenant's insurance limits should be established accordingly. The same considerations are pertinent where the Lease calls for a percentage of Tenant's receipts, *e.g.*, Gross Revenues as a component of "Rent". In such instances, it is suggested that the Lease also specifically address the treatment of any Business Income insurance proceeds received by Tenant -- *i.e.*, whether such proceeds are to be included in the "percentage of Gross Revenues" component of "Rent".

Where the Damage and Destruction Clause of the Lease permits Landlord to elect to terminate under certain loss scenarios, the Tenant with favorable Lease terms can lose a valuable asset. The exposure can be insured under what is usually termed "Leasehold Interest Insurance." This type of coverage responds to the loss represented by the difference between the favorable rent paid under the terminated Lease, and that which must be paid for replacement premises. The measure of recovery provisions under this type of coverage vary, so they warrant special attention. (Note: Unexercised option periods should be considered in assessing the value of the favorable Lease in order to determine the appropriate amount of Leasehold Interest coverage to maintain.)

3. Perils. The most common distinction has traditionally been between **Special Form Perils/"All Risk"** coverage and **Named Perils** (or "Specified Perils") coverage. Special Form Perils coverage applies to direct damage to property from all perils that are not specifically excluded. Under a Named Perils policy form, coverage applies to only those perils that are specifically listed as covered under the policy. The latter is what is generally contemplated by the phrase "Fire and Extended Coverage". "Fire & EC" perils have been extended over time so they are now expected to include fire, lightning, explosion, windstorm or hail, smoke, aircraft or vehicles, riot or civil commotion, vandalism, sprinkler leakage, sinkhole collapse and volcanic action.

Special Form Perils property insurance has become so readily available that it is unusual to see Named Perils coverage with any insured that is not purchasing its property insurance under rather unusual circumstances. We therefore prefer to focus the discussion on the Special Form Perils coverage form, or more specifically, on what is **not** covered under a Special Form Perils coverage form. These excluded items are very important to a Mortgagee, particularly a Mortgagee under a non-recourse mortgage. It is also suggested that these items be given thoughtful consideration whenever you represent a Landlord and are contemplating requiring the Tenant to provide the property insurance on the building. (From the Tenant's perspective, these would also be important considerations when your Tenant client's interests are best served if the building is well-insured.)

- a. "Ordinance or Law" Clause. This is one of the most troublesome exclusions in property insurance. It appears in real property and personal property coverage forms of all sorts, including Boiler & Machinery policies. There are variations to the exclusionary language, but the exclusion usually states to the effect that there is no coverage for loss occasioned by the enforcement of any ordinance or law regulating the construction, use, repair or demolition of any property. There are at least four potentially significant insurance consequences to the exclusion:
 - (1) The direct damage recovery can be limited to only the loss attributed to the damage caused by the insured peril, with no coverage for any loss resulting from a lawful order to demolish the remaining undamaged portions of the building. For example, if 50% of the building was damaged by fire, and as a result of a determination of structural unsoundness or other dangerous condition the entire building was ordered demolished, the insurance recovery could be limited to 50% of the total insured value.

Page 8

⁸ The Insurance Services Office no longer uses the term "All Risk" to describe that type of policy. The current ISO All Risk perils coverage form is titled "Causes of Loss - Special Form", and the perils covered under the form are generally referred to as "Special Form Perils."

- (2) Unless the policy provides otherwise, there is no coverage for the actual cost of demolition, or for the cost of removing that part of the debris resulting from the demolition.
- (3) If, after such loss, the cost of repair or replacement is increased due to the necessity to conform to then current building or zoning codes, that additional expense would not be covered.
- (4) Either the demolition or the "increased cost to rebuild" situation can result in an unsatisfactory indirect loss recovery. In short, customary Business Income, Extra Expense and Rental Income coverages do not apply during that portion of the rebuilding time attributed to restoration of the part of the building that was demolished, or to the additional time attributed to repair or replacement in order to comply with existing building codes. In other terms, the Ordinance or Law exclusion can prevent the indirect loss recovery from continuing until the building has been fully restored.

All four of these consequences can be covered, but under the standard property insurance policy approach, only if the exposures are identified and specific coverage extensions are negotiated. It is worth noting that some insurers that issue other than standard ISO coverage forms automatically include coverage for some or all of these "Ordinance or Law" exposures under their policies.

b. Water Perils/Flood and Earthquake Hazards. As a general matter, Special Form Perils coverage forms are not expected to include any flood or earthquake coverage. It may or may not be obvious when these coverages, particularly "flood," should be added. A federally supervised financial institution may not make a loan secured by improved real estate or a mobile home located in an area of special flood hazard unless the property is covered by flood insurance. Consequently, it is uniform practice in loan transactions, and customary practice in many other types of transactions, to require a survey certifying whether the property is located within an area of special flood hazard.

The standard property insurance exclusion for "flood" loss rather broadly excludes water damage perils. For example, in the standard ISO "Causes of Loss - Special Form," *i.e.*, the standard All Risk policy form, the exclusion applies not only to flood *per se*, but also to damage from runoff of surface water, mudslide or mudflow, water that backs up or overflows from sewers, drains or sumps, or water under the ground that causes damage when released through hydrostatic pressure. It is possible to

⁹ See 42 U.S.C. § 4012a

negotiate reinstatement of any of these coverages. In addition, some insurers that issue other than standard ISO coverage forms limit the definition of "flood", and therefore limit the scope of the flood exclusion to "flood" in its traditional sense, *i.e.*, the overflowing of water from its natural boundaries, or to flood and runoff of surface water.

c. <u>EDP Perils</u>. Special Form Perils coverage is often inadequate to respond to computer-related exposures. This is principally because of three exclusions. Most (but not all) All Risk policy forms, as well as the standard ISO Special Form Perils policy form, exclude loss or damage caused by or resulting from: (1) artificially generated electrical current, (2) mechanical breakdown, and (3) dampness or dryness of atmosphere, changes or extremes of temperature. In addition, recall the general proposition (*Contingent* Business Income/Extra Expense coverage being the exception) that if there is no direct damage coverage, there is no indirect loss coverage. As a result, any Business Income or Extra Expense coverage would not be triggered if the damage to the computer equipment or media was not covered because one of these peril exclusions applied.

Either the exclusions must be deleted, at least with respect to EDP loss, or a separate EDP policy or coverage extension part should be purchased.

d. <u>Equipment Breakdown/Boiler & Machinery Perils</u>. The standard Special Form Perils policy is not intended to respond to Equipment Breakdown exposures. The fundamental distinction between conventional Property Insurance and Boiler & Machinery Insurance is that the former covers loss or damage from an external source or event, while the latter is intended to insure against a covered item of equipment (an "object" in traditional Boiler & Machinery policy terms) suddenly and accidentally damaging itself.

Most (but not all) conventional Property Insurance policies contain exclusions for damage resulting from explosion of pressure vessels, mechanical breakdown and electrical disturbance (other than from lightning), and therefore coverage against loss from those perils must usually be provided under a separate Equipment Breakdown Policy. It may be the case that this is well-recognized with respect to the need to add mechanical breakdown coverage for such equipment as steam boilers, steam turbines, motors, pumps, and the like, but it is probably not as well understood that under a traditional Boiler & Machinery policy the basic coverage must be extended if the policy is going to respond to damage from electrical disturbance (e.g., from arcing) to a building's electrical panels. One of the advantages of the newer Equipment Breakdown

¹⁰ As is the case with the term "All Risk coverage", the term "Boiler & Machinery coverage" has fallen into disfavor with the U.S. insurance industry. The emerging favored term is "Equipment Breakdown Coverage." As is the case with "All Risk", it is not yet clear that "Boiler & Machinery" will be replaced soon in contract insurance provisions.

policies is that coverage for damage to Covered Equipment from electrical disturbance is automatically covered.

As previously noted, it is important to remember that generally a covered direct damage loss is required to trigger any "indirect" loss coverage, *e.g.*, Business Income, Rental Income or Extra Expense coverage. As the conventional Special Form Perils property policy is expected to exclude coverage for damage from explosion of pressure vessels, mechanical breakdown and electrical disturbance, any resulting indirect loss will also not be covered. Business Income and other indirect loss coverages can be added under the Equipment Breakdown or Boiler & Machinery Policy.

Even where the Equipment Breakdown/Boiler & Machinery exposure has been recognized and a policy is in place, there are many of the same limiting considerations that apply to the Special Form Perils coverage. For example, if a building is dependent upon utility company electrical service, as most facilities are, or upon outside steam or chilled water, then the Business Income and other indirect loss coverages must be triggered by covered direct damage to the pertinent non-owned property. The need for "Contingent" Equipment Breakdown/Boiler & Machinery coverage would have to be recognized if the exposure is to be addressed.

4. Measure of Recovery.

Replacement Cost vs. Actual Cash Value. The principal distinction is a. between Replacement Cost and Actual Cash Value. The former contemplates the actual cost to repair or replace (with like kind and quality), without deduction for depreciation. Actual Cash Value, on the other hand, requires a deduction for depreciation. In short, Replacement Cost is the appropriate measure of recovery where the objective is to fund the full repair or replacement of the property. It should be noted that there is usually a requirement that the property actually be replaced, sometimes within a stated period of time (usually two years), or the Replacement Cost measure of recovery reverts to Actual Cash Value. Also note that some Replacement Cost provisions require that a building be replaced at the same site, which might be inconsistent with the client's anticipated business response following a major loss. Much more often, the policy will limit the amount of recovery to what it would have cost to replace at the same site, rather than limit replacement to the same site.

Where the contract includes a requirement to insure the building to a specific valuation standard, *e.g.*, its "full insurable replacement value", it would be wise to consider including a cost mechanism for determining that standard. For example, a requirement for a Replacement Cost appraisal at least every three to five years, or application of a customarily acceptable annual inflation index.

- b. <u>Legal Liability</u>. It was noted above that a legal liability standard of recovery usually applies in the case of certain losses, *e.g.*, those involving Personal Property of Others. Again, the Insured's objectives should be examined to determine whether this is or is not appropriate. The Insured might be able to negotiate Replacement Cost coverage where it is preferred.
- c. <u>Tenant's Improvements</u>. One of the more important considerations in this area with respect to Leases is the measure of recovery applying to Tenant's Improvements. In the first instance, the Tenant's policy might provide for Actual Cash Value, rather than Replacement Cost recovery. This could be a significant problem if your Tenant client is required to restore the premises following the damage.

There is another type of problem that can be presented where your Tenant client does not have to make the repairs because the Lease will be terminated, but it has directly funded the Improvements and needs the insurance proceeds to apply to Improvements at replacement premises. In that case, there may be a problem if the measure of recovery for Tenant's Improvements under the circumstances is based on the Tenant's "use interest". This approach would generally result in the Tenant being entitled to receive a proportion of the original cost of the Improvements as determined by the amount of time remaining on the Lease from the date of damage relative to the total length of the Lease term. In other words, if the loss occurred at the end of the third year of a five year lease, your client would receive only 40% of the original cost of the Improvements.

The recovery problem here can be compounded if the policy does not address the possibility that there were Lease options to be exercised. For example, if the damage causes the Lease to be terminated after the third year of a five year term, but there was a five year option period that your client planned on exercising (and invested in Improvements accordingly), would the recovery be 40% or 70% of the original cost of the Improvements? Some policies address the issue, others do not.

Both parties to the Lease have an interest in making certain that the Lease provisions addressing repair/replacement of Tenant's Improvements and the coverage for such Improvements are specific enough to meet their respective objectives. For example, in a loss scenario in which Tenant is required under the Lease's Damage/Destruction provision to repair or replace the damaged Improvements, Tenant's repair/replacement expense would not be fully funded if a "use interest" or an Actual Cash Value measure of recovery applied under Tenant's policy. On the other hand, Landlord's reversionary interest in the Improvements will likely be covered under its own policy, which is expected to cover all of Landlord's

interests in the building. It would therefore appear in many instances to be in the interests of both parties that the Damage/Destruction provision applying to repair/replacement of Improvements be drafted to contemplate a realistic assessment of the insurance proceeds that are likely to be received by each of them.

- d. <u>Computer Media</u>. A standard property insurance policy will likely respond to the direct loss of computer media only to the extent of the cost of replacing the disc, tape, etc., in blank form. It is not likely to provide insurance other than, perhaps, a modest amount of automatic coverage, to fund the cost of reconstructing the data, reproducing the program, etc., nor is it likely to respond adequately to the Business Income or Extra Expense consequences that might be involved. More responsive coverage can usually be negotiated.
- e. <u>Valuable Papers and Records</u>. As with computer media, recovery for valuable papers and records will probably be limited to the cost of replacing the materials in blank form, when the real expense will be incurred in the effort to research and reconstruct the contents of the records. Although there might be a modest automatic amount of such coverage, separate coverage providing for more responsive "Reproduction Cost" recovery can be added.
- 5. <u>Coinsurance</u>. Property insurance policies often contain coinsurance limitations on recovery. Coinsurance represents the insurance company's approach to "encouraging" the Insured to maintain policy limits that are at or near the full value of the insured property. The basic effect of the coinsurance clause is to penalize an Insured that does not insure to the specified percentage of value, the penalty being proportional to the amount of underinsurance. Coinsurance penalties will not apply so long as the amount of insurance carried is at least equal to the specified percentage of the value of the property. The coinsurance formula:

\$ Loss x <u>Amount of Insurance Carried</u> = \$ Recovery Amount of Insurance Required

The "Amount of Insurance Required" is determined by multiplying the Actual Cash Value or Replacement Cost of the insured property, whichever measure of recovery applies under the policy, by the coinsurance requirement.

For example, the client owns a building with a Replacement Cost value of \$1,000,000. It insures the building under a policy with a \$500,000 limit, and an 80% coinsurance requirement. A \$300,000 fire loss occurs. The client would recover (subject to the policy deductible) \$187,500, as follows:

Coinsurance requirements can often be eliminated from the policy by establishing to the underwriter that the property is being insured to its full insurable value. (General negotiating leverage might also be enough to avoid coinsurance.) One way to eliminate coinsurance requirements is through an "Agreed Value" endorsement, which suspends or removes the coinsurance provision. One should also keep in mind that the objective of insuring for full insurable value can be undermined if coverage limits are not adjusted periodically to reflect appreciation. (12)

To the individual Insured, coinsurance can be acceptable if its application is understood. Whether or not it is acceptable in a transaction is largely a matter of the circumstance. Where one party is very dependent upon thorough coverage under insurance carried by the other party, coinsurance risk can be problematic. Coinsurance is generally not acceptable to a Mortgagee.

6. <u>Builder's Risk Insurance</u>. Where the property to be insured is in the process of being constructed or altered, general property insurance coverage may not be available or the coverage may have inappropriate limitations. Builder's Risk coverage is generally a more effective way to address construction phase exposures. The policy is designed specifically for construction risks. It is also often required by contract.

A good Builder's Risk policy should include the following advantages:

- a. Ease in properly covering all of the interests required to be covered under the Construction Contract, *e.g.*, owner, general contractor, and all subcontractors of all tiers. (Most general property insurance policy forms have a number of Property of Others, measure of recovery, and other provisions that must be superseded to properly extend coverage to all parties in interest in a construction setting.)
- b. Responsive Transit and Unscheduled Locations coverage (general property policy forms must usually be adjusted).
- c. Coverage for foundations (not covered under most general property insurance forms).

When addressing coverage on a building, the phrase "full insurable value" contemplates that there will likely be some components of the building that are not covered under the policy and should therefore not be included for valuation purposes, *e.g.*, foundations and underground pipes, flues and drains.

¹² Some property insurance policies either automatically include, or offer as an option, a feature that automatically increases policy limits. See, *e.g.*, the optional "Inflation Guard" provision in the standard ISO Building and Personal Property Coverage Form (CP 00 10).

- d. Coverage for collapse (varying treatment under general property insurance forms).
- e. Coverage for theft of building materials (varying treatment under general property insurance forms).
- f. "Ensuing loss" (or "resulting loss") exception to the Design Error and Faulty Workmanship exclusions (varying treatment under general property insurance forms).
- g. Responsive indirect loss coverage (general property insurance forms require substantial modification). In Builder's Risk terms, these can include not only Business Income (or "Delay in Startup"), Expediting Expense, Extra Expense and other conventional coverages, but also "Soft Costs" coverage for specific construction-phase exposures, such as: (1) increased costs of construction (resulting from changes in building code requirements), (2) increased debt service expense, including additional construction loan expense and increased mortgage cost, (3) additional architect's and engineer's fees, (4) additional costs incurred for permits and licenses, (5) real estate taxes and other assessments, (6) advertising and promotional expenses, (7) insurance premiums, and (8) rental expense for construction equipment.

III. COMMERCIAL GENERAL LIABILITY (CGL) COVERAGE

There is much greater uniformity in primary liability insurance policies issued in the U.S. than there is in primary property insurance policies issued in the U.S., notwithstanding that the minimum coverage terms of U.S. primary property insurance policies are often governed by a statute setting out the state's "standard fire policy". The ISO Commercial General Liability Policy ("CGL") is the current standard primary liability coverage form. The ISO CGL has been revised periodically, and is a descendent of the former *Comprehensive* General Liability Policy (also referred to as "CGL"). Unless otherwise indicated, "CGL" refers to the current standard ISO CGL coverage form. Terms that are defined in the CGL policy are set out in bold in this discussion.

A. <u>Basic Coverage</u>. The CGL's "Coverage A" Insuring Agreement provides that coverage applies to sums that the Insured becomes legally obligated to pay as damages because of **bodily injury** or **property damage** to which the policy applies. Definitions:

Bodily injury - Bodily injury, sickness, or disease sustained by a person, including death resulting from any of these at any time. ¹⁵

¹³ See, *e.g.*, Minn. Stat. §65A.01.

¹⁴ As noted in footnote 2, there may be more than one version/edition of the standard ISO CGL being issued at any given time.

¹⁵ Damages from mental anguish, mental injury, humiliation, shock, and the like, are expected to be covered if they

Property damage -

- 1. Physical injury to tangible property, ¹⁶ including all resulting loss of use of that property; or
- 2. Loss of use of tangible property that is not physically injured. 17
- B. <u>Coverage Trigger</u>. The **bodily injury** or **property damage** must occur during the policy period and must be caused by an **occurrence**. The **occurrence** must take place in the **coverage territory**.
 - 1. Occurrence vs. Claims-Made Coverage. The requirement that the injury or damage occurs during the policy period distinguishes an occurrence-based policy from a "claims-made" policy. Claims-made CGLs are only imposed on insureds with unusually high risk operations, or in other unusual circumstances. Exception: Employee Benefit Liability Coverage, a form of "Errors & Omissions" insurance addressing negligence in the administration of Employee Benefit Plans, is often included as an extension to the CGL. This "EBL" coverage is often (but not always) provided on a claims-made basis.

Claims-made policies do, however, predominate in other liability insurance areas, such as Directors' & Officers' Liability, Fiduciary Liability, and Professional Liability and Errors & Omissions Liability of all sorts. Claims-made coverage is undesirable in a transactions context, where one party is relying upon the insurance carried by another party.

- 2. <u>Coverage Territory</u>. The term is defined to mean the United States, including its territories and possessions, Puerto Rico and Canada. There are some broadening exceptions, *e.g.*, where the injury or damage arises out of goods or products made or sold by the Named Insured in the territory described above, or from the activities of a person whose home is in such territory but is away for a short time on the Named Insured's business. However, it is important to note that those exceptions only apply to settlements agreed to by the insurer or to damages awarded in a **suit** brought in the **coverage territory**. More responsive "worldwide" coverage might be provided through an Umbrella or Excess Liability policy, or through a policy specifically designed to address foreign exposures.¹⁸
- 3. <u>Occurrence</u> is defined to mean "an accident, including continuous or repeated exposure to substantially the same general harmful conditions". The basic intent

result from the **bodily injury**, but standard CGL policies are not expected to cover allegations of "stand-alone" mental anguish, etc., -- *i.e.*, where the mental anguish, etc., is not alleged to have resulted from the **bodily injury**.

¹⁶ The definition of **property damage** was revised in the 10/01 edition of the CGL to make it clear that electronic data is not "tangible property", a matter that had previously been the subject of some prominent litigation.

A significant amount of the coverage initially provided by this part of the definition is later excluded by the "Damage to Impaired Property or Property Not Physically Injured" exclusion (m).

¹⁸ There will likely still be some limitations on the coverage territory, *e.g.*, exclusions for countries subject to U.S. trade sanctions.

of the CGL is to respond to accidents. There is a specific exclusion for **bodily injury** or **property damage** "expected or intended" from the standpoint of the insured.

- C. <u>Other Coverages</u>. The policy Declarations page indicates which coverages are included. That is, a limit will be shown for those coverages that are provided, and the absence of coverage will be indicated by either an entry of "none" or "excluded", or by the absence of any limit inserted in the appropriate space.
- D. <u>Coverage Restrictions Sources</u>. The Exclusions sections are only one of the places where significant limitations on coverage appear. Important restrictions are also found in the Declarations, the Insuring Agreements, the "Who is an Insured" section, the Definitions, Limits and Conditions sections.
- E. <u>Limits</u>. During the mid-1980's, the "Commercial" General Liability Policy was introduced to replace the "Comprehensive" General Liability Policy. Both coverage forms were in use simultaneously for a time, and both were, and still are, referred to as a "CGL".

Prior to the introduction of the new CGL, limits under the CGL policy were provided generally on a "per occurrence" basis. Policy aggregate limits were most often found in the Products–Completed Operations Hazards coverage, and in the Personal Injury Liability and Advertising Injury Liability coverages.

One of the major changes introduced with the 1986 CGL is that for most Insureds the coverage limits will be subject to a policy aggregate. The CGL policy is now generally structured to provide an "Each Occurrence" limit, subject to a total policy limit called the "General Aggregate". As a practical matter, this means that it is very difficult to determine at any given time how much of the other party's CGL limits, if any, remain available to protect your client. Once the General Aggregate has been exhausted, there is no further coverage under the CGL. There might be coverage under the other party's Umbrella (or Excess) Liability Policy, if one is maintained, but it is now very likely that the Umbrella (or Excess) Liability Policy will also be subject to an aggregate policy limit.

It should also be noted that CGL limits are generally provided today with the stated amount of coverage applying to all **bodily injury** and **property damage** arising out of any one occurrence. This is to be distinguished from the "split limits" scheme that provided separate limits for "bodily injury - any one person", "bodily injury - all persons" (or "per occurrence"), and "property damage - per occurrence". A Lease insurance provision calling for split limits therefore invites technical non-compliance. By its terms, the CGL limit applies to the combined liability for both **bodily injury** and **property damage**, and can therefore be exhausted by payment for either or both.

F. <u>Duty to Defend</u>. The CGL is a "duty to defend" policy. That is, the insurer has a duty to undertake or pay for defense, rather than to indemnify the Insured for defense costs previously incurred. The standard ISO CGL provides coverage for defense expense in

addition to the stated limits of liability. The insurer will not, however, be obligated to fund defense once the limits of liability under the policy are exhausted by the payment of judgments or settlements.

In preparing the Indemnification/Hold Harmless provision favoring your client, be cautious not to tangle up the defense language with indemnity language. It should be clear that the other party's obligation is to actively provide a defense for your client.

- G. <u>Control of Defense and Settlement</u>. A requirement that the indemnitor "use counsel satisfactory" to the indemnitee, or providing that the indemnitee has the right to select defense counsel, may violate CGL policy terms, as it is expected that the CGL insurer will have the right to select counsel. Similarly, language that gives the indemnitee the right to control defense and settlement will likely conflict with the CGL insurer's policy rights to control such matters.
- H. <u>Contractual Liability Coverage</u>. There are two principal ways to access another party's CGL: under the CGL Contractual Liability coverage, and as an Additional Insured (or perhaps, Additional Named Insured see discussion below).

Although the standard CGL includes "blanket" Contractual Liability coverage, there is no guarantee that the other party to your transaction does not have a CGL with the coverage excluded, or with coverage restricted to "designated" (i.e., specifically scheduled) contracts. It is therefore suggested that the Lease Insurance provision specifically requires that the other party's required CGL policy includes Contractual Liability coverage applying to the Lease.

The CGL's Contractual Liability coverage is rather broad. The policy initially excludes coverage for liability assumed under contract or agreement, but then excepts liability assumed under an **insured contract** from the exclusion. The definition of **insured contract** includes (among other agreements) a lease of premises, and agreements pertaining to the Named Insured's business under which the Named Insured assumes the tort liability of another party to pay for **bodily injury** or **property damage** to a third party.

There must be a transfer of liability in order to trigger the CGL's Contractual Liability coverage, and this is, of course, usually accomplished through the Indemnification/Hold Harmless provision in the Lease or Mortgage. An indemnitor's assumption of the obligation to provided the indemnitee with a defense should constitute a sufficient assumption of liability to trigger the indemnitor's CGL Contractual Liability Coverage.

Since the introduction of the 1996 edition of the ISO CGL, the important exceptions language of the Contractual Liability Exclusion has conditioned coverage for defense obligations under a contractual indemnification provision upon the insured indemnitor assuming either the indemnitee's defense or the funding of that defense. Moreover, the Supplemental Payments section of the policy, which previously provided that defense expense incurred by the insurer would be provided in addition to the stated policy limits,

was revised to impose a number of problematic conditions upon that response in the case of the defense of an indemnitee. If all of the conditions are not met, the Supplemental Payments section coverage does not apply, and the expense incurred for the defense of the indemnitee will be covered as "damages" under the policy's Contractual Liability Coverage and thereby be included within the stated policy limits. Stated somewhat differently, that expense will be applied to reduce the Each Occurrence and Aggregate limits available to the insured indemnitor. Fortunately, there are commonly-issued CGL endorsements that eliminate the limiting language. That said, there is no assurance that your client or its insurance agent will have secured the endorsement.¹⁹

With respect to accessing the other party's CGL through the Contractual Liability coverage, note:

- 1. The CGL will not respond to liability imposed under the Indemnification/Hold Harmless Clause that is beyond the scope of the policy's coverage. For example, there must be an **occurrence** or a covered "offense" a mere breach of contract, without more, will not trigger the coverage. Also, the standard CGL is not expected to respond to allegations of intentionally caused **bodily injury** or **property damage**, or to allegations of discrimination, wrongful termination, mental distress, shock, or other intentional torts not among the specified "offenses" included in the definition of **personal and advertising injury**. (Cf. There will likely be coverage for mental anguish, etc., arising out of covered **bodily injury**.)
- 2. The other party may have jeopardized the coverage, *e.g.*, by making misrepresentations in the application/underwriting submission.
- 3. The Contractual Liability coverage might not apply to **personal and advertising injury** claims (there is a specific exclusion in the standard ISO CGL).
- 4. A court may decide not to enforce the Indemnification/Hold Harmless clause, *e.g.*, because it is determined to be so overreaching as to be against public policy.
- I. <u>Additional Insured vs. Additional Named Insured Status</u>. The preference is to combine the Indemnification/Hold Harmless clause protection with Additional Insured status under the other party's CGL. The principal virtue of Additional Insured status is that it affords easy and direct access to the other party's CGL. There is no necessity to establish a covered transfer of risk to trigger the policy's Contractual Liability coverage.

Page 19

Where this new CGL Contractual Liability and Supplemental Payments language does apply, the real estate attorney might be faced with a counter-intuitive negotiating dilemma in which the indemnification language proposed to the indemnitor-client does not include an affirmative obligation to defend the indemnitee or to fund the indemnitee's own defense. Without such language the client's CGL might not respond with defense of the indemnitee, leaving the indemnitor's attorney in the position of having to decide whether or not to propose broadening the client's indemnification obligation in order to hopefully trigger the desired coverage for the client. Even if the attorney is familiar with the client's current CGL policy particulars, counsel should consider what might be down the road if the client is involved in a multi-year real estate transaction.

There is also no longer any need under the standard CGL to negotiate a "cross liability clause". The standard CGL provides for "Separation of Insureds" (formerly "Severability of Interests") which, in essence, means that the insurance applies separately (except with respect to limits) to each "Insured", which includes Additional Insureds. In practical terms, this means that your Additional Insured client may be entitled to defense and coverage under circumstances in which the Named Insured's coverage is excluded.

Contract insurance provisions often require that a party be designated an "Additional *Named* Insured" under the other party's CGL. Named Insureds have obligations under the policy that do not apply to Additional Insureds, and there are also exclusions that apply only to Named Insureds. As such, it is suggested that Additional Insured status is preferred.

- J. <u>Care, Custody or Control Exclusion</u>. This is one of the most important provisions in the CGL, particularly with respect to Leases. In pertinent part, it excludes **property damage** to:
 - "(1) Property you own, rent or occupy; ...
 - (4) Personal property in the care, custody or control of the insured."

In other words, there is generally no coverage for liability for **property damage** to leased premises or to leased personal property. (There is an exception for premises rented for 7 or fewer consecutive days, but that exception does not apply to damage by fire.)

The standard CGL can provide a limited exception to this exclusion. A limited amount, usually \$50,000 or \$100,000, of "Damage to Premises Rented to You" coverage is usually included (coverage must be indicated in the Declarations) to respond to legal liability for **property damage** "any one premises, while rented to you, or in the case of damage by fire, while rented to you or temporarily occupied by you with permission of the owner, arising out of any one fire."

In sum, it may be quite difficult to maintain a liability insurance program that responds adequately to the exposure faced by most tenants for property damage to the leased premises. The exposure is more properly addressed through direct property insurance. If the intent of the parties is that each is to rely upon its own property insurance for property damage loss, then it is critical that the property insurance provisions in the Lease be accompanied by a proper Release from Liability/Waiver of Subrogation provision. Otherwise, the intent of the parties to rely upon property insurance for property damage loss could be undermined by the property insurer's subsequent subrogation action.

IV. EVIDENCE OF INSURANCE

Certificates of Insurance are the most common form of evidence of insurance. The great majority of contractual insurance provisions that will be proposed to or by your clients will require that the client and the other contracting party each evidence compliance with their respective contractual insurance obligations by providing Certificates of Insurance to the other party or other person or entity designated as the "Certificate Holder" on the required Certificate of Insurance.

There are, however, exceptions. For example, some "direct writer" property insurance companies²⁰ provide evidence of the coverage they are providing in the form of a summary letter or memorandum. Also, some insurers authorize their agents or brokers to issue evidence of insurance in a similar form. Given these variations in evidence of insurance, it is suggested that it may be appropriate to phrase the evidence of insurance language in the contract to contemplate what can actually be provided from time-to-time; *e.g.*, by adding to your usual Certificate of Insurance requirement: ". . . or other form of evidence of insurance reasonably acceptable to [the other party]."

The "ACORD 25" is the most frequently issued Certificate of Insurance form. Although the ACORD 25 form is titled "Certificate of Liability Insurance," other coverages, such as Crime and Property, can be, and often are, evidenced on the form along with the various liability insurance coverages.

ACCORD 28, Evidence of Commercial Property Insurance, is the customary form for evidencing commercial property insurance.

Certificates of Insurance are generally prepared and then sent to the Certificate Holder by the insured's insurance producer (*i.e.*, the insured's agent or broker, or in the case of a direct writer insurance company, that company's employee producer or "captive" agent). Sometimes direct writer insurance companies that work with outside agents or brokers grant the agent or broker Certificate issuing authority, but the direct writer may well retain that function notwithstanding the outside agent or broker arrangement. The insurance producer's Certificate issuing authority is determined by the terms of its contract with the insurer, and in the case of agent or broker insurance producers those contracts allow varying degrees of authority and latitude when it comes to issuing Certificates and to keeping the insurer informed of what Certificates have been issued and where Certificate content or process has not conformed to standard procedure or form.

Notwithstanding that Certificates of Insurance are relied upon as the customary way to evidence insurance coverage, they have some noteworthy shortcomings in serving that purpose. There are prominent "hedging" statements on the face of the standard ACORD 25 and 28 forms (note that there are slight variations in these statements in ACORD 25 and 28):

(1) "THIS EVIDENCE OF COMMERCIAL PROPERTY INSURANCE IS ISSUED AS A MATTER OF INFORMATION

insurance products offered by other insurers.

[&]quot;Direct writer" insurance companies generally sell their insurance products through employee sales representatives who sell only the insurance products offered by their employer, or through "captive" agents independent contractors who generally sell only one insurance company's products (although some captive agents can also sell insurance products not offered by their direct writer). However, some direct writers can be accessed by agents and brokers, and some direct writers maintain their own broker operations in order to be able to provide

ONLY AND CONFERS NO RIGHTS UPON THE ADDITIONAL INTEREST **NAMED** BELOW. **THIS** EVIDENCE DOES NOT AFFIRMATIVELY OR NEGATIVELY AMEND, EXTEND OR ALTER THE COVERAGE AFFORDED BY THE POLICIES BELOW. THIS EVIDENCE OF INSURANCE DOES NOT CONSTITUTE A CONTRACT BETWEEN THE ISSUING INSURER(S), AUTHORIZED REPRESENTATIVE PRODUCER, AND OR THE ADDITIONAL INTEREST."

(2) "SHOULD ANY OF THE ABOVE DESCRIBED POLICIES BE CANCELLED BEFORE THE EXPIRATION DATE THEREOF, NOTICE WILL BE DELIVERED IN ACCORDANCE WITH THE POLICY PROVISIONS."

Lenders and others with an insurable interest in property required to be insured by others often require the mortgagor or other party whose interest is subject to their interest to provide evidence of required insurance on an ACORD 28 "Evidence of Property Insurance" Certificate form. The form includes a "check the box" format by which the nature of the Certificate Holder's interest can be readily identified as Mortgagee, Lender's Loss Payable, or other (with a blank for the description to be provided).

V. GENERAL INSURANCE-RELATED COMMENTS ON REAL ESTATE DOCUMENTS

A. Be Specific.

Be thorough and specific in documenting insurance requirements.

B. Property Insurance vs. Liability Insurance.

Recognize the difficulties in maintaining a **liability** insurance program that adequately addresses significant exposures for **property damage**. Structure the document to require appropriate **direct property damage coverage** to address property damage exposures. Include appropriate Release/Waiver of Subrogation language.

- C. <u>Control and Monitoring of Coverage</u>.
 - 1. Whenever it is important to your client that there be an adequate insurance recovery, put your client in a position to control the quality of the insurance coverage. Either (1) establish specific property insurance requirements for the other party (and secure the right to effectively monitor compliance with same), or (2) give your client the right to provide the coverage.
 - 2. A Certificate of Insurance is usually used as evidence that the required coverage is in effect. The Certificate should be prepared to show that all

of the specific requirements of the document are met. Documents often require that Certificates of Insurance evidencing the renewal or replacement of required coverage be provided within a stated number of days prior to the expiration of the Policy Period. In many instances, this is just not practical, and it appears that the requirement is therefore often ignored.

Certificates of Insurance have limited value, principally for two reasons. First, the standard "Acord" Certificate of Insurance form states, "(t)his Certificate is issued as a matter of information only and confers no rights upon the Certificate Holder." Certificate of Insurance forms specifically intended to create a contractual obligation have been developed, but it may be difficult to get these issued. Second, Certificates of Insurance are often issued by brokers or agents. The problem here is that the Certificate Holder is not in a very good position to determine whether or not the agent or broker has the contractual authorization of the insurance company to issue Certificates. This is less likely to be a problem in states, like Minnesota, where there are only insurance "agents," rather than "brokers." It may, however, be an issue if you represent a client with operations in other jurisdictions. In all events, the objective is to rely upon the assets of the other party's insurance company, rather than upon the Errors & Omissions coverage of its insurance broker.

If you are serious about monitoring the insurance of the other contracting party, then you should at least preserve your client's right to obtain insurer-certified copies of the actual insurance policies. This is the only truly effective way to make certain that your client has the ability to determine whether there is full compliance with the insurance requirements of the pertinent document.

3. Require that your client be given at least 60 days written notice prior to the effective date of insurer cancellation of the other party's coverage. Most states now have regulations that require a reasonable number of days' notice prior to either insurer cancellation or non-renewal. Most of these regulations also provide, however, that a lesser notice period (usually 10 days) is required in the case of cancellation for non-payment of premium. Where adequate notice of insurer cancellation or intent to non-renew is a significant consideration, it is best to not rely solely upon the statement in the Certificate of Insurance that the Certificate Holder will be given a stated number of days' prior notice. It is suggested that, in such instances, it be required that the other party's **policy** be specifically endorsed to incorporate the notice requirement to your client.

Documents sometimes require, in addition to notice of Insurer cancellation, notice of Insurer intent to non-renew, and perhaps further, notice of any "material change" in coverage. Because there is no standard endorsement to provide for these notices, these latter requirements, particularly the one for notice of material change in coverage, are often ignored. Again, it is suggested that your client will be in a stronger

- position if an actual policy endorsement incorporating such notice requirements is issued.
- 4. Because of the difficulty of monitoring the continuation of "claims-made" liability coverage, require "occurrence" coverage wherever possible.

D. Insurance Limits.

- 1. With respect to property insurance, it is rarely practical to specify a specific dollar amount for limits. Generally, the best one can do is require the coverage to be in an amount equal to replacement cost (or if Actual Cash Value coverage is used, market value). Consider whether the document should require periodic review of the amount of coverage, typically through an insurance appraisal.
- 2. With respect to liability insurance, policy limits should either be specified, or else your client should have approval of the amount. It may be appropriate to provide a mechanism for future increase in limits. You should specify whether the stated limits are on the old "per person/per occurrence/property damage" Split Limits basis or on the now more customary Combined Single Limit basis.

As indicated in Parts II and III above, there are a number of situations in which sublimits apply. Sublimits are almost never addressed in real estate documents, but this does not mean they shouldn't be, at least in special circumstances where they are particularly important.

Another limit issue which presents very thorny problems in real estate documents is aggregate limits. The existence of aggregate limits means that a situation can occur where all of the insurance requirements of a document have been complied with, yet there is no coverage because the aggregate limit was exhausted elsewhere. Unfortunately, there is no complete resolution to this problem. If the amount of coverage required is likely to call for an Umbrella or Excess policy, avoid language that requires the full limits to be provided by a CGL. Clarify that the Umbrella or Excess policy is to afford coverage that is (perhaps, "in all material respects") at least as broad as that required in the primary coverage. If appropriate, establish alternative (lesser) limits requirements if coverage is provided on a "per occurrence basis," without aggregate limits. Include a covenant that the aggregate limit remaining available never falls below the required occurrence limit. Recognize that even if you do all of the above, the aggregate limit can be exhausted without your knowledge due to reasons beyond your control.

E. <u>Additional Insured; Loss Payee</u>.

- 1. Where appropriate, require that the client be included as an Additional Insured under the other party's liability policies.
- 2. Generally, your client will not want to add the other party as a Loss Payee on its property insurance, because the other party will be a co-payee on any claim payment. It is generally where the other party has an interest in

the insured asset (e.g., in the case of leasehold improvements in which it has a reversionary interest, a landlord) that Loss Payee status is important in a property insurance context. However, absent Loss Payee status it is vital to have an adequate waiver of claims and subrogation clause.

- 3. A mortgagee wants to be added to property insurance as a "Mortgage Holder" (or comparable terminology used in the pertinent policy) which gives the mortgagee the rights of a Loss Payee, plus protection against defenses of the Insurer against the Named Insured, and the right to notice of cancellation.
- 4. Some Umbrella policies automatically include as Additional Insureds all Additional Insureds under the primary liability policy. Some also include automatically as Additional Insureds all parties that the Named Insured has agreed under contract to add. Some Umbrellas do not have any provision for automatically adding Additional Insureds. It is therefore suggested that the document specifically address the issue.

F. Financial Strength of Insurer.

Some documents require that the CGL insurer be licensed to do business in the pertinent state. There could be any number of good reasons that the other party may be doing business with an insurance company that is not licensed in the pertinent state. As a practical matter, this "licensed to do business in [state]" requirement will likely be ignored where the insurer is otherwise acceptable.

Some provisions are drafted to require that the insurer have, at minimum, a specified Best's Rating. (The A.M. Best Company "Key Rating Guide" is widely accepted as a reliable reference for such purposes.) A recommended acceptable Best's Rating is from B+VII on the low side to A+XV on the high side. Although there may be understandable reasons for doing business with a "B-rated" insurer, it is wise to keep in mind that there have been a number of property/casualty insurer insolvencies over the past few years. It is noteworthy that many insurance agents will ask for a written disclaimer from Insureds that select a B-rated insurer when coverage is available from an A-rated insurer.

VI. <u>INSURANCE REQUIREMENTS IN SPECIFIC REAL ESTATE</u> <u>DOCUMENTS</u>

A. Leases.

- 1. See Attachment A for sample liability insurance clause. See Attachment B for sample property insurance clause.
- 2. Property Insurance.
 - a. It is nearly universal for the Landlord of a multi-tenant building to carry property insurance on the building. Sometimes in a single tenant building Tenant will carry the property insurance on the

Building. If so, Landlord must insist upon being named as Loss Payee and needs to be very attentive to the quality of Tenant's insurance and to the monitoring of coverage concerns discussed above.

It is nearly universal for Tenant to carry insurance on Tenant's fixtures and personal property. The responsibility for carrying insurance on leasehold improvements varies, and is often vague. It may be best for Landlord to insure all leasehold improvements. Landlord often gets a better premium rate, Landlord then has no need to monitor Tenant's coverage, and coverage disputes between insurers are avoided. It should, however, be noted that Tenant may also be insuring the leasehold improvements, particularly where Tenant has paid for the improvements, or where the Lease provides circumstances under which Tenant is responsible for repair or replacement of damaged improvements.

- b. In general, each party will want to avoid naming the other party as a Loss Payee. However, if Tenant insures any portion of the leasehold improvements, Landlord will want to be a Loss Payee under Tenant's policy.
- Landlord will generally have rent loss coverage even if the Lease does not so state. If Tenant is not entitled to rent abatement, Landlord may require Tenant to carry Business Interruption and Extra Expense insurance.
- d. Landlord will probably require Tenant to insure its personal property on the leased premises, primarily because such insurance, together with the customary Waiver of Claims/Waiver of Subrogation clause, protects Landlord against liability for damage to Tenant's personal property. Landlord should consider requiring Valuable Papers and EDP coverage where these exposures are significant.
- e. Tenant may want a right to self-insure, especially if Tenant is responsible only for personal property. Landlord will want to be satisfied with Tenant's credit before agreeing to let Tenant self-insure.

3. Liability Insurance.

- a. It is generally customary for Tenant to carry liability insurance for the leased premises. Landlord will have liability insurance for the entire project, but the lease form rarely requires Landlord to do so.
- b. Landlord will insist upon being an Additional Insured on Tenant's liability insurance. Tenant would benefit from being an Additional Insured under Landlord's liability insurance, but Landlord will resist for several reasons: (i) a special endorsement to Tenant's policy will be required to be sure Tenant's insurance has primary

coverage for the leased premises, (ii) for a Landlord with lots of tenants it is a major administrative headache, and (iii) it may increase Landlord's premium.

B. <u>Mortgages and Contracts for Deed.</u>

1. See Attachment A for sample liability insurance provision. See Attachment B for sample property insurance clause.

2. Property insurance.

- a. Mortgagee or Contract for Deed Vendor (either being hereafter "Mortgagee") will require Mortgagor to carry a thorough program of property insurance, generally including Boiler and Machinery and flood insurance. Will we see earthquake insurance more commonly required? Mortgagee is highly (and in a non-recourse situation, totally) dependent upon Mortgagor's property insurance to protect Mortgagee's collateral in the event of a casualty.
- b. Mortgagee will insist upon being a "Mortgage Holder" or its equivalent
- c. Mortgagee will not want the property insurance to contain any coinsurance risk, which can be accomplished through either deletion of the coinsurance clause or through an "Agreed Amount" endorsement.
- d. Mortgagee will generally want the property insurance limit to be at least the mortgage balance.
- e. Mortgagee may require Business Interruption insurance.
- f. Mortgagee should try to preclude exposure under the "Ordinance or Law" clause.
- g. Many mortgagees have a kind of property insurance that furnishes backstop protection if their mortgagors fail to insure, but this never plays any role in the negotiation of the insurance requirements of the mortgage.

3. Liability Insurance.

Mortgagee will require the Mortgagor to carry liability insurance on the mortgaged property naming Mortgagee as Additional Insured.

C. Purchase Agreements.

- 1. Insurance is often not required.
- 2. Buyer sometimes requires Seller to carry liability insurance, to provide some comfort that there is coverage for claims accruing at about the time of closing.
- 3. The risk of loss provision generally provides that if there is a loss and Buyer does not terminate the Purchase Agreement, Seller will assign property insurance proceeds to Buyer.

VII. WAIVER AND INDEMNITY CLAUSES

A. <u>General Principles</u>: Waiver and Indemnity clauses are devices for shifting risks between the parties. (Absent such clauses, tort law will allocate the risks.) Risks to be shifted may have different insurance coverage consequences to the respective parties: one party may be insurable and the other uninsurable, one party may be coverable by property insurance and the other by liability insurance.

Obviously, it makes sense to have a risk borne by an insurable party.

It also generally makes sense for a risk to be borne by the party with property insurance rather than liability insurance: (i) property coverage limits relate directly to the value of the property in question, whereas liability limits do not, (ii) there are generally no problems with aggregate limits in property policies, (iii) collecting on property insurance is simpler than collecting on liability insurance, (iv) liability premiums tend to reflect loss history, through retrospective rating adjustments or other mechanisms. The counter-arguments are: (i) sometimes a risk is covered by liability insurance at no additional premium, but to add property insurance coverage would require additional premium, and (ii) many parties bear a significant portion of their property insurance cost through deductibles, co-insurance and self-insurance.

Some lawyers believe all risks should be borne by the negligent party, but this frequently does not result in concordance between risk allocation and insurance coverage.

B. Waiver of Subrogation/Claims

- 1. Why is waiver of subrogation/claims desirable? Because otherwise the insurer for one party (e.g., Landlord) upon paying a claim to its insured is subrogated to the rights of its insured, and may assert a tort or contract claim against the other party (in our example, Tenant). There are at least 3 reasons why this is undesirable:
 - a. In a net lease situation, Tenant has typically paid part or all of the premium for the insurance policy under which Tenant is now being sued.
 - b. The "care, custody and control" exclusion in Tenant's liability policy may leave Tenant uninsured or substantially underinsured. It is either difficult and expensive or impossible for Tenant to obtain alternative insurance protection to cover Tenant.
 - c. Landlord derives little or no benefit from its insurer's subrogation claim.
- 2. There are 2 alternative ways to achieve the desired result:
 - a. Each party can obtain a waiver of the **right of subrogation** from its insurer. The disadvantages of this approach are:

- (1) the deal is held up waiting for receipt of these waivers from the insurers, and
- (2) such waivers must be obtained on an ongoing basis as the parties change insurers or policies.
- b. The parties can waive their respective **claims** against each other to the extent [select the appropriate scope of waiver from the alternatives below]:
 - (1) the loss is reimbursed by insurance proceeds
 - (2) the loss is covered in whole or in part by insurance carried
 - (3) the loss would have been covered by the insurance required by the documents
 - (4) the loss is coverable by [specify coverages] property insurance.

Where the party has waived its claim, the insurer has no claim to which to subrogate. The advantage is that the problem is solved without the need for involvement of the insurers.

- 3. Under virtually all modern general scope property policies (but **not** under certain specialized type policies which are unlikely to be pertinent to real estate transactions) such a claim can be waived without impairing coverage.
- C. Waiver of Claims to the Other Party's Personal Property

There is an insurance basis for one party (<u>e.g.</u>, Landlord) to require the other party (Tenant) to waive any claims for damage to Tenant's personal property, however caused. The argument is:

- 1. Liability coverage for property of others is complex. Cash, securities, valuable papers and records of others are not covered under a standard CGL policy.
- 2. The owner of property is in the best position to insure its property it knows the kind and value of the property.

The counterargument, particularly for a Tenant which self-insures a significant portion of its property risks, is that Tenant will then have to pay for Landlord's mistakes.

D. <u>Indemnity for Own Negligence</u>

"Agreements seeking to indemnify a party for losses resulting from that party's own negligent acts are not favored in the law and are not construed in favor of indemnification, unless such intention is expressed in clear and unequivocal terms. <u>Johnson v. McGough Construction Co., Inc.</u>, 295 N.W.2d 286, 288 (Minn. 1980). However, a specific reference to "negligence" is not required if the provision as a whole states the indemnitor's intent to be liable for the

indemnitee's negligence. <u>Id.</u>" <u>Oster</u> v. <u>Medtronic, Inc.</u>, 428 N.W.2d 116 (Minn. App. 1988).

In some circumstances, the indemnitee definitely wants the indemnity provision to encompass negligence of the indemnitee.

One example is Landlord's potential liability for losses to the person or property of third parties on Tenant's premises. Tenant cannot waive the rights of others, and consequently an indemnity is the only way for Tenant to protect Landlord. If the indemnity clause does not encompass Landlord's negligence, it accomplishes nothing. If Landlord was not negligent, there is generally no cause of action the third party can assert. If Landlord was negligent, but the indemnity provision does not satisfy the test quoted above, Landlord is unprotected. The average indemnity provision in Landlord's lease form, broad and onerous as it may appear, accomplishes precious little because it does not satisfy the standard of the cases cited above.

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ATTACHMENT A

SAMPLE LIABILITY INSURANCE PROVISIONS – LONG FORM

- (a) Party A shall maintain in effect at all times during the term of the [Document] a "Commercial General Liability Insurance" policy (Insurance Services Office form title), providing coverage on an "occurrence," rather than on a "claims made" basis, which policy shall include, but not be limited to, coverage for Bodily Injury, Property Damage, Personal Injury, Contractual Liability (applying to this [Document]), Independent Contractors, and Products-Completed Operations liability, or an equivalent form (or forms), so long as such equivalent form (or forms) affords coverage which is at least as broad. An Insurance Services Office "Comprehensive General Liability" policy which includes a Broad Form Endorsement GL 0404 (Insurance Services Office designation) shall be considered to be an acceptable equivalent policy form. Such policy shall name Party B as an Additional Insured thereunder.
- (b) Party A agrees to maintain at all times during the term of this [Document] a total combined liability policy limit of at least \$________, applying to liability for Bodily Injury, Personal Injury, and Property Damage, which total limit may be satisfied by the limit afforded under its Commercial General Liability Policy, or equivalent policy, or by such Policy in combination with the limits afforded by an Umbrella or Excess Liability Policy (or policies); provided, that the coverage afforded under any such Umbrella or Excess Liability Policy is at least as broad as that afforded by the underlying Commercial General Liability Policy (or equivalent underlying policy), and further, that Party B is included as an Additional Insured thereunder.

Such Comprehensive General Liability Policy and Umbrella or Excess Liability Policy (or policies) may provide aggregate limits for some or all of the coverages afforded thereunder, so long as such aggregate limits have not, as of the beginning of the term or at any time during the term, been reduced to less than the total required limits stated above, and further, that the Umbrella or Excess Liability Policy provides coverage from the point that such aggregate limits in the underlying Comprehensive General Liability Policy become reduced or exhausted. An Umbrella or Excess Liability Policy which "drops down" to respond immediately over reduced underlying limits, or in place of exhausted underlying limits, but subject to a deductible or "retention" amount, shall be acceptable in this regard so long as such deductible or retention amount does not cause Party A's total deductible or retention for each occurrence to exceed the amount shown in the provision immediately below.

Party A's liability insurance coverage may be subject to a deductible, "retention" or "participation" (or other similar provision) requiring the Party A to remain responsible for a stated amount or percentage of each covered loss; provided, however, that such deductible, retention or participation amount shall not exceed \$ ______ each occurrence.

- (c) At least 10 days prior to the beginning of the term, Party A shall provide Party B with evidence that the insurance coverage required under this paragraph will be in full force and effect at the beginning of the term. At least 10 days prior to termination of any such coverage, Party A shall provide Party B with evidence that such coverage will be renewed or replaced upon termination with insurance that complies with these provisions. Such evidence of insurance shall be in the form of a standard Certificate of Insurance, or in such other form as Party B may reasonably request, and shall contain sufficient information to allow Party B to determine whether there is compliance with these provisions. At the request of Party B, Party A shall, in addition to providing such evidence of insurance promptly furnish Party B with a complete (and if so requested, Insurer-certified) copy of each insurance policy intended to provide coverage required hereunder. All such policies shall be endorsed to require that the Insurer provide at least 60 day notice to Party B prior to the effective date of policy cancellation, nonrenewal, or material adverse change in coverage terms.
- (d) All policies of insurance required under this paragraph shall be issued by financially responsible insurers with a current A.M. Best Company rating of at least [A:VII].
- (e) At the request of Party B, Party A shall promptly furnish loss information concerning all liability claims brought against Party A (or any other Insured under Party A's required policies), that may affect the amount of liability insurance available for the benefit and protection of Party B under this provision. Such loss information shall include such specifics and be in such form as Party B may reasonably require.

ATTACHMENT B

SAMPLE PROPERTY INSURANCE PROVISIONS – LONG FORM

- (a) <u>Risks to be Insured</u>. Party A, at its sole cost and expense, will maintain the following insurance:
 - (i) Insurance on [specified property] against loss by fire and other hazards covered by the so-called "all-risk" form of policy, in an amount equal to the actual replacement cost thereof (exclusive of foundations and excavations) without deduction for physical depreciation[, which insurance shall in no event be less than the unpaid principal balance of the Note at any given time.] While any building or other improvement is in the course of being constructed or rebuilt on the Land, such insurance shall be in builder's risk completed value form, including coverage available on the so-called "all-risk" non-reporting form of policy, for an amount equal to 100 of the insurable replacement value of such building or other improvement. Such insurance shall include Flood and Earthquake coverage; "Contingent Liability from Operation of Building Laws," demolition and increased cost to rebuild coverages; Valuable Papers and Records coverage, providing for Reproduction Cost measure of recovery; and coverage for damage to Electronic Data Processing Equipment and Media, including coverage for the perils of mechanical breakdown, electronic disturbance and atmosphere and temperature conditions.
 - (ii) If the Property includes steam boilers or other equipment excluded from coverage pursuant to a Boiler and Machinery exclusion, Boiler and Machinery insurance in an amount reasonably satisfactory to Party B.
 - (iii) If the Land or any part thereof is located in a designated official flood-hazardous area, flood insurance insuring the buildings and improvements now existing or hereafter erected on the Land in an amount equal to [the lesser of the principal balance of the Note or] the maximum limit of coverage made available with respect to such buildings and improvements under the Federal Floor Disaster Protection Act of 1973, as amended, and the regulations issued thereunder.
 - [(iv) Insurance against interruption of business in respect of the property in an amount sufficient to pay one (1) year's debt service on the Note, including principal and interest thereof and tax and assessment payments.]
- (b) <u>Policy Provisions</u>. All insurance policies and renewals thereof required herein shall:
 - (i) be written by an insurance carrier satisfactory to Party B, who shall maintain a "Best Rating" of at least [A:VII].;
 - (ii) contain a [Loss Payee/standard mortgage clause] in favor of and in form acceptable to Party B;

- (iii) contain an agreement of the insurer that it will not cancel or modify the policy except after 30 days' prior written notice to Party B;
- (iv) have an "agreed amount" endorsement or otherwise exclude co-insurance participation by the insured; and
- (v) be reasonably satisfactory to Party B in all other respects.
- (c) <u>Delivery of Policy</u>. Party A will deliver to Party B copies of policies satisfactory to Party B evidencing the insurance which is required herein, and Party A shall promptly furnish to Party B copies of all renewal notices and all receipts of paid premiums received by it. At least 30 days prior to the expiration date of a required policy, Party A shall delivery to Party B a copy of a renewal policy in form satisfactory to Party B. Party B may from time to time, but not more often than every 3 years, require an insurance appraisal, reasonably satisfactory to Party B, confirming the replacement cost of the insured property. If Party A has a blanket insurance policy in force providing coverage for several properties of Party A, including the Property, Party B will accept a certificate of such insurance together with a copy of such blanket insurance policy; provided the certificate sets forth the amounts of insurance and coverage, and such amounts are at least equal to the amounts required hereinabove, and otherwise complies with the requirements hereof.