INSURANCE FOR
COMMERCIAL BUILDING TENANTS

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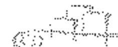

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TABLE OF CONTENTS

INTRODUCTION	1
SOME FUNDAMENTAL FACTS	**2**
Net Lease Concept	2
Landlord's Ownership of Leasehold Improvements	2
Common Elements Within and Enclosing the Premises	2
Tenant Has No Interest in Landlord's Policies	3
Landlord Expects Tenant to Indemnify It From Claims	3
Tenant Must Have Source of Funds for Tenant's Repair and Indemnity Obligations	3
Risk of Loss Due to Business Disruption Caused by Perils Must be Covered	3
PROPERTY INSURANCE COVERAGE	**5**
The Property That Must Be Insured	5
The Interests of the Landlord and the Landlord's Mortgagee(s)	5
Named Insureds vs. Additional Insureds	6
Distinguish Between Trade Fixtures and Leasehold Improvements	9
Section 6 of the Mortgages Act	9
BUILDER'S RISK INSURANCE	**11**
Construction Activities	11
Construction Activities Require Special Insurance	11
Delayed Opening Endorsement	11
Occupancy Endorsement	12
FIRE AND EXTENDED PERILS OR ALL RISKS	**13**
Fire and Extended Perils Coverage Insurance	13
All Risks Insurance	13
BOILER AND MACHINERY INSURANCE	**14**
NINE ESSENTIAL SPECIAL FEATURES OF PROPERTY INSURANCE	**15**
1. Replacement Cost	15
2. By-Law Exposure	15
3. Co-Insurance Clause Endorsements	15
4. Primary Coverage When There is Other Insurance Available	17
5. Breach of Conditions Clause	17

6. Mortgage Clauses 18
7. Joint Loss Agreement 18
8. Non Cancellation or Waiver Clause 18
9. The Waiver of Subrogation Clause 18

BUSINESS INTERRUPTION INSURANCE **21**

The Due Diligence and Dispatch Requirement 21
Relationship to Property Insurance 21
Damage to other Persons' Property - Egress Extension 22
Types of Business Interruption Insurance 22

LIABILITY INSURANCE FOR TENANTS **24**

General Liability Policies 24
Specialized Liability Policies 24
Automobile Liability Insurance 25
How Much Liability Insurance is Enough? 25

NECESSARY ENDORSEMENTS OR INCLUSIONS FOR TENANTS' **26**

COMPREHENSIVE OR COMMERCIAL GENERAL LIABILITY POLICIES **26**

Contractual Liability 26
Automobile Liability 26
Non-owned Automobile Liability Insurance 27
Employer's Liability 27
Property Occupied by or in the Care, Custody and Control of the Insured 27
Personal Injury Coverage 28
Occurrence Basis Property Damage 28
Owners and Contractors Protective Liability 28
Product Liability 29
Pollution Liability 29

PROTECTING THE LANDLORD UNDER THE TENANT'S LIABILITY POLICY **30**

Primary Coverage 30
Cross Liability Endorsement 30
Severability of Interests 31

CONCLUSION AND CAUTIONARY NOTE **32**

INTRODUCTION

Nothing that you learn in law school or in business school prepares you adequately for dealing with risk management and insurance issues in leases. It seems at first to be an overwhelming complex, and confusing mass of jargon and unfamiliar concepts. Fortunately, however, when the basic concepts are sorted out, insurance is all very logical and a lawyer or business person can easily learn the basics. These basics are essential if you want to work effectively with the insurance representatives who perform the critical function of ensuring that insurance coverage for each business that operates within a shopping centre is appropriate to the risks to which shopping centre tenants are exposed.

This paper should be useful to people who want to figure out what the technical insurance language in standard form leases means and what the insurance provisions are trying to accomplish. There are variations in the standard form insurance provisions but the pattern of insurance concepts identified in this paper does tend to recur in most standard forms. (This is attributable at least in part to the fact that lenders that provide financing for shopping centres will impose requirements in their loan documents for the insurance and risk management provisions of the standard leases which creates a degree of consistency).

SOME FUNDAMENTAL FACTS

The best starting point is to take note of certain fundamental facts that influence the way in which insurance provisions in standard lease forms are drafted. These facts are as follows:

Net Lease Concept

Since normally the lease is a net lease, the tenant is responsible for constructing and installing all of the improvements and equipment for the leased premises. What the landlord normally provides is, in the case of a shopping centre location, a basic shell with concrete floors, no ceiling, no storefront, bare walls, and no heating, ventilating and air-conditioning distribution, nor electrical or sprinkler distribution systems In the case of an office building, the landlord provides, usually, the leased premises in base building condition with no floor coverings, interior partitions walls or finishes, and with standard heating, ventilation and air conditioning distribution, and standard electrical and sprinkler distribution systems, and a standard ceiling and lighting grid. The tenant provides and installs at its expense, all of the required partitioning, finishing and other improvements. In situations where the tenant leases space that has been previously occupied, it will normally accept the premises on an "as is" basis and will be responsible for all the cost of modifications.

Landlord's Ownership of Leasehold Improvements

Although the tenant is fully responsible for the cost of improvements and is responsible for repairing and replacing them, it is the landlord, and not the tenant that owns the improvements, except for trade fixtures. Trade fixtures are things which a tenant installs to enable it to carry on business; which are capable of being removed without causing any material or irreparable damage to the premises; and which can be removed without being entirely demolished or losing their essential character or value.

Common Elements Within and Enclosing the Premises

There will be included within the boundaries of the leased premises parts of the shopping centre which are considered as common elements. These would include structural columns, exterior wall assemblies, pipes, conduits and wires that serve other parts of the shopping centre. If any of

these common elements, or if the structural roof, or floors which the leased premises occupy are damaged in connection with the tenant's use of the store, the landlord will look to the tenant to repair them.

Tenant Has No Interest in Landlord's Policies

None of the landlord's insurance policies is intended to benefit the tenant. This is so even though the tenant pays its proportionate share of the premiums for that insurance. The tenant has no right to the benefit of the landlord's policies.

Landlord Expects Tenant to Indemnify It From Claims

The landlord expects the tenant, (since a shopping centre lease is a net lease), to protect the landlord from any claims that are made against the landlord where they arise in connection with the tenant's occupation of the leased premises or its conduct of business in the leased premises.

Tenant Must Have Source of Funds for Tenant's Repair and Indemnity Obligations

The landlord wishes to ensure that there is available at all times, sufficient funds to enable the tenant to satisfy its repair obligations; to enable it to protect the landlord from claims by third parties relating to the tenant's use of the leased premises and the building; and, to protect the tenant from becoming insolvent as the result of claims made against the tenant by other parties (which might include the landlord) as a result of the tenant's negligence or other wrongful acts.

Risk of Loss Due to Business Disruption Caused by Perils Must be Covered

The tenant must also have available sufficient funds to enable it to avoid becoming bankrupt should the leased premises, or other property which the tenant needs in order to enable it to carry on business, become damaged.

The insurance that a tenant needs in light of these basic facts falls into two broad categories:

(1) **Property insurance** - This insurance includes the various types of insurance policies that provide coverage for loss of or damage to property. It usually

includes coverage also for loss arising out of a complete or partial inability to conduct business or operations as a result of a loss of or damage to property.

(2) **Liability insurance** - The kinds of policies that fall within this category provide funding in respect of liability which the insured has to third parties. Included in this category are a number of specialized forms such as tenant's legal liability, automobile, and non-owned automobile policies and coverage.

PROPERTY INSURANCE COVERAGE

The Property That Must Be Insured

Typically, a tenant is responsible for not only its inventory, furniture, equipment, and trade fixtures, all of which are, usually, owned by the tenant, but also the improvements in the leased premises of a more permanent nature (often referred to as leasehold improvements) such as ceilings, the storefront, electrical and mechanical distribution systems, and wall and floor finishings none of which is owned by the tenant. These leasehold improvements are usually owned by the landlord regardless of whether they are paid for and installed by the tenant. They form part of the leased premises and the tenant has a leasehold interest in them. That is, the tenant has the right to use them as part of the leased premises during the term of the lease. A third entity, the mortgagee of the building will also have an interest in the leasehold improvements because when the landlord mortgages the building it mortgages also its ownership interest in the leasehold improvements.

The Interests of the Landlord and the Landlord's Mortgagee(s)

The lease will often require the tenant to maintain property insurance covering not only tenant's own property but also the interests of each of the tenant, the landlord and the landlord's mortgagee in the leasehold improvements. When loss or damage occurs these separate interests in the leasehold improvements do not cause a problem in connection with the tenants insurance policy as long as the proceeds of insurance are used to repair or restore the damage. In certain situations however, where extensive damage occurs, the landlord obtains the right to terminate the lease. When it exercises this right problems of apportionment and valuation occur. It becomes necessary to determine what part of the insurance proceeds should be paid to the tenant and the landlord respectively having regard to the fact that the value of the tenant's interest in the leasehold improvements will decline relative to the value of the landlord's interest as time approaches the end of the term. This is because at the end of the term, the landlord, as owner of the leasehold improvements gets to use them free and clear of the tenant's leasehold interest. (Unless the property is insured on a "replacement cost" basis, normally the insurance company will pay to the tenant only that portion of the value of the leasehold improvements which the

remaining term of the lease at the time of the damage bears to the age of the damaged improvements projected to the expiry date of the term of the lease.) The mortgagee of the shopping centre will also have an interest in the insurance proceeds to the extent that its loan has not been repaid. Prudent landlords should therefore demand that leasehold improvements be insured by tenants on a replacement cost basis and that loss, if any, be payable to the landlord as a named insured.

Named Insureds vs. Additional Insureds

In view of the diverse interests and concerns the landlord will insist upon the tenant. adding the landlord and its mortgagee as named insureds under the tenant's insurance policies. Subject to what is stated below, when the landlord and the mortgagee are designated as named insureds under the tenant's property and boiler policies the following results are achieved:

(1) They obtain the right to sue the insurance company directly in their own names for payment of claims in respect of their interests in the leasehold improvements.

(2) The tenant cannot amend the policy without their consent.

(3) When loss or damage occurs negotiations with the insurance adjuster will, of necessity, include both the landlord and the mortgagee.

(4) The cheque issued by the insurance company in settlement -or payment of a claim will be drawn payable in favour of all of the named insureds with the result that the landlord and the mortgagee obtain direct control over the use of the insurance proceeds.

When a person is merely added as an additional insured and not a named insured, the person does not have direct rights under the policy such as those noted above. The insurance company is bound by the policy to pay for losses to the additional insured's property or in the case of a liability policy, to provide a legal defense and to pay claims within the policy limit but the additional insured must rely on the named insured to ensure that the insurance company pays the additional insured when the additional insured's property covered by the policy is damaged or

lost or in the case of a liability policy, provides a legal defense and payment of claims within the policy limit. (As a matter of policy insurance companies will usually pay claims to additional insureds even though the additional insureds are not parties to the insurance contract and do not have direct legal status to sue the insurance company but if a claim were large enough, an insurance company might be tempted to dispute its legal responsibility to make payment).

In dealing with an insurance company to add an additional party to the policy as a named insured, or as an additional insured, it is important to keep certain matters in mind to ensure that the wording of the policy and the coverage provided in the policy are consistent with the intention of the named or additional insured. It is equally important to include the right requirements in the lease. The first concern arises from the fact that, legally, the use of the word "named" insured as opposed to "additional" insured does not, necessarily, by itself, carry with it any of the four benefits outlined above. There appears to be a custom, or practice among brokers, some risk managers and insurers to treat the description of a party as a "named" as opposed to an "additional" insured as though it carried with it, automatically, the four benefits noted above, but there is little, if any, Canadian case law to support that conclusion. It is best to include in the policy wording express language stating that each "named" insured has the same benefits as the first named insured (the one that purchased the policy) under the policy, and to include language that the first named insured acts as agent for the others in purchasing the policy, so that privity of contract is established between the insurer and the other named insureds. It is best also to include an acknowledgement by the insurer that only the first named insured is liable for premiums. Several U.S. Courts have held additional named insureds liable for premiums although they did not purchase the policy. This was done based on a principle that a party cannot enjoy the benefits of a contract without accepting the responsibilities imposed by the contract. This principle does not appear to have been adopted in connection with insurance in Canadian jurisdictions, but to foreclose any argument to the effect that such a principle should be applied, it is best to include the suggested acknowledgement.

Liability insurance wording requires particular attention. There is a view among some brokers, some risk managers, and insurers that an additional insured is not entitled to protection against

claims arising from its negligence and is protected only in respect of vicarious and strict liability. The *additional insured is only protected against claims arising from the named insured's* operations and not those arising from its own operations. (This view is derived from a line of U.S. Court decisions but Canadian caselaw has not yet emerged in support of it.) The scope of protection should be defined to cover the operations of the additional insureds related to the operation of the property. Even in the case of a "named" insured, it is best to define the scope both in the policy and the lease. If a lease merely requires that a landlord be added as a named insured, it is open to the tenant to obtain a policy that adds the landlord as an insured, but only as to limited categories of liability. The coverage may be limited to claims that arise from the tenant's activities and may not include claims arising from the activities of the landlord. Conversely, if a lease requires the tenant to add the landlord as an insured ("named" or "additional"), the landlord would, theoretically, be able to argue that the coverage should include activities of the landlord regardless of where they occur so that the landlord could have recourse to the policy even if the occurrence giving rise to the claim takes place at a different property and is entirely unrelated to the tenant's activities or the landlord's activities which impact the tenant at the property in which the leased premises are situated.

The practice of simply requiring that a party be added as a "named" or as an "additional" insured, without describing in the lease and the policy the scope of coverage to be provided leaves the door open to litigation when claims arise.

A party to a lease may object to the requirement to add another to its policy as a named insured and to have the policy worded to give the other party privity of contract with the insurer even after the scope is properly defined. Often the objection arises from the administrative inconvenience to a tenant with multiple locations of adding a long list of named insureds to its policies. One way to address this concern may be to have the landlord added as an additional insured, while including language in the lease and the policy which irrevocably appoints the landlord as the sole attorney of the tenant to deal with those aspects of the policy which apply to coverage in favour of the landlord, and to deal with claims by the landlord as an additional insured.

Distinguish Between Trade Fixtures and Leasehold Improvements

It should be noted that the insurance provisions of many leases require the landlord and the mortgagee to be named under the tenant's property insurance policies without making any distinction between the leasehold improvements (which the landlord owns) and the tenant's trade fixtures and other property in respect of which neither the landlord nor its mortgagee have an ownership or mortgage interest. It would be prudent for tenants to attempt to amend the lease provisions so as to require the landlord and the mortgagee to acknowledge to the insurance company that all proceeds in respect of trade fixtures and other property owned exclusively by the tenant will be paid directly to the tenant. Otherwise, the tenant will find itself in the position, where loss or damage occurs, of having to obtain releases from the landlord and the landlord's mortgagee in respect of insurance-proceeds that are payable in respect of items of property in which neither of them has any insurable interest. Landlords will often resist this amendment, however, at least as far as the trade fixtures are concerned, on the basis that they want to ensure that replacement trade fixtures are purchased and installed in the premises in accordance with the lease before the insurance proceeds are released to the tenant.

Section 6 of the Mortgages Act

It is important also to keep in mind Section 6 of the Mortgages Act of Ontario. Normally, the landlord will have mortgaged its interest in the building and that mortgage will cover the landlord's interest in leasehold improvements installed by the tenant which are owned by the landlord. Section 6 of the Mortgages Act provides that a mortgagee can require that all money received on an insurance policy covering the mortgaged property is to be applied in or towards the discharge of the money due under the mortgage. This means that, unless the mortgagee agrees otherwise, if a fire or other peril damages the leasehold improvements, the mortgagee is entitled to require that the insurance proceeds, instead of being applied to restoring the leasehold improvements will be applied to pay any amounts that are owing under the mortgage at the time. Also the mortgage might contain an acceleration clause which makes the full amount of the mortgage due when significant damage to the building occurs. The effect of Section 6, especially when there is such an acceleration clause (and even when there is not) can result in insurance proceeds under a policy which the tenant has taken out to cover leasehold improvements

installed by it on the premises (but owned by the landlord) being taken to reduce the landlord's mortgage debt. When this happens the tenant receives no funds from its insurance company to pay the cost of restoring the leased premises after damage. This is particularly irksome for tenants keeping in mind the fact that the lease requires the tenant, in most cases, to restore the premises (including leasehold improvements) after damage whether or not insurance proceeds are available. It should be obvious that a tenant would be well advised to amend the landlord's standard form in order to require that insurance proceeds under its policies be made available to restore the leased premises and that any mortgagee of the building be obliged to waive its rights under Section 6 of the Mortgages Act to apply insurance proceeds in payment of the mortgage loan. Alternatively, the tenant should simply refuse to name the landlord or add the landlord as an additional insured under the insurance policy that the tenant takes out in connection with leasehold improvements. If the landlord has no interest in this insurance policy then the landlord's mortgagee has no status under Section 6 of the Mortgages Act to divert insurance proceeds in payment of the outstanding amounts under the mortgage.

BUILDER'S RISK INSURANCE

Construction Activities

Builder's Risk insurance is the form of property insurance that is appropriate when construction is being done in connection with the premises. It covers all permanent construction and temporary work used to facilitate construction against "all risks" of physical loss subject to certain exclusions. Where modifications or improvements are being made to the premises the policy should be taken out for the full replacement cost of the premises as well as the cost of the improvements. It is the form of insurance that should be maintained also during any period when the tenant is making substantial alterations to the premises or major repairs.

Construction Activities Require Special Insurance

Surprisingly, tenants often fail to arrange for builder's risk insurance and landlords' standard lease forms often fail to require the tenant to obtain it. Standard leases often do not require builder's risk insurance. Instead there is a simple requirement that all risks insurance (which is described in more detail below under the heading "All Risks Insurance") be obtained but it is of limited usefulness where construction activity occurs. This is because the insurer could regard the construction activity as a material change in risk and might deny coverage unless, in advance of the work, the insured notified the insurance company of the proposed work and agreed to pay any increased premium that may be needed in order to compensate the insurance company for the increased risk.

Delayed Opening Endorsement

An endorsement that is sometimes added to builder's risk insurance is a delayed opening endorsement. This endorsement enables the landlord to be compensated for lost income, other carrying costs, and for other extra expenses that would be incurred by the landlord if a fire or other perils damaged the work before it was completed and caused a delay in the opening of the premises for business. (Note that the tenant should arrange its own business interruption insurance for protection of its own interests in this regard).

Occupancy Endorsement

Another important endorsement is an occupancy endorsement. Without it, the builder's risk coverage would end immediately upon the leased premises becoming occupied, (or more frequently, upon the leased premises being accepted by the tenant as being completed and ready for occupation) even if this occurred before the tenant actually opened for business. It is prudent also, where possible, to arrange for builder's risk coverage with the same insurer from which the tenant obtains its all risks insurance so that there is less chance of a gap in coverage occurring between the end of the builder's risk coverage and the start of the ordinary all risks coverage. (However this is not often practical when more than one broker represents the separate interests of the landlord and tenant(s).)

FIRE AND EXTENDED PERILS OR ALL RISKS

There are basically two forms of property insurance policies for tenants to consider after the construction activity is finished.

Fire and Extended Perils Coverage Insurance

This form (which is rarely used today) is basically a fire insurance policy to which, by means of an extended coverage endorsement, there is added a further list of named possible causes of loss or damage for which the insurer will pay. This is the minimal form of coverage which mortgagees, banks or other lenders are likely to insist upon. Increasingly, this type of insurance is being replaced by an "all risks insurance

All Risks Insurance

This type of insurance, generally speaking, provides coverage for all of the things that the fire and extended coverage policy covers but it also provides coverage in respect of any other accidental loss of, or damage to the property covered. However, there are exclusions. For example, damage caused by earthquake, flood, snowslides, landslides, subsidence, seepage, leakage or influx of water is not covered unless endorsements are added to remove these exclusions or the policy is specifically written to cover damage caused by these otherwise excluded perils. The essential difference between the fire and extended perils kind of policy and the all risks policy is that in the fire and extended perils policy, when loss or damage occurs, if the peril is included among the ones listed in the policy, coverage is provided, while in the case of an all risks policy, if the peril is not one that is excluded, then coverage is provided.

(In purchasing an all risks policy, it must be kept in mind that there are certain coverages offered in a standard fire and extended perils policy which are not offered in an all risks policy regardless of the express exclusions in the policy. It is prudent to include an extension of coverage endorsement in the all risks policy to include all those coverages that are covered in the standard file and extended perils policy.)

It should be noted that in the case of both the fire and extended perils form of policy and in the all *risks policy, loss arising from the explosion of pressure* vessels, mechanical breakdown, and electrical disturbances due to electrical currants artificially-generated is not covered. For that reason, in addition to the property insurance described above, it is necessary for the tenant, in most cases, to take out boiler and machinery insurance.

BOILER AND MACHINERY INSURANCE

When an explosion or breakdown occurs from within a boiler, transformer, refrigeration or air-conditioning unit, the boiler and machinery policy insures against the resulting loss-of, or damage to property that is owned by the insured as well as property which the insured does not own but which is in the care, custody and control of the insured. The property covered may not be just the boilers and machinery. If the damage is caused by an explosion or breakdown such as those described above, office contents, stock, inventory, buildings and other types of property are also covered. The policy is referred to as a "boiler and machinery" policy only because a boiler or piece of machinery must be the source of the accident causing the loss or damage. It should be noted too that the kinds of objects that the boiler and machinery policy will deal with include not only boilers, but also refrigerating and air-conditioning systems, production machinery, electrical apparatus used for generating, transmission or utilizing mechanical or electrical power, and axillary piping.

Tenants will sometimes argue that since they do not have boilers on the leased premises they do not need boiler and machinery insurance. It should be evident from the list of objects above, that in fact, in many cases, boiler and machinery insurance is required even when no boiler is contained on the leased premises. If a tenant has any refrigeration equipment, (as is often the case with restaurants) or a transformer, a generator, a water heater, a dishwasher, or where the tenant owns its own H.V.A.C. equipment or is responsible for the maintenance and repair of the H.V.A.C. equipment, the tenant will need boiler and machinery insurance.

NINE ESSENTIAL SPECIAL FEATURES OF PROPERTY INSURANCE

Both the fire and extended perils and the all risk property insurance policy are inadequate for use in connection with in multi-occupant buildings premises unless certain specific provisions are built into them or certain amendments (endorsements) are made to them. Generally, nine specific features are needed. The first four affect the ultimate dollar amount that is paid to the insured. The remaining six affect the conditions under which claims are paid.

1. Replacement Cost

Without this feature, the basis of settlement is actual cash value (which reflects physical deterioration) at the time of loss. Actual cash value is the replacement cost of an item less physical deterioration. Where new improvements will need to be constructed in order to replace the damaged improvements, actual cash value will often be inadequate as a basis of settlement. Accordingly, a replacement cost feature is needed so that when improvements are damaged or destroyed, the insurance company will make available an amount necessary to replace them with new improvements of the same type and quality as the damaged improvements without deduction for depreciation.

2. By-Law Exposure

New by-laws, regulations, and other governmental requirements imposed in connection with properties, alter their original construction can result in new standards and requirements that pertain to rebuilding or replacement. Additional costs over and above the original construction costs can result. For example, additional fire retardant materials and sprinklers might need to be included in a building that did not previously include them. Standard policies contain an exclusion that prevents recovery of these additional costs and it is therefore necessary to obtain a policy or endorsement that removes the exclusion or provides coverage for these additional costs.

3. Co-Insurance Clause Endorsements

A property insurance policy will invariably state a maximum dollar amount available to meet a claim. The sum insured will affect the amount of premium that is charged for the policy. More often than not, when a building or other improvement is damaged, it is not totally destroyed. In a

sense the risk factors associated with the upper portions of value of a property are lower than for the lower portions of value. To assist in setting premium rates realistically, insurance companies include co-insurance clauses in their policies. The co-insurance clause requires the insured to maintain an amount of insurance that is at least equal to a stated percentage (typically 80%) of the value of the insured property at the time of the loss. If the sum of insurance needed to achieve the stated percentage is not maintained, the insured will be precluded from recovering a portion of the loss (and in that sense is a co-insurer or a self-insurer). This non-recoverable portion of the loss is determined as follows:

$$\frac{\text{insurance required - insurance carried}}{\text{insurance required}} \times \text{loss}$$

For example, if a tenant insures property valued at $100,000.00 under a policy with a stated percentage in the co insurance clause of 80%, the required amount of insurance is $80,000.00. If insurance of only $50,000.00 is in force, the deficiency between the required amount ($80,000.00) and the actual amount of the insurance ($50,000.00) is $30,000.00. If the insured property is damaged to the extent that it costs $40,000.00 to restore it, the tenant's recovery would be reduced by an amount calculated as follows:

$$\frac{\$80{,}000.00 - \$50{,}000.00}{\$80{,}000.00} \times \$40{,}000.00 = \$15{,}000.00$$

Even if the required amount of insurance is maintained at the beginning of the policy period, the addition of new improvements to the premises, or inflation could result in the minimum required amount not being complied with at the time of the loss.

To avoid these problems, the one solution is to include a "stated amount co-insurance clause". It states that insurer waives the co-insurance requirement if the insured maintains insurance equal to the amount agreed upon and stipulated at the inception of the policy. Alternatively, the co-insurance clause could (for a price) be waived altogether.

4. Primary Coverage When There is Other Insurance Available

When two or more property insurance policies cover the same interest in damaged property, the several insurance companies that issued the policies are required to contribute to payment in respect of the loss according to certain guiding principles. Tenants' leases will normally require them to insure not only the tenant's interest but also that of the landlord in the improvements which the tenant installs in the leased premises. Those improvements normally become the property of the landlord upon their installation. Landlords, as a precaution, will often take out their own insurance covering the same property. Therefore it is common to find a tenant's insurance policy and a landlord's insurance policy both covering the interest of the landlord in the same property. However, the landlord intends for its policy to apply only on a contingent or secondary basis. For that reason, it is typical for a lease to require the tenant to have its property insurance policies endorsed or written to "be non-contributing with and to apply as primary and not excess to any other insurance' available to the landlord. The effect is that when damage occurs to the property the tenant's insurance company will not be able to require the landlord's insurer to contribute. The landlord's policy would only respond in connection with the damage if the tenant failed to maintain the required insurance. In this situation the landlord's insurance premiums are lower because the risk of a required damage or loss payment by the landlord's insurer is lower.

5. Breach of Conditions Clause

A tenant might invalidate its policy by breaching its conditions. The result is that when damage occurs, the landlord who relied primarily on the tenant's insurance for coverage on the improvements installed in the leased premises is unable to recover insurance proceeds. To avoid this situation the tenant will be required to have its insurance policy written or endorsed so that no breach or violation by the tenant of any warranties, representations, declarations or conditions contained in the policy will invalidate coverage in respect of the interest of the landlord (and vice versa).

6. Mortgage Clauses

Mortgage companies will sometimes have their own specific form of non-invalidation clause to protect their interests in mortgaged property in situations where they rely on insurance taken out by tenants, landlords, or other parties. Therefore the tenant will normally, in addition to obtaining the non-invalidation endorsement mentioned above, be required to obtain an endorsement to include a specific non-invalidation clause in the form approved by the mortgagee of the property.

7. Joint Loss Agreement

This is recommended where the tenant must maintain both property insurance and boiler and machinery insurance. When a fire or other catastrophe occurs it will often be unclear whether it is the tenant's property insurance policy or its boiler and machinery policy that should respond to the loss. Delay in obtaining payment can result. The joint loss agreement requires that each of the property insurer and the boiler and machinery insurer pay a pre-determined share. After payment of the loss in their pre-determined shares, they settle and re-adjust between themselves the ultimate liability of each.

8. Non Cancellation or Waiver Clause

It is also common to require tenants to have their policies endorsed so that no material change in any of its terms or conditions can be effected and no cancellation can occur without thirty days prior written notice by registered mail to each of the landlord and the mortgagee of the property. This enables the landlord to monitor the tenant's insurance. The requirement may seem superfluous in situations where the landlord and the landlord's mortgagee are added as additional named insureds under the policy (no material change, .cancellation or modification of the policy would be effective as against them without notice to them.) However, the precaution of including the specific notice provision is recommended because it gives to the landlord the additional assurance of specifying the address to which notices must be given in order to be effective and enables the landlord to require that the notice be given by registered mail.

9. The Waiver of Subrogation Clause

The waiver of subrogation clause is the source of much confusion. If an insurance company pays for loss or damage covered by a policy, the insurance company obtains the right by law (and

usually also by virtue of the wording of the policy) to the extent of its payment, to exercise whatever rights the insured has against any wrongdoer who caused the loss or damage. This right is called a right of subrogation. For example, if a landlord negligently caused a fire in a tenant's store and the tenant's insurance company paid the cost of restoration, the insurance company could sue the landlord to obtain recovery of the amount paid by the insurance company. To avoid these lawsuits, the landlord will include a requirement in its lease that the tenant obtain a waiver of subrogation clause in its policy which precludes the insurance company from exercising its right of subrogation against the landlord.

There is virtually never any extra cost for the waiver of subrogation clause. The reason appears to be the development in case law over the last twenty years of a doctrine which is sometimes referred to as the "doctrine of immunity". Under this doctrine, if one party agrees with another that it will obtain insurance coverage for property, and the property is damaged by a peril which is supposed to be insured, neither the party that agreed to obtain the insurance nor the insurance company that issued the policy can claim against the other party for damage to the property (even if the other party is negligent). Since the lease will normally, expressly require the tenant to insure its property, under the doctrine of immunity, the insurance company would automatically be prevented from successfully suing the landlord even if the landlord negligently damaged the tenant's property. This would apply even if there were no waiver of subrogation included in the policy. Accordingly it is not appropriate for an insurance company to charge extra premiums for the waiver of subrogation endorsement.

Because of the doctrine of immunity, it might be suggested that the landlord's requirement for the tenant's policy to contain a waiver of subrogation is superfluous. However, it must be noted that the doctrine of immunity may not apply to persons that are not parties to the agreement in which the obligation to insure is included. For example, since the employees of the landlord are not parties to the lease, the doctrine of immunity does not benefit them. It is for this reason that a carefully drafted waiver of subrogation requirement is an important feature of the lease and a carefully drafted waiver of subrogation endorsement is essential for the tenant's insurance policy. The waiver of subrogation can be drafted so that it extends not only to the landlord but

also to the management company that operates the property and the mortgagee of the property, as well as their officers, directors and employees and those of the landlord.

Unfortunately, however, there is some doubt as to whether even a waiver of subrogation that is expressed to benefit this larger category of persons (for example the employees of the landlord) would be entirely effective. This doubt arises from a peculiar rule of Canadian contract law which is sometimes referred to as the "third party benefit rule". Under this rule, when parties to a contract agree to provide a benefit to a person (a third person) who is not a party to the contract, the third person is not entitled to sue to enforce it.

There is no completely satisfactory way of dealing with the third party benefit problem. The most common solution is to have the party who seeks to benefit the third party act as the agent or trustee for the third party. When this is done the third party benefit rule may be avoided. Accordingly leases should state clearly that the landlord, in requiring the tenant to obtain insurance and to obtain a waiver of subrogation, is acting on behalf of not only itself, but as agent or trustee for the benefit of any management company that operates the shopping centre, the mortgagee of the shopping centre, and the officers, directors and employees of all of them. This solution is not entirely satisfactory, because where a person is not an officer, director, or employee or is not the manager or the mortgagee of the landlord at the time the lease is entered into, a true agency or trustee relationship may not exist. Nevertheless, this solution, flawed as it is, seems to be the best in the circumstances.

BUSINESS INTERRUPTION INSURANCE

A tenant's loss of income arising from its inability to carry on business as the result of property damage, can be insured with business interruption insurance. This coverage is usually accomplished as a rider or an added feature of the tenant's property insurance. Standard lease forms require tenants to maintain this type of insurance so that when property damage occurs the tenant's ability to continue paying rent during the business interruption is sustained. Where, as is often the case, the lease provides for an abatement of minimum rent to the extent the tenant's premises are not usable due to property damage, the need for business interruption insurance is reduced. However, many standard leases restrict the rent abatement to basic or minimum rent and do not permit an abatement in respect of common area operating costs, real property taxes, and other additional rent items. Also standard forms will often preclude a rent abatement where the tenant is at fault in connection with the damage. Moreover business interruption insurance is essential for the other items of cost which will continue during the period of the business interruption. For example, interest costs on purchased inventory, equipment rental costs, and salaries of employees will need to be paid.

The Due Diligence and Dispatch Requirement

The due diligence and dispatch requirement precludes payment for any loss of income to the extent it is caused by a failure to exercise due diligence and dispatch in the repair and restoration. The tenant should ensure that the due diligence and dispatch provision is worded so that it is only to the extent the tenant's lack of due diligence and dispatch causes delay that proceeds are reduced. Otherwise, if the landlord is slow or inefficient in completing the landlord's portion of any repair work the tenant may find that its own business interruption insurer will not pay the part of its claim for lost income that is attributable to the delay.

Relationship to Property Insurance

Business interruption insurance is always related to property damage caused by perils included in the coverage. If a business is interrupted by other causes that do not involve damage to property caused by an included peril, business interruption coverage will not be available. For example, if, in redeveloping a portion of the property the landlord impedes access to the tenant's premises,

the tenant's business interruption insurance will not respond. This is because the interruption is not the result of property damage caused by an insured peril. Similarly, if the tenant is required to cease the conduct of business in its premises due to damage by a peril that is not included in the policy coverage (for example damage by vehicle impact), no business interruption insurance proceeds will be available.

Damage to other Persons' Property - Egress Extension

A tenant's business can be interrupted by damage that occurs to other persons' property. For example, if a department store is an anchor in the shopping centre is damaged by fire and ceases to operate, during the restoration, the tenant's business can be dramatically affected. Also, if premises occupied by a supplier of inventory that is essential for the tenant's business is damaged, the interruption can have a major effect on the tenant's ability to carry on business. Another example may be damage by a peril which affects a telecommunications network or telecommunications lines and equipment. The potential for disruption of business in this situation is high. These exposures can be covered by special forms of business interruption insurance. Although standard leases seldom require the tenant to obtain these forms of business interruption coverage tenants would be prudent to consider them.

Types of Business Interruption Insurance

There are basically two categories of basic business interruption insurance from which to choose. They are the "Gross Earnings" form and the "Profits" form. The main difference between the two is that under the Gross Earnings form, income protection is afforded only during the period of restoration. Under the Profits form, income protection is afforded during and after restoration until income levels are re established. This can be important because when a store ceases to operate it may lose a portion of its market and there may also be disruption attributable to re-hiring, re-training of staff and other factors. Normally, however, there will be a twelve month limitation on the indemnity period under the Profits form (which can be extended, according to need). The choices of which form to obtain and (under the Profits form) the duration of the indemnity period, are a factor of how quickly a business will be able to re establish itself after it

re-opens. With a gross earnings form, income protection is afforded only during the period of restoration.

Although these forms of business interruption insurance will insure those additional expenses incurred to reduce loss of both or either of income and profit, it often is necessary for tenants to incur expenses above profit levels in order to ensure continuance of their business at temporary premises. These additional expenses may be insured under a third type of business interruption policy. EXTRA EXPENSE INSURANCE may be purchased instead of, or to complement, one of the other forms of business interruption insurance.

LIABILITY INSURANCE FOR TENANTS

Insurance policies (aside from personal insurance such as life insurance, disability insurance, and retirement and annuity plans) fall generally into two broad categories: property and liability. The policies previously discussed, being fire; all risks; boiler and machinery; and business interruption insurance policies, are all forms of property insurance. Each involves the insured obtaining payment directly from the insurer for loss of, or damage to property in which the insured has an interest. Liability policies, on the other hand, are purchased for the purpose of protecting the insured from claims made against the insured in connection with injury to other persons, or in connection with loss or damage to the property of other persons, when the loss or damage is caused by the insured. Liability insurance is a shield against claims by others. There are two general categories: general liability and specialized liability.

General Liability Policies

General liability policies protect the insured not just from specific types of risk, but from a wide range of liability risks. Examples are the garage liability policy designed for the operators of motor vehicle garage; the tenant's liability policy, and the storekeeper's liability policy; and the comprehensive or commercial general liability policy. This last mentioned policy is the policy which responds to the greatest range of liability risks and is the form that most standard lease forms require tenants to maintain. Even the comprehensive general liability, however, needs to be amended and supplemented with endorsements and riders if it is to be adequate. Now we will deal with the deficiencies in this policy, and the manner in which they can be remedied.

Specialized Liability Policies

Specialized liability policies are designed to deal with specific categories of risk. They include policies such as (1) professional liability policies, which protect architects, engineers, lawyers, doctors and other professionals from claims arising in connection with the performance of their professional services; (2) directors and officers liability which protect the senior executives and the directors of corporations from claims made against them arising from things that they have done or failed to do in their capacities as directors, or officers of a corporation; and (3)

automobile liability insurance. Of these specialized forms only the automobile policy needs to be discussed in the context of the special needs of tenants in multi-occupant buildings.

Automobile Liability Insurance

The automobile liability policy is needed because general liability policies exclude coverage in respect of claims arising from damage caused by an automobile. If a tenant's vehicle damages improvements on the property and the tenant is sued by the landlord for the cost of restoring the damage, the tenant's general liability insurance will not defend against or pay the claim. Also if a tenant's motor vehicle were to cause major damage to property, or if personal injury were caused, the amount of the claim could be sufficient to bankrupt the tenant. For these reasons, standard form leases often require this coverage.

How Much Liability Insurance is Enough?

The question of how much liability insurance should be purchased frequently arises. The answer is that the tenant should purchase as much liability insurance as it can possibly afford. Personal injury claims frequently involve millions of dollars and a single inadvertent act of negligence can cause many millions of dollars worth of property damage and business loss. Generally, insurance representatives recommend a minimum of five million dollars of liability coverage under each of the recommended policies mentioned above. Most standard leases provide for a minimum of two million dollars, in the case of shopping centres, and five million dollars, in the case of office towers (where fire and flood will usually affect premises above and below on multiple levels).

NECESSARY ENDORSEMENTS OR INCLUSIONS FOR TENANTS' COMPREHENSIVE OR COMMERCIAL GENERAL LIABILITY POLICIES

The type of general liability insurance policy which is best suited for tenants in multi-occupant buildings is the commercial general liability policy (the "CGL" policy). It provides the widest range of coverage. However, even the CGL policy can be inadequate. This is because the policy often contains exclusions which leave holes in the protection afforded to the insured and because certain coverages are not always included. Certain of the exclusions, such as those pertaining to aircraft or watercraft liability, are not relevant in the context of real estate property leasing and are usually left uncovered. The important exclusions or special coverages that need to be considered are addressed below.

Contractual Liability

When an insured assumes liability under a contract by agreeing to take responsibility for losses or damages that might be suffered by other parties, the CGL policy will not provide coverage for this contractually assumed risk. For example, if a tenant (as is often the case) agrees, in its lease, to indemnify and save the landlord harmless from loss or damage arising from certain occurrences or events, the CGL policy will not cover this extra risk. It will only cover the risk to the extent the tenant, due to its negligence or other act or omission, would have been liable at law for the damage or loss regardless of the indemnity. To cover this extra risk, the tenant must obtain a contractual liability endorsement for its policy.

Automobile Liability

Liability arising from damage caused by a motor vehicle is not covered. Coverage for liability arising from damage caused by an automobile owned or operated by the insured must be covered by a separate automobile insurance policy. Liability arising from damage caused by a motor vehicle not owned by the insured where it is operated by an employee of the insured in the course of performing the employee's duties, is usually covered by adding a non-owned automobile liability rider to the CGL policy.

Non-owned Automobile Liability Insurance

Non-owned automobile liability insurance is required to deal with situation where an employer has employees who drive their own vehicles in the course of their employment. Legally, an employer is liable for the acts of employees committed while they are carrying out their duties. If an employee, while driving on the job causes an accident and is found to be negligent, both the employee and the employer are liable. This liability is not covered by the tenant's automobile policy It is usually covered by the tenant's commercial general liability policy. Landlords, wishing to ensure that tenants are not bankrupted by the negligent acts of their employees, require tenants to maintain this coverage. The coverage also provides protection to the landlord indirectly in that the policy would be available to pay claims where property damage is caused to the property by a motor vehicle that is negligently driven by the employee of a tenant.

Employer's Liability

The basic CGL policy excludes coverage for bodily injury to an employee of the insured arising out of, or in the course of his employment by the insured. It also excludes coverage in respect of any obligation for which the insured is held liable under any workers' compensation law. These exposures are covered by the combination of (a) the workers' compensation funds to which businesses in specified categories are required by provincial law to contribute based on assessments imposed on them, (b) the employer's liability endorsement which covers claims by employees who are not covered by workers' compensation legislation, and (c) the contingent employer's liability endorsement which adds coverage for claims by employees who are covered by workers' compensation but who might be able, for legally recognized reasons, to recover against their employer.

Property Occupied by or in the Care, Custody and Control of the Insured

Coverage for the insured's liability in respect of damage to property that is leased or occupied by the insured, or that is in the care, custody, or control of the insured is excluded. However, the tenant might be legally responsible for restoring damage to the leased premises or to parts of the leased premises which is not covered by the tenants' property insurance policy. The tenant might also be responsible to repair or restore components which are not actually part of the leased

premises but which are occupied by, or are used or operated exclusively by the tenant. (Air-conditioning equipment, and structural floors, walls, and ceilings are common examples.) These exposures are covered by means of a tenant's legal liability endorsement under their property policy, or by means of a separate tenant's legal liability policy.

Personal Injury Coverage

The CGL Policy covers the liability of the insured in respect of damages caused because of "bodily injury". "Bodily injury" does not include such things as libel, slander, false arrest, wrongful eviction, wrongful entry, invasion of privacy, or malicious prosecution. These are all matters involving harm to a person but not necessarily physical injury. It is important that "personal injury" be covered to give protection against claims made against the insured by third parties who have been personally injured but who have not suffered physical injury.

Occurrence Basis Property Damage

The CGL Policy covers liability for damages arising from property damage caused by an "accident". Many things, although they are unexpected or unintended, are not considered to be accidents. The insurer may argue that certain damage was not an accident but rather, was an inevitable consequence of the behaviour of the insured. For example, if a tenant had a defective refrigerator on its premises which leaked onto adjoining premises on a continuing or repeated basis the leakage would at a point, be considered no longer as an accident but as an inevitable consequence of the tenant's failure to replace or repair the refrigerator. It is important to ensure that the policy is written or that it is endorsed to cover "occurrences" in addition to accidents.

Owners and Contractors Protective Liability

A tenant who hires a contractor to do work or repairs on the premises or who hires a contractor to perform some other service for the tenant can be sued if an accident or occurrence takes place in connection with the activities of the independent contractor. (A lease form may require the tenant to take responsibility for the actions of its contractors.) Since the activities of independent contractors may be very different from the normal operations of a tenant, the risk of liability in connection with the activities of independent contractors must be assessed separately. For that

reason, the CGL Policy provides for a separate category of liability hazard to be identified in the declarations so that the insurer can charge separately for this risk.

Product Liability

A tenant can be held liable in respect of defects in products sold or manufactured where the defect or the product causes damage to property or bodily injury. This kind of liability could easily bankrupt a tenant. It is therefore important for a tenant to ensure that the CGL Policy includes in it declarations, coverage in respect of products liability.

Pollution Liability

A CGL Policy does not cover bodily injury or property damages arising from the discharge, dispersal, release or escape of the smoke, vapours, soot, fumes, acids, toxic chemicals, liquids or gases, waste materials or other irritants, contaminants or pollutants. No protection is provided against many potential environmental damage liability situations nor does it provide coverage in respect of fines or penalties. The only way landlords and tenants can fully protect themselves from pollution liability (whether caused by either gradual or sudden and accidental events) is by the purchase of pollution liability insurance at adequate limit levels. Coverages available, in an ever increasing competitive insurance marketplace, include Third Party Liability (Bodily Injury and Property Damage), Remediation Expenses (cleanup costs at owned or premises) and related Legal Expenses.

Specialized forms of insurance are available for unique exposures such as lead based paint, asbestos, above or below ground storage tanks or for contracting operations (including full coverage or remediation projects). Coverage is even available to cap the cost of cleanup projects.

Landlord and tenants should carefully review their individual exposures to loss and take appropriate action, contractually or otherwise, to transfer these risks to each other or to Insurers.

PROTECTING THE LANDLORD UNDER THE TENANT'S LIABILITY POLICY

Most leases of space in buildings are net leases. They are structured so as to protect the landlord from costs associated with the tenant's occupation of the premises or its use of the ~ Accordingly, the lease will require that the landlord be added as a named insured under the tenant's liability insurance policy. The intent is that should the landlord be sued by anyone as a result of anything that occurs in connection with the tenant's occupation of the premises or the tenant's use of the property, or by anyone in connection with the landlord's activities that affect the tenant's use of the lease premises, the tenant's liability insurer will take responsibility for the claim. (Note the comments set out previously in this paper under the head "Named Insureds vs. Additional Insureds" which recommend that the scope of coverage for the landlord under the tenant's policy be defined in the lease and the policy). Also, naming the landlord as an insured does not, in itself, avoid the possibility of the landlord's liability insurer being called upon to pay amounts in respect of claims against the landlord arising from occurrences connected with the tenant's occupation of the premises or the tenant's use of the shopping centre. To accomplish this purpose, three things must be done in connection with the tenant's policy.

Primary Coverage

If an insured has coverage available to it under two or more policies in respect of the same occurrence, each of the insurers is required to contribute toward payment of the claim. When a landlord is named as an insured under a tenant's liability policy it will usually have coverage available to it from both the tenant's policy and its own. For this reason, the landlord will require that the tenant's liability insurance policy apply as primary and not excess to any other insurance available to the landlord.

Cross Liability Endorsement

When there is more than one party insured under the same liability policy (as is the case where the landlord is added as an insured to the tenant's policy) it is necessary to consider the situation where one of the insureds has a claim against another of the insureds. A cross-liability clause is normally added to avoid an argument by the insurer that since one of the insureds under the policy is suing another insured under the same policy, coverage is not available. The clause

allows the tenant to sue the landlord or the landlord to sue the tenant, as the case may be, and the insurer will be responsible to pay the claim in either case.

Severability of Interests

If there is more than one insured under a policy, there is a risk that one of the insureds might do something which voids the policy with the result that the other, innocent insured, is without coverage. To avoid this sort of problem a severability of interests clause is added. Its effect is to require the insurer to recognize that each of the insureds under the same policy is a distinct legal entity. The policy is interpreted as though a separate policy had been issued to each insured.

An example of how the severability of interests clause can be important is the situation where a tenant that knows of a claim fails to communicate knowledge to the insurer. The insurer in that situation (since the requirement to communicate knowledge of claims is a prerequisite of coverage) can deny coverage to the tenant. However, where the policy contains a severability of interests clause, if the party that sues the tenant also sues the landlord, the insurance company would be required to take responsibility for the claim, against the landlord (assuming the landlord did not know about the claim and therefore had no duty to report it to the insurer). The severability of interests clause can also protect the landlord in certain situations where exclusions from coverage in the policy apply to the tenant. For example, if the policy excludes coverage for liability for injuries to employees of the tenant, where an employee of the tenant is injured and sues both the tenant and the landlord, although the tenant would not be covered, the landlord would be covered. This is because the severability of interests clause requires the policy to be treated as though it were a separate policy issued to each of the insureds and the employee, in this case, is not an employee of the landlord.

CONCLUSION AND CAUTIONARY NOTE

Although the insurance provisions in commercial leases seem at first to be overwhelmingly complex, the several components fit together neatly and easily when their underlying logic is applied and the meanings of the key terms and definitions become familiar. Since insurance provisions in commercial leases drafted for standard forms tend to follow the same pattern a paper such as this should be useful to anyone that reads a commercial lease and needs to find out what the various insurance clauses say and why they say it.

It is crucial to keep in mind however, that in addition to the clauses of the lease that specify the types of insurance that the tenant must maintain, other provisions of the lease such as the "repair after damage" clauses, the exculpatory (release) clauses, and the indemnity provisions must all be drafted and read carefully to ensure that they mesh properly with the insurance provisions. Failure to ensure that there is a proper meshing among these clauses can have a disastrous effect.

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