

# Insurance And The Commercial Lease

---

Raymond S. Iwamoto

Raymond S. Iwamoto

is a member of the firm of Schlack Ito Lockwood Piper & Elkind, in Honolulu.

---

Policies change. Procedures change. Leases change. At the very least, the lessor and lessee should coordinate their insurance coverages.

---

**FOR LESSORS, LESSEES, AND THEIR ATTORNEYS,** reading an insurance policy can be a lot like reading the U.S. Internal Revenue Code. Much of the language is arcane and difficult to understand. There are a lot of nuances and court interpretations, not all of which are consistent. Yet the risks intended to be covered by insurance are often significant risks with serious consequences if something goes wrong.

Consequently insurance in the context of leased property is a very important thing to have, for both the lessor and the lessee. This stems from the nature of leases: first, a lease conveys real estate; and second, a lease is a contract. As a contract, the lease describes the various agreements between the lessor and lessee. One of the most crucial agreements that the lessor and lessee make addresses two basic types of risks inherent in leased real property: the risk of loss due to fire or other property damage, and the risk of liability for damage to property, personal injury, or death. In connection with property damage and loss, generally for the lessor, there are two risks: damage to lessor's building resulting in a cancellation of the lease, and a disruption in lessor's rental income from the property. For the lessee, the risk is having to repair the damage, the loss of use, and the possible obligation to continue to pay rent despite the damage and loss of use. Leases deal with these two risks through provisions for insurance, indemnity, waivers, subordinations, and releases.

Lawyers sometimes address or attempt to allocate these risks based on their notions of who was at fault or sometimes how serious was the fault; for example, was it simple negligence or gross negligence? Many of their clients, on the other hand, may be less interested in punishing the party that is at fault than they are interested in just having the problem taken care of through insurance protection. As a result, the lessor and the lessee might have differing ideas on what sort of insurance is appropriate, and who should be responsible for getting it. Businesses do

not purchase insurance on a project by project basis and leases should not require drastic changes to the tenant's insurance program.

Generally, if the lessee is leasing the entire building, the lessee will assume the responsibility for maintenance and repair of the building. In this case, it is appropriate for the lessee to agree to procure and maintain the property insurance. If the lessee is leasing only a portion of the building, then it is appropriate for the lessor to procure and maintain the property insurance for the building, with the lessee buying property insurance for its own property within the premises. Whatever the situation, the parties and their lawyers need to coordinate their efforts so that there are no inconsistent provisions in the lease.

This article presents only the basics, and there are exceptions and carve-outs that are beyond the scope of this article. Terrorism insurance is not mentioned. The specimen lease provisions included are provided solely to assist in discussing these concepts. (*See Using Insurance in Commercial Leases*, which appeared in the May 1994 issue of *The Practical Real Estate Lawyer* for a discussion of lease provisions such as indemnification, exoneration, concepts of negligence and fault and how the use of insurance interplays with these concepts.) In any event, when considering the question of insurance for leased property, it is a good idea to consult both with an insurance professional in determining what coverages are available and with experienced legal counsel in crafting lease provisions tailored to each situation.

**COVERAGE BASICS** • In commercial leases, the property insurance is generally referred to as "Commercial Property Insurance." These policies basically cover physical damage and destruction to buildings and the contents of buildings. By endorsement, coverage for loss of rental income, business interruption, and extra expense in connection with the physical damage can be added.

### **Named Perils And All Risks Insurance**

There are basically two types of commercial property insurance. First, there are those that cover only the perils that are listed and those that cover all perils except those that are listed as being excluded. The first are called "named perils" coverage and the second are called "all risk" coverage. Note that "all perils" or "all risk" exclude certain listed risks. Most policies are written on the Insurance Services Office, Inc. forms. These are called "ISO" forms. Even when ISO forms are not used, the lease should be drafted to require certain agreed levels of coverage, using the ISO policy forms as the standard for the coverage. For example, the lease could require coverage that was at least as broad as the coverage under the ISO broad causes of loss form. Especially for long-term leases, because terminology and insurance products change, it would be prudent for the lease clause to say, "or its equivalent." In other words,

the provision would read, "the ISO broad causes of loss form or its equivalent."

### **Basic ISO Forms**

The following are the three ISO Commercial Property Insurance forms:

- Basic causes of loss form (CP 10 10);
- Broad causes of loss form (CP 10 20); and
- Special causes of loss form (CP 10 30).

In older leases (and possibly in modern leases as well), there may be references to "fire and extended coverage." This was the terminology used in the old ISO forms, which are no longer used and are outdated. "Extended coverage" is now covered by the basic causes of loss form. In most leases today, either the broad or the special coverage is required.

Outdated terminology:

*At all times during the term, landlord will carry and maintain: Fire and extended coverage insurance covering the project, its equipment and common area furnishings, and leasehold improvements in the premises to the extent of the tenant finish allowance (as that term is defined in the workletter).*

Current terminology:

*At all times during the term, landlord will carry and maintain commercial property insurance covering the building, fixtures, equipment, tenant improvements and betterments which shall, at minimum, cover the perils insured under the ISO broad causes of loss form (CP 10 20) [ISO special causes of loss form (CP 10 30)].*

### **Exclusions**

What perils are not covered? As noted above, the Basic and Broad forms cover only the perils that are listed. If a peril is not listed, it is not covered by these forms and there will be no insurance coverage if the loss is a result of the perils not listed. The "Causes of Loss-Special Form" is the broadest standard property coverage available. The Special form covers all perils except those that are excluded. There will be insurance coverage so long as the loss is not caused by one of the excluded perils. There is a long list of exclusions. A few notable exclusions are coverage for flood and earthquake and for changes in laws and ordinances and debris removal. These can be covered by extension endorsements. Coverage for flood and earthquake perils should be negotiable based on location, nature of the property, and especially the cost of coverage.

To require coverage for some of the excluded items, leases sometimes provide:

*Landlord shall maintain Property Insurance upon all buildings, building improvements, and personal property owned by Landlord with coverage for perils as set forth under the Causes of Loss-Special Form, with coverage extended for the perils of flood and earthquake, in an amount equal to full insurable replacement cost. Such insurance shall contain an agreed valuation provision in lieu of any co-insurance clause, an ordinance and law endorsement, debris removal coverage, and a waiver of subrogation endorsement in favor of Tenant.*

*Tenant shall maintain Property Insurance upon all tenant improvements and personal property owned*

*by Tenant with coverage for perils as set forth under the Causes of Loss-Special Form, with coverage extended for the perils of flood and earthquake, in an amount equal to full insurable replacement cost. Such insurance shall contain an agreed valuation provision in lieu of any co-insurance clause, an ordinance and law endorsement, debris removal coverage, and a waiver of subrogation endorsement in favor of Landlord.*

See the discussion concerning the waiver of subrogation later in this article.

### **Tenant Improvements And Betterments**

The ISO Policy includes coverage for improvements and betterments made by a tenant ("TIB") insured under the policy to a building or structure occupied by that insured but not owned by that insured. Under the ISO Policy, improvements and betterments are "fixtures, alterations, installations or additions" that are made a part of the non-owned building or structure occupied by the insured, and which were acquired or made at the insured's expense, but which cannot be legally removed. Note that, in addition, the tenant will normally obtain insurance for its personal property.

Customarily in multitenant buildings, landlords insure the building while the tenants insure their TIB. Recently landlords have begun to insure not only the building but also all of the TIB with the Tenant insuring only its personal property and FF&E. The cost of insuring all of the TIB is often less than the combined cost of each tenant insuring its own TIB. However certain large retail chains may command better rates. In leases where the Landlord insures the TIB, the Landlord and not the tenant will usually have the obligation to repair or restore the TIB. Landlords recognize that there are benefits of having a single contractor, a single insurance company and a single deductible in these circumstances. Usually leases will provide that under certain circumstances, the Tenant is released from the lease and from the obligation to restore by turning over the insurance proceeds to the Landlord. In these situations the Landlord will find that the Tenant's TIB policy converts from a replacement cost policy to a "loss of use value" policy which is considerably less. If the Landlord insures the TIB and restores the TIB, this problem could be avoided.

### **Amount Of Coverage**

Once it is determined that the loss is due to a cause that is covered by the policy, then the next question is how much insurance proceeds will be payable by the insurer. In all events, the maximum the insured will pay is the amount of the loss in excess of the deductible, up to the Insurance Limit set forth in the policy. For ease of discussion, the deductible is not mentioned in some of the discussion below. Assuming that the cause of loss is covered by the policy, we need to determine whether Actual Cash Value or Replacement Cost Coverage was selected.