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# Commercial Lease Negotiations: Property and Liability Insurance, Proof of Coverage, AI and Loss Payee Issues

Structuring Lease Provisions to Require Coverage and Receive Benefit of Coverage Provided

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Today's faculty features:

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## Insurance

Insurance is kind of a wilderness for many lawyers. Many of us simply do not know enough about it, so we pass the responsibility for the review of the language to insurance agents or risk managers. While it is a good idea for a lawyer representing a landlord to have a knowledgeable insurance expert review the language when it is drafted into the lease form, it does not often happen. That is why many leases still refer to “comprehensive liability insurance” when the real name, other than for automobile insurance, is “commercial liability insurance”, or why leases have low insurance amounts or have different amounts for personal injury and for property damage, when policies are now written with a combined single limit, or why leases still refer to the National Board of Underwriters, which has not existed since the 1930’s.<sup>1</sup>

The following is a primer on the treatment of insurable risks in commercial leases. Although rather long, I hope you find it useful.

It is always a good idea for the lawyer representing the tenant to have the tenant’s insurance person review the insurance related provisions to confirm that the tenant has or will be able to get the required coverage. It should be noted that there are more sections in the lease which are insurance impacted than the ones labeled “Insurance”. Those include the sections pertaining to waiver of claims, waiver of the right of subrogation, indemnities and fire and casualty, all of which are discussed below.

Simply stated, leases must deal with three insurance issues:

- Who causes what loss to whom or to whose property?
- Who has the ultimate liability for the loss?
- Whose insurance is going to pay for it?

Every landlord's lease form deals with those issues and every tenant wishes to minimize its own risk.

Liability arises when one party injures another or damages the other's property, usually as a result of some sort of fault such as negligence or deliberate misconduct. Liability is imposed to compensate the victim for the loss or damage occasioned by that wrongful act. The most common form of liability arises out of automobile accidents, but the real estate professional is

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<sup>11</sup> I have developed a non-conventional “no fault” (really less fault) approach to insurance provisions in my lease forms which I have been using for several years. While I often get push-back on the concept, when it is understood, it is generally accepted. You can learn more about it in my Article, “Allocation of Insurable Risks in Commercial Leases” published in the Real Property, Probate and Trust Journal, Volume 37, Number 3 at page 479 (Fall 2002). It is available free to ABA members, accessible at the following website: [http://www.americanbar.org/tools/digitalassetabstract.html/content/dam/aba/publishing/real\\_property\\_trust\\_estate\\_law\\_journal/rpvt\\_mo\\_premium\\_rp\\_publications\\_journal\\_2002\\_fall\\_saltz.pdf](http://www.americanbar.org/tools/digitalassetabstract.html/content/dam/aba/publishing/real_property_trust_estate_law_journal/rpvt_mo_premium_rp_publications_journal_2002_fall_saltz.pdf)

aware that the issue often arises when a person slips and falls on real estate or when personal property is damaged as a result of such things as falling ceiling tiles or leaking roofs.

A property loss occurs as a result of a casualty that causes the damage or destruction of property, real or personal. A common type of such a casualty is fire, but damage caused by high winds or other natural occurrences is also a casualty loss.

Businesses purchase property insurance to create a source of funds from which to recover for property damage resulting from a casualty;<sup>2</sup> they also carry separate liability insurance (frequently with different insurance companies) to provide a defense and funds that they can use to pay third parties for losses that they caused. Although they tend to think that these two sorts of risks are not interrelated, the loss arising from a casualty that is caused by the negligence or other fault of one party and causes a loss to a second party may be insured both by the liability coverage of the party at fault and by the property insurance of the injured party. For example, assume that a building owner is inspecting the roof and drops a cigarette, causing a fire that damages the tenant's merchandise or machinery and equipment. The loss is covered by the building owner's liability insurance, but may also be covered by the tenant's contents insurance, which is a form of property insurance. Conversely, if the tenant's employee throws a lighted match in a wastebasket and causes the building to be substantially damaged by fire, the damage is covered by the landlord's property insurance on the building and may also be covered by the tenant's liability insurance.

If both parties carry property insurance and liability insurance, why is it necessary for the lease to deal with insurance issues at all? Or, why should the lease not provide that the party at fault bears the loss and, to the extent that the loss is not covered by liability insurance, the property insurance of the other party pays the balance? The relevant provisions of many leases deal with the risks in just this way; but this arrangement is not the most economical way to deal with those risks, nor is it necessarily in the best interest of either party.

The basic problem relates to limits on the proceeds of insurance policies. Property insurance typically is tied in some way to the value of the property whereas liability insurance is purchased with a somewhat arbitrarily determined maximum level. Until several years ago, it was typical to carry liability insurance for damage to property in an amount of only between \$250,000 and \$500,000 per occurrence. Today, the insured customarily obtains a personal injury and property damage liability policy with a combined single limit of, for example, \$3 million. Substantial excess liability (or "umbrella") coverage with higher limits may also be purchased.

Thus, if the tenant's employee (in the second example) caused a building with a replacement cost of \$50 million to be totally destroyed, the landlord's property insurance, if purchased with at least that insurance limit, would be obligated to pay the entire loss. But the

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<sup>2</sup> Insurance professionals and real estate professionals have a nomenclature problem. Real estate professionals tend to refer to risks involving "fire and other casualty" as "casualty" risks and refer to "property damage" as a liability issue (as in "personal injury and property damage"). Insurance professionals use the word casualty to refer to an occurrence causing damage and define insurance covering "fire or other casualty" as "property insurance". I will use the insurance companies' terminology, referring to "property insurance," "liability insurance," and, where appropriate, "property damage liability insurance".

parties would discover that if the tenant's property damage liability insurance were applied to the loss, the maximum amount of recovery is the policy limit, which probably is substantially less than \$50 million. Similarly, the destruction of extremely valuable machinery and equipment (computer equipment or very costly merchandise) as a result of the landlord's negligence might not be adequately covered by the landlord's property damage liability insurance.

A further complication is the fact that, under common law, any person causing damage by his negligence or other wrongful act has liability for the damage, whether or not he has liability insurance to cover that loss. Thus, in the example in which the tenant's employee caused the building to burn down, the landlord has the right to sue the tenant (the tenant is liable for the negligent act of its employee performed in the course of his or her employment), whether or not the tenant has liability insurance and whether or not that insurance provides coverage or is adequate.

In fact, if the landlord's property insurance carrier pays the landlord for the loss of the building, the insurance carrier has the right under common law to sue the tenant (the party at fault) to recover the amount that it paid to the landlord. The right of the insurance company to “stand in the shoes” of its insured and to bring the insured's negligence claim against the party at fault is called a “right of subrogation.”<sup>3</sup> Whether the lawsuit is brought by the landlord or the landlord's insurance company, it could result in liability imposed upon the tenant for an amount far in excess of the tenant's liability insurance coverage. Obviously, the same principles apply in the example in which the landlord's negligence caused the extensive loss to the tenant.

You can see that it is in the interest of each party to have losses arising out of the damage or destruction of their property paid by a property insurance carrier and somehow to negate both the right to action of the party owning the damaged property and the right of subrogation of that party's property insurance carrier. Both of these ends can, with some limitations, be accomplished in the lease. I recommend the following three-pronged approach:

Each party should be required to carry property insurance with appropriate coverage and appropriate amounts (see the following discussion); each party should waive its right to claims for damage to its property arising out of the negligence or wrongful act of the other party; and each party should agree to obtain from its insurance carrier a waiver of the right of subrogation. The waiver of subrogation might, in fact, be evidenced by a provision in the insurance policy that the coverage is not invalidated by reason of the fact that the insured has, prior to a loss, waived its right to proceed against a party at fault causing the damage or destruction of the property insured by the policy.

These three requirements—insurance coverage, waiver of claims, and waiver of subrogation rights—go a long way toward eliminating fault as the basis for paying for damage or destruction of property and limit coverage of that risk to the property insurance of the party owning the property.

#### *Waiver of Claims and Waiver of Subrogation*

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<sup>3</sup> “Subrogation” and “subordination” may sound the same, but they are different and unrelated. Do not become confused.

Many leases contain specific provisions to the effect that the tenant waives claims against the landlord for property damage. It is not as common that there are such specific provisions for the benefit of the tenant. On the other hand, most (but certainly not all) waivers of subrogation provisions are mutual and protect each party. A mutual waiver of subrogation provision, to be effective, should also contain a waiver of claims and provide for a waiver of subrogation so long as such protection is available from insurance carriers, plus provisions for notice if such a benefit is either not available or is available only at additional cost. The right of the insured to waive (prior to a loss) the right of subrogation is now common in the insurance industry. As a rule, insurance companies make such waivers generally available because their premiums are based on risk factors that do not include an anticipation of recovery of the proceeds of the insurance from a third party. In other words, property insurers do not think they will be able to recover from third parties (whose identity may not even be known), so they calculate the insured's premium on the assumption that no such recovery will be possible.

Sometimes language drafted into the lease is evenhanded and is generally acceptable to both landlords and tenants. However, some waiver of claims provisions and mutual waiver of subrogation provisions contain unacceptable and dangerous language because they deal with matters other than property damage or they do not sufficiently eliminate fault from the allocation of risk. For example, waivers of claims provisions frequently refer to "injury to persons". They are asking the tenant to waive claims for personal injury as well as property damage, even though personal injury is not a risk compensated by the tenant's property insurance. This is unfair to injured persons because it may deprive them of the right to recover damages. Tenants should reject a waiver of claims for personal injury in a lease.<sup>4</sup> Many jurisdictions have statutes or case law that state that such waivers of claims of personal injury are void as against public policy.

Some waivers of subrogation are, unfortunately, not *mutual* waivers. Sometimes landlord-prepared forms require the tenant to waive claims against the landlord, and they require the tenant's insurance carrier to waive its right of subrogation against the landlord; however, they contain no reciprocal landlord agreements for the benefit of the tenant. Some waivers of subrogation provide that the waiver applies only to the extent of *collectible* insurance proceeds. This is a substantial limit on the benefits of the waiver if the party that owns the damaged property has no property insurance or inadequate property insurance (or if it gave the insurance carrier a defense against the payment of insurance proceeds, for example, by making false statements when it procured the insurance).

Thus, the waiver of subrogation should apply to the extent of the other party's property insurance (which should be described and should be adequate to cover possible losses). If, for example, the lease requires the landlord to carry property insurance on a full replacement cost basis, the waiver should apply to the extent of insurance required to be carried, but if the lease does not expressly require the landlord to carry such insurance, the waiver should apply to an amount of proceeds that the landlord would have recovered if so-called "all-risk" (really "Special Form) property insurance were carried on a full replacement cost basis without coinsurance.

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<sup>4</sup> If the tenant is an entity, the waiver by that entity does not bind the employees of that entity who are injured. Even if the tenant is a live person, the waiver for personal injury would affect only that person and not his or her employees. For that reason, Landlord's may require an indemnity, which is discussed below.

Obviously the same principle applies regarding the tenant's insurance. Nearly all leases require the tenant to insure its contents. Not as many require the landlord to insure its property. Appropriate provision should also be made in the event that the party owning the property carries a large deductible or self-insures for a property loss. In that case, to the extent the party self insures, that self-insurance should be deemed to be "insurance" for the purpose of the waiver of claims and of subrogation.

In short, the waiver of claims and the waiver of subrogation should eliminate fault as a factor in connection with the payment for a loss and place the risk on the party that owns the property who is in the position to carry property insurance.<sup>5</sup>

The amounts and kinds of property insurance to be required should vary with the nature of the insured property. The lease should discuss the following matters:

- Contents insurance;
- Property insurance on the Building;
- Proceeds available to rebuild;
- Rent insurance; and
- Other insurance issues.

#### *Contents Insurance*

Optimally, the lease should require the tenant to insure all contents, trade fixtures, machinery, equipment, furniture, and furnishings in the premises on a replacement cost basis under Special Form coverage insurance. "Special Form" coverage insures what used to be known as "all-risk" insurance, which was confusing because it did not really cover all risks, but every risk except for certain excluded risks, which were specified in the policy. In other words, it was not all risk insurance after all.

In a lease that contains waivers of claims and mutual waivers of subrogation rights, the landlord wants this clause to ensure that the tenant has adequate insurance on its own property. If the tenant is actually carrying the required insurance and collects for any insured loss from its own insurance carrier, it has no economic reason to bring an action against the landlord even if the loss arises from the landlord's negligence; meanwhile, the waiver of the right of subrogation protects the landlord from suit by the tenant's insurance carrier.

#### *Property Insurance on the Building*

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<sup>5</sup> The property owner may contract with the other party to carry the property insurance. This occurs when a net lease requires that tenant to purchase the property insurance on the building.

In a multitenant building, the landlord customarily carries the building's property insurance, whereas in a single-tenant building, the tenant sometimes carries the building insurance, naming the landlord as the insured.

When the landlord does carry the insurance in industrial/warehouse buildings, it pays the premium and usually passes all or some of the cost to its tenants. In office buildings and in shopping centers, the cost of building insurance is typically an "operating expense," or a "common area charge" which is passed through, in whole or in part, to the tenants. The building coverage may be broad or narrow; it may include only standard fire and extended coverage insurance, or it may include Special Form coverage. Usually, the landlord insures the entire building, including leasehold improvements. But sometimes the landlord insures only the shell of the building, and the tenant insures its own leasehold improvements. In my judgment, it is better for both parties (and certainly for the landlord's mortgagee) if landlord undertakes to rebuild the entire building to its prior condition, and insures on that basis.

If the tenant is obligated under the lease to repair or restore following damage or destruction of the building (which is not unusual in ground leases and other net leases of a fairly long duration), the lease customarily provides that the proceeds needed for rebuilding will be made available to the tenant. If the tenant is not obligated to rebuild, the lease will generally specify the conditions under which a landlord must do so. It should be noted that in either event, the landlord's mortgage may provide that the lender has the right to apply insurance proceeds to pay down the indebtedness, rather than to make the proceeds available to rebuild.

#### *Proceeds Available to Rebuild*

Unfortunately, this is an area which does not receive much attention until after a fire or other insurable casualty has actually occurred. Leases typically require that the landlord's insurance proceeds be payable to the landlord, subject to a standard mortgage clause in the event that the premises are mortgaged to secure the landlord's indebtedness. The standard mortgage clause requires the insurance company to pay the proceeds to the lender. Whether the lender makes the insurance proceeds available so that the landlord (or the tenant, if so provided in the lease) can rebuild the premises depends on the terms of the mortgage. The first draft of most mortgages provides that if there is a fire or other casualty, the proceeds are to be paid to the lender, who may then apply the proceeds to pay down the loan or to restore the property (it is beyond the scope of this book, but I strongly argue that the lender should, in most cases, be obligated to make the proceeds available to restore, and that should be dealt with when the loan commitment is being negotiated).

If a proposed lease is to be in place before the building is mortgaged, the parties to the lease, and their lawyers, should make sure that the mortgage will provide that the insurance proceeds will be made available to rebuild—provided, of course, that the lease remains in full force and effect. That is easier said than done since the mortgage may not be negotiated until some time after the lease is signed and the lawyers have by then moved on to other deals. In that situation, however, the lawyers should educate their clients so that when the landlord mortgages the property, it will be alert to the issue, and when the tenant is asked to sign a Subordination, Non-Disturbance and Attornment Agreement, it can seek to negotiate a provision in that Agreement to the effect that the proceeds will be made available to rebuild the tenant's premises.

Obviously the tenant may need some economic clout to get such a provision, but that is the only time it may get the relief it requires.

If the mortgage is in place before the lease is signed, the tenant's lawyer should review the mortgage to determine if that document provides for the proceeds to be made available. If it does not, and if again the tenant has sufficient economic clout, it can make the lease conditioned on obtaining a Non-Disturbance Agreement which will require the lender to make the proceeds available to rebuild, subject to customary conditions (such as the landlord's not being in default under the loan documents or there being enough time left in the term of the loan, or the landlord's making up any shortfall in the insurance proceeds). If the protection required by the tenant is not forthcoming, the tenant should seek the right to terminate the lease before any money is spent on construction of the tenant's improvements.

If the lender has not agreed in the loan documents or, as to a particular tenant in a Non-disturbance Agreement, to make the proceeds available to rebuild, and if the landlord cannot obtain such an agreement at the time of a casualty, the landlord should have a right to terminate its tenant leases (otherwise, it would be in default under the leases). However, the tenant may not get a comparable right to terminate.

It is critically important to the landlord that tenants not be able to terminate their leases merely because of a fire or other casualty. If the leases are terminated, the lenders will certainly not make the insurance proceeds available for the rebuilding of the property (and that will no doubt be stated in the loan documents as an exception to the lender's obligation to make them available). The landlord would then be in an untenable position, especially if the building is only partly damaged. In that case, any proceeds that the landlord receives would probably not be enough to pay off the loan, the debt service payment obligation would continue without reduction or abatement, and the landlord would have little or no income from which to service the debt. He would have to go into the mortgage market, possibly in a higher interest rate market, with a half-destroyed building, to borrow funds to pay off the old debt and to rebuild the building so that he could re-lease it on a speculative basis. Of course, the tenant should be able to terminate if the landlord defaults in its obligation to rebuild (or to make the proceeds available to the tenant to rebuild if the tenant is obligated to do the restoration), or if the lender does not make the proceeds available.

### *Rent Insurance*

The party that purchases the property insurance can, for a reasonable additional premium, buy coverage that will pay continuing expenses (like rent and taxes) during the period that the leased premises are untenable (which means unfit for the purpose for which they are leased). If the lease is a net lease in which the rent is not abated, the insurance proceeds will not be paid. If the lease is silent on rent abatement, the tenant's lawyer should find out whether rent insurance proceeds will be paid because the law in most states provides that rent will not abate in that case. In those states rent abates only if the lease expressly provides for abatement. If rent does not abate, either because the lease so provides or because there is no provision in the lease and the law of the state is that it does not, then the insurance company will probably assert that there is no loss to the landlord and accordingly that there should be no proceeds of rent loss insurance. If, however, the rent does abate as a result of the fire or other casualty, the landlord must be certain

that he receives insurance proceeds that will permit him to continue to pay debt service and taxes.

Many leases provide that rent does not abate if the tenant caused the loss. If that is the case, the insurance company may have a defense to paying the proceeds of the rent loss insurance. Such a provision is intended to punish the tenant, but it does not really benefit the landlord. It only benefits the insurance company, which does not have to pay a claim for which it was actually compensated in its premium. If the tenant does not have business interruption insurance (actually called "business income insurance"), the tenant will likely be unable to pay the rent while it is out of business because of the loss. Thus a provision that says rent does not abate if the tenant caused the loss makes no sense at all since it punishes the landlord as well as the tenant, and perhaps even more than the tenant.

### *Business Income Insurance*

If all or a part of the premises are rendered untenable and the lease does not terminate, the tenant may be forced to move out of the premises, move into other premises on a temporary basis, set up its operation and pay rent there, and then move out of the other premises and reoccupy the original leased premises when the repair or restoration is completed. If the rent does not abate, the tenant will continue to have to pay the rent as well. All of that will, of course, involve considerable expense that the tenant may cover business interruption and extra expenses by means of so-called "business income insurance". Most leases are silent about tenants' business income insurance. Tenants may argue, in negotiating for a right to terminate, that moving out and moving back in involves tremendous inconvenience and trauma, but the landlord's response must be that both landlord and tenant suffer from a casualty and that so long as the economic loss can be covered by business income insurance, the tenant should not have a right to terminate the lease. The problem of the retail tenant is more difficult than the problem of other tenants because comparable store premises may simply not be available in the same market. However, tenants can insure against loss of profits.

### *Loss Payable Provision*

Occasionally, when the lease requires the tenant to carry the building property insurance, the tenant may seek to negotiate that insurance proceeds be payable to both parties "as their interest may appear." However, the proceeds of the building property insurance should be payable only to the landlord. After all, the landlord does own the building. If he is having a dispute with the tenant, he does not want to be required to get the tenant's endorsement on the insurance proceeds check. Likewise, the tenant wants to be certain that the landlord's signature is not required on the check for its contents insurance proceeds.

If the tenant is required to rebuild leasehold improvements or alterations, and to insure them separately, it may want to be a payee of the insurance check for those items. On the other hand, the installed leasehold improvements do belong to the landlord, and they are subject to the lien of the landlord's mortgage. In that situation, the tenant's insurance should include a standard mortgage clause. I have serious issues with provisions in leases which require tenants to insure their leasehold improvements and alterations, which will be discussed below.

### *Adjustment of Loss*

It takes considerable time to adjust the loss after a fire or other casualty in a commercial building. The loss may be adjusted by the insurance carrier or by a public adjuster; it may be contested and involve lengthy disputes. Until the adjustment process is almost completed, the party obligated to rebuild does not know the extent of the proceeds available to rebuild and accordingly cannot make binding commitments. Once it can start planning, it must have plans and specifications drawn and find and negotiate with a contractor to perform the work.

Many leases give the party required to rebuild sixty days to accomplish the necessary steps prior to the commencement of the repair or rebuilding. That is an extremely short time for the landlord to adjust the loss, have the reconstruction designed, hire contractors and be prepared to start construction. However tenants, who may be out of business argue for the shortest possible time and that is how it often ends up.

### *Replacement Cost, Actual Cash Value, and Co-insurance*

If someone insures a building for its actual cash value (sometimes referred to as “insurable value”), the insurance proceeds are limited to the building's replacement cost at the time of the loss, minus physical depreciation (usually estimated at one percent for each year of the building's age). Assume that a twenty-year-old building with a replacement cost of \$10 million is insured for that amount on an actual cash value basis and is totally destroyed. The insurance carrier may assert that the physical depreciation is 20 percent or \$2 million and that the net proceeds of the insurance are limited to \$8 million. Obviously this leaves the landlord with less than he needs to rebuild the building.

If, however, the insurance is written on a full replacement cost basis, the insurer makes no deduction for physical depreciation, and the insured is entitled to receive the full cost of replacement (provided the insured has accurately estimated and purchased coverage for the actual replacement cost and subject, of course, to deductibles).

Many policies are written with 100 percent co-insurance clauses. That means that the insurance company pays 100 percent of the loss (assuming, again, that the amount of insurance carried is enough to pay the loss and that the insurance is carried on a replacement cost basis). This is appropriate if the insured has not underestimated the replacement cost. If the insured is carrying less insurance than is required to replace the building, not only would the underinsuring insurance buyer collect less than the building's replacement cost in the case of a total destruction, but he would collect less than the actual cost of repairing in the event of a partial destruction. Here is how it works. If an owner insures the same \$10 million building for \$6 million at 100 percent co-insurance on a replacement cost basis and the building is totally destroyed, the insurance company is obligated to pay only the face amount of the policy. If, however, the loss is a partial rather than a total loss, the insurance company would pay only 60 percent of the actual loss because the owner's insurance was only 60 percent of the replacement cost. The insurance company would pay only \$600,000 of a \$1 million loss, even though that payment is significantly less than the \$6 million face amount of the policy.

An insurance buyer can avoid the co-insurance problem by purchasing a policy with an “agreed amount endorsement”. This endorsement is not a confirmation by the insurance company that the amount of the insurance is adequate. It is merely an agreement by the insurance company that the coinsurance result described above will not apply and that the insurance company will pay 100 percent of any partial loss, provided it is not in excess of the face amount of the policy. Obviously, such an endorsement is important to both parties to a lease.

To reduce the likelihood of underinsurance, it may be appropriate to provide in the lease for a periodic insurance appraisal, which provision should also specify who is obligated to pay for that appraisal.

### *Uninsured Risks*

Although it is possible to insure against most casualty risks, certain risks, such as flood and earthquake, are not covered by Special Form policies. If a property is in a flood-risk area, flood insurance is usually available through an agency of the United States government. Earthquake insurance, on the other hand, may either be unavailable or may be very expensive, even in low-earthquake-risk areas. Unless there is a specific exclusion in the lease, the party obligated under the lease to rebuild following a casualty has contractually obligated himself to rebuild, even in the event of an uninsured casualty. That should certainly be considered in the negotiations.

### *Liability Insurance*

Most liability situations in real estate do not arise because an act by one party to the lease results in damage to property of the other party. Those situations are covered by the waiver of claims and waiver of the right of subrogation discussed above. Liability situations usually arise because some real person is injured or because a third party's property is damaged. Injury or damage can occur within the premises or in a common area. To avoid the risk of not suing the right party, the injured party customarily asserts a claim or files suit against all the persons having an interest in the property. To prevent gaps in insurance coverage that may result in liability being imposed on an uninsured party, the system of requiring insurance naming another party as an additional insured has evolved. Still, because of the substantial problems that may arise if an injury to a person is uninsured, the parties frequently duplicate insurance, especially in a multitenant building.

In a single-occupant building in which the tenant also has the exclusive use and occupancy of the parking lot and the balance of the real estate, the tenant's liability insurance should cover the entire property, and the landlord may decide not to carry liability insurance at all. If the landlord does carry this insurance, its cost probably would be reduced because it would be considered secondary rather than primary coverage. In multi-tenant buildings, landlords should carry liability insurance because injuries occurring in the common areas may not be covered by the tenant's liability insurance unless they result from the tenant's acts. Of course, each party should carry liability insurance covering its own acts off the property.

### *Additional or Named Insured*

Landlords' lease forms customarily require the tenant to carry liability insurance that names the landlord (as well as the landlord's mortgagee) as an additional insured for injuries to persons or damage to property that occur on the premises themselves. This can generally be achieved without the payment of additional premiums, presumably because the tenant has exclusive control of the premises and because if negligence is involved, it will be the tenant's rather than the landlord's. Thus, if a person is injured on or about the premises, the tenant's liability insurance will respond to that loss, whether it is caused by the landlord or the tenant.

“Additional insured” should not be confused with “named insured”. While there is some question (due to judicial decisions) about the scope of the coverage for the landlord if it is included in the tenant's policy as an “additional insured”, it is clear that if the landlord is a “named insured” it is actually one of the parties that is covered by the insurance provided for in the policy. While the landlord who is a named insured is jointly liable with the tenant for the payment of the premium, the lease will provide that the tenant must pay for the coverage. Most tenants strongly object to including Landlord as a “named insured”, particularly tenants that have policies covering more than one location. Still, it is sometimes agreed to in single tenant buildings because the tenant will not have to pay for its own liability insurance and for a separate policy for the landlord's.

#### *Insurance Limits*

Leases customarily specify the amount of liability insurance that the tenant must carry. The required amounts have increased over the years. Given the phenomenon of rising judgments, at some point during the term of a long or extended lease, the specified amount may prove inadequate. A well-drafted lease, therefore, gives the landlord the right, on notice, to require the tenant to increase the liability insurance limits if, in the landlord's reasonable judgment, the specified amount is insufficient to protect the various parties. This requirement protects the tenant as well as the landlord, although it does place the decision in the landlord's hands, to which the tenant or its lawyer may object. An alternative is to relate required amounts of liability insurance to amounts customarily carried in the geographic area. It is not wise to tie increases in liability insurance coverage to increases in the Consumer Price Index because changes in that index are not necessarily related to increases in judgment amounts.

#### *Combined Single Limit per Occurrence/Aggregate*

Liability insurance used to be written with separate amounts for personal injury to one person, for personal injury to more than one person in one occurrence, and for property damage. Now liability insurance is written on the basis of a combined single limit per occurrence and aggregate. This means that there is one limit for the sum of all claims, demands, or actions that arise in a single occurrence, whether those claims, demands, or actions arise out of personal injury or property damage.

The word "aggregate" that the insurance companies tack on to the end of the policy description means that they will not pay more than the aggregate limit in any one policy year. For example, a policy may be written with a \$1 million occurrence limit and a \$2 million aggregate. If there were three losses of \$800,000 each during the policy year, the insurance company would pay only \$400,000 toward the third loss. It is possible to obtain an endorsement that speci-

fies that "aggregate" shall apply separately to each location owned or rented by the tenant. It is obviously in the interest of both landlord and tenant to obtain such an endorsement whenever the tenant has more than one location, so that no risk is left uncovered.

### *Occurrence and Claims-Made Coverage*

Yet another wrinkle arises from time to time in connection with liability policies. A change in general liability coverage has been imported by the insurance industry from products liability and malpractice coverage. Although it is not common, liability coverage occasionally is written on a claims-made rather than on an occurrence basis. In the occurrence basis situation, a claim is covered if the loss occurred while the policy was in effect, even if the claim is made after the policy expires. A claims-made policy provides coverage only for claims made while the policy is in effect even if the events on which the claims are based occurred before the particular policy was purchased. Liability insurance written on a claims-made rather than on an occurrence basis can cause gaps in coverage. Assume, for example, that someone is injured on the premises during the last year of the lease term. The tenant moves out at the end of the term and does not continue to maintain claims made liability insurance because it is going out of business.<sup>6</sup> The injured party sues the landlord and tenant after the lease term ends. The tenant's liability insurance no longer covers the loss because the claim was made after the term of the insurance expired. Unfortunately, in this situation, the landlord's problem would not be solved by a provision in the lease requiring the tenant to continue to carry liability insurance on a claims-made basis after the lease has expired. Even if the tenant remains in business, there is no efficient way for the landlord to police or to enforce that obligation.

Most tenants who carry insurance on a claims-made basis are large companies that own or lease numerous properties. Although such large companies are likely to remain in business and to continue to carry insurance on a claims-made basis until after the statute-of-limitation period shall have expired to cover incidents that occurred during the lease term, the landlord has no assurance that this will be the case. The only way a landlord can adequately protect itself in this situation is to carry its own liability insurance. There is, obviously, a cost in doing that, and landlords expect tenants to bear the cost. It is doubtful that tenants would agree.

### *Indemnity*

Another way for parties to a lease to protect themselves from liability for injuries to persons or damage to property is by the use of indemnities. Leases typically require tenant indemnities to protect the landlord. Liability insurance policies usually contain "contractual liability" language. That means the policy covers liability assumed by the tenant under the lease for injury to persons or damage to the property of others, provided the assumption of liability occurs before the injury or damage. An indemnity, unlike the insurance, is not usually limited in amount; thus, the tenant is assuming liability to pay a judgment against the landlord that might be greater than the coverage required in the lease or the amount of the tenant's actual liability insurance limits (if greater than what the lease requires). Indemnities frequently cover more than

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<sup>6</sup> If the tenant is continuing in business elsewhere, it will most likely be continuing the insurance coverage, which is fine, unless the tenant switches to occurrence insurance; going out of business is the major risk for landlords.

liability claims. They may relate to claims for damages arising out of the failure of the tenant to perform other obligations of the tenant under the lease. Insurance would not cover those other claims.

Although tenants frequently request that the indemnity exclude losses arising from the landlord's negligent or willful act, this does not seem appropriate if the tenant's liability insurance names the landlord as an additional insured or if the indemnity is covered by the contractual liability provision in the tenant's policy. On the other hand, it seems reasonable that if the landlord's negligence or willful act causes a loss that exceeds the amount of liability insurance, the landlord, and not the tenant, should be responsible for the excess over the insurance coverage.

Tenants frequently request that landlords indemnify them against the landlord's acts. Landlords confront several problems in giving indemnities that are as broad as the indemnities that they require from tenants. A landlord should not indemnify a tenant against events that the tenant, but not the landlord, is required to be insured against; a landlord that does agree to such an indemnity could assume liability for which it has no liability insurance coverage. Any landlord's indemnity should carefully exclude liability arising on the premises or for losses caused by the tenant. Essentially, this means that if the landlord is insuring the common areas, the landlord can indemnify the tenant (and obtain contractual liability insurance coverage for such indemnity) for the landlord's acts relative to the common areas.

Other Issues:

#### *Goods Owned By Third Parties*

Landlords that lease premises to users who store or sell products belonging to third parties, such as public warehouses, third party logistics companies, warehouses used by common carriers, or retail tenants that accept goods on consignment have special problems. The waiver of claims by the tenant does not protect the landlord from liability for damages to goods owned by third parties caused by the landlord's negligence. The value of those goods may well exceed the liability insurance carried by the landlord, especially since the landlord has no way of knowing the value in the first place, so the landlord has no practical way to protect itself. A warehouse operator or the retailer who accepts consignment merchandise can put in its contract a limitation of its liability, but that does not benefit the landlord. The landlord can insist on an indemnity from the tenant (and adequate insurance), but that is expensive and may not be agreeable to the tenant. I can offer no easy solution to this problem, but lawyers for both the landlord and the tenant should be aware of it; not many lawyers are.<sup>7</sup>

#### *Tenant Improvements and Alterations*

Many leases require the tenant to insure its alterations in the premises, and some require the tenant to insure the initial tenant improvements. In my judgment, this is not appropriate. The landlord should, and usually does, insure the building as improved. It is, most likely, required to do so in its mortgage because the lender does not want to have to chase a number of tenants to

get the insurance proceeds so it can systematically make them available, to rebuild. The tenant is paying for the landlord's property insurance, either in its base rent or in additional rent. If, in addition, it is required to carry property insurance on its alterations or leasehold improvements, it is paying twice for the same insurance, which is in neither party's interest.

Sometimes, in representing tenants, I get the "Taj Mahal" argument. Why, it questions, should all the tenants pay if a particular tenant spends an enormous sum to improve its space? There are two answers to that. Unless it is the major tenant, the cost of the insurance will probably not increase that much. If there is a substantial increase in the cost of the insurance, however, the landlord should (and will usually) require the tenant to pay that increase as a condition to consenting to the improvement. Since most tenants will not ordinarily negotiate to share in the benefit of other tenants paying a greater share of the landlord's insurance cost, the landlord will, in all probability not reduce the other tenants' share of the cost of insurance, so the landlord may double dip (keeping the excess for itself). In any case, that is an unusual occurrence.

### *Self-Insurance*

Many financially strong tenants seek the right to self-insure. This is certainly understandable since the net worth of those companies may exceed that of some insurance carriers and those tenants may consider the insurance an unnecessary expense. In the alternative, those tenants may seek the right to carry insurance with very large deductibles, and thus insure only catastrophic risks.

Tenants' self-insurance creates risks for landlords. First, what if the strong tenant assigns the lease to a weak one? The right to self-insure should not pass to the assignee. Second, what if the strong tenant suddenly becomes a weak one, as happened so often during the recession during which once mighty General Motors sought bankruptcy reorganization and a government bail-out? The right should end if the tenant does not maintain a certain tangible net worth.<sup>8</sup> Third, the landlord was counting on the tenant's property insurance to give effect to the waiver of claims and the waiver of the right of subrogation; how does the landlord protect itself against suits for negligent damage to the tenant's property? The lease should specifically provide that the self-insurance is deemed to be insurance for the purpose of those waivers.

### *Summing up.*

I have used a lot of space in this book and spent a lot of your time on insurance related issues. What you have learned here will, I believe, be very useful in your profession. I caution you, however. There is still much I have not covered and the insurance business, like the real estate business is not static. What is called Special Form today may well have another name tomorrow, or even by the time you are reading this book. It is a good idea to befriend a good insurance agent, whose brain you may pick for information and advice. That is how I learned about insurance. The same advice would apply to any number of experts in other fields that impact leasing.

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<sup>8</sup> I prefer using "tangible net worth" to plain old "net worth", which might include good will or other intangibles which do not have ready market value.

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# ALLOCATION OF INSURABLE RISKS IN COMMERCIAL LEASES

Sidney G. Saltz\*

*Editors' Synopsis: This Article examines the allocation of insurable risks in commercial leases between a landlord and tenant as well as third parties. Specifically, Part I of the Article proposes a new approach that places the risks on an insurance carrier, and Part II focuses on how a landlord can avoid liability to a third party for damage caused by the landlord. The Article includes several sample lease forms that provide language to accommodate these situations.*

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### INTRODUCTION

Parties to commercial leases customarily include numerous provisions seeking to allocate, as between them, the risks of injury to persons or damage to property<sup>1</sup>. Commercial leases also require insurance to cover these risks, but unfortunately, the drafters of many leases have followed an historical approach to risk allocation (adopting and revising language in earlier leases) rather than an analytical approach (determining the most commercially reasonable way to allocate risks). The purpose of this Article is to examine the allocation of insurable risks in commercial leases in two situations. Part I deals with allocation of risks as between the landlord and the tenant, including the risk of loss of the property owned by each party. Part I proposes a new approach under which the risks are placed, to a commercially reasonable extent, on the insurance carrier who is paid a premium to assume those risks. Part II of this Article deals with the situation in which personal property in the leased premises belongs to a third party, and focuses primarily on how the landlord can avoid liability to the third party for damage to its property caused by the landlord.

#### PART I: ALLOCATION OF RISKS AS BETWEEN LANDLORD AND TENANT

##### A. The Role of Fault

Scattered throughout the typical lease are provisions dealing with insurance requirements and risks that may be covered by insurance. Because most lease forms are written by landlords, a person examining a

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<sup>1</sup> For a general description of insurance in commercial leases, see generally, Sidney G. Saltz, *The Treatment of Insurable Risks in Commercial Leases*, REAL ESTATE REVIEW, Winter 1989, at 56.

lease can expect to find that the tenant is required to carry substantial insurance and bear numerous risks, including those created by the tenant or its employees, and many created by other persons, who may or may not include the landlord. In seeking to evaluate a tenant's risks, the tenant's attorney or insurance agent must be prepared to review sections of the lease that specify the types and amounts of insurance the tenant must carry, whether the risk pertains to liability or property damage, and the sections pertaining to indemnity, waiver of claims, fire, alterations, and waiver of subrogation.

The assumption underlying all these sections is that the law will impose responsibility for damage to third parties, or damage to the property of either party to the lease, based on which of the parties is at fault; that assumption is not unreasonable, considering the application of tort law to such events. Not satisfied with the allocation of risk based entirely on fault, landlords frequently attempt to avoid liability or to shift to the tenant responsibility for losses caused by the landlord. Landlords seek to avoid liability by a waiver of claims provision in the lease, and seek to shift liability by including an indemnity provision from the tenant.

The situation is complicated in several jurisdictions, which have statutes or case law stating that exculpation of landlords from their negligence or other tortious acts is against public policy, and thus unenforceable.<sup>2</sup> Some courts have gone further and have vitiated indemnity provisions on the same ground.<sup>3</sup> As a result of this legal doctrine, many "waiver of claims" sections in leases are being changed to exclude the landlord's negligence, or to limit the waiver to the extent

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<sup>2</sup> See William K. Jones, *Private Revision of Public Standards: Exculpatory Agreements in Leases*, 63 N.Y.U. L. REV. 717 (1988) (declaring that there is a strong argument for holding unlawful exculpatory clauses in residential leases); compare *Madigan Bros., Inc. v. Melrose Shopping Ctr. Co.*, 556 N.E.2d 730 (Ill. App. Ct. 1990) (applying Illinois statute, 765 ILL. COMP. STAT. 705/1-1 (1996), in tort but not in contract) with *Econ. Mech. Indus. v. T.J. Higgins Co.*, 689 N.E.2d 199, 202 (Ill. App. Ct. 1997) (rejecting the *Madigan Bros.* distinction between tort and contract as producing unjustifiably inconsistent results); *Penn Ave. Place Assocs. v. Century Steel Erectors, Inc.*, 767 A.2d 1120 (Pa. Super. Ct. 2000) (confirming that mutual waivers of subrogation in a standard construction-industry contract are enforceable and do not violate public policy); and Harris Ominsky, *Waivers of Subrogation are Enforceable*, 2 E-DIRT 3 (Spring 2001), at <http://www.abanet.org/rppt/publications/edirt/2001spring/article3.html> (asserting that mutual waivers of subrogation in standard construction industry contracts are enforceable and do not violate public policy).

<sup>3</sup> See, e.g., *McMinn v. Cavanaugh*, 532 N.E.2d 343, 356-57 (Ill. App. Ct. 1988) (finding that Illinois statute prohibiting lease exculpatory provisions implies a prohibition against certain lease indemnification provisions); *Econ. Mech. Indus.*, 689 N.E.2d at 202.

permitted by law. The effect skews the landlord's intended shifting of responsibility from the landlord to the tenant, which of course, has pleased tenants.

#### B. The Genesis of an Idea

An oasis in the desert of fault and imposition of responsibility on tenants is known as the "mutual waiver of subrogation."<sup>4</sup> Actually, that phrase is a shortened version of a larger concept that deals with the waiver by each party of its right of action for property damage resulting from the tort of the other party, and the exclusion of the right of an insurer, after payment of insurance proceeds following such damage, to recover from the tortfeasor.

For a more extensive description of the underlying concept, take the example of a tenant's negligence causing a fire in the leased building that results in material damage to the landlord's property. Under basic common law principles, the landlord has a cause of action against the tenant for those damages. If the landlord recovers insurance proceeds covering the cost of repairing the damage, the insurance carrier succeeds to the landlord's cause of action and can sue the tenant for the cost of repair paid out of the insurance proceeds. The insurance carrier's right to make the landlord's claim against the negligent tenant is known as the "right of subrogation."<sup>5</sup> The same principle applies if the landlord's fault causes damage to the tenant's trade fixtures, inventory, or other personal property, and the tenant collects insurance proceeds to replace the same.<sup>6</sup>

From an economic point of view, the common law approach to handling losses based on fault makes no sense. To protect itself from possible liability for property damage to a large building in which the premises may be located, each tenant in the building would need to carry

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<sup>4</sup> See *Commercial Union Ins. Co. v. Bituminous Cas. Corp.*, 851 F.2d 98, 100 (3d Cir. 1988) (holding waiver of subrogation effective in construction contract); *Loctite VSI Inc. v. Chemfab N.Y. Inc.*, 701 N.Y.S. 2d 723, 724-25, (N.Y. App. Div. 2000) (finding plaintiff's "subrogation" complaint against defendant was inappropriate as lease agreement between parties contained express waiver of a subrogation clause in the context of plaintiff's obligation to obtain fire insurance); *Am. Risk Funding Ins. Co. v. Lambert*, 59 S.W.3d 254, 257 (Tex. App. 2001) (finding that waiver of subrogation was not void in a contract that provided the intervener would waive subrogation rights, and that waiver violated neither public policy nor any express law).

<sup>5</sup> See *Standard Marine Ins. Co. v. Scottish Metro. Assurance Co.*, 283 U.S. 284, 287 (1931); *Hartford Fire Ins. Co. v. Chicago, Milwaukee, & St. Paul Ry. Co.*, 175 U.S. 91, 92-93 (1899).

<sup>6</sup> See, e.g., *Int'l Ins. Co. v. Med.-Prof'l Bldg.*, 405 S.W.2d 867, 869 (Tex. App. 1966).

massive amounts of liability insurance. At the same time, the tenants are paying for the landlord's property insurance as part of their rent or as additional rent. Similarly, a landlord whose tenant has expensive personal property would need to carry substantial liability insurance to protect against claims by its tenants or their insurers. Consequently, most leases contain a provision known as the mutual waiver of subrogation.<sup>7</sup>

Actually, the name of the provision is somewhat misleading. Under the mutual waiver of subrogation provision, each party waives any claims against the other based on insured or insurable property damage to the waiving party (these provisions vary, but a discussion of the variations is beyond the scope of this Article). The inclusion of this provision in the lease defeats the insurer's right of subrogation because no claim exists to which the insurer has a right to succeed.<sup>8</sup> On the other hand, the waiver of claims by the insured may negate the coverage, and most leases provide that the waiver is invalid if its effect is to negate the insurance coverage. However, the negation of coverage is not usually the case. Most insurance policies contain a clause stating that the waiver of claims by the insured prior to the occurrence of the loss will not invalidate or negate the insurance coverage.<sup>9</sup> This clause is the actual waiver of subrogation. Insurance companies are willing to waive their right to subrogation<sup>10</sup> because their pricing of insurance premiums is accomplished without anticipating recovery of insurance proceeds from the party at fault—who may be unascertainable or without the resources to pay a judgment.

Thus, a waiver of subrogation provision should contain both a waiver of claims and a requirement that the insurance policy of the waiving party provide for an effective waiver of subrogation. The provision creates a no-fault effect in a situation in which a claim might otherwise arise based on property damage. But remember the public policy dictating that a waiver

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<sup>7</sup> Some leases have waivers of subrogation protecting the landlord only, but these unilateral waivers are relatively rare, and mutuality can generally be negotiated.

<sup>8</sup> See *Int'l Ins. Co.*, 405 S.W.2d at 869; see also *Gen. Cigar Co. v. Lancaster Leaf Tobacco Co.*, 323 F. Supp. 931, 935 (D. Md. 1971).

<sup>9</sup> See 1 MILTON R. FRIEDMAN, *FRIEDMAN ON LEASES* § 9.9 at 591-92, nn. 69-71 and accompanying text (4th ed. 1997).

<sup>10</sup> See ISO Commercial Risk Services, Inc., *Commercial General Liability Coverage Form, Commercial Property Conditions, CP00 90 07 88*, § 1 at 2 (1987), or other updated versions of the same. ("If any person or organization to or for whom we make payment under this Coverage Part has rights to recover damages from another, those rights are transferred to us to the extent of our payment. That person or organization must do everything necessary to secure our rights and must do nothing after loss to impair them. *But you may waive your rights against another party in writing. . . .*") (emphasis added).

by a tenant of claims based on the landlord's tort cannot be enforced? How does that policy square with the tenant's waiver of claims against the landlord which is contained in the waiver of subrogation section? The answer is that it might not,<sup>11</sup> but it does not much matter so long as the insurance company pays the claims, and not the tenant.

### C. Germination of the Idea

Under a waiver of subrogation provision, the parties to the lease transfer risk of physical loss to the property to the insurance carrier, rather than require the party at fault to bear the loss. Why could that principle not be applied to other risks insurable at a commercially reasonable cost and typically insured by landlords and tenants? The main additional risks to be considered are those relating to injury to persons, including the landlord and the tenant themselves, or damage to the property of third persons.

The public policy prohibiting the waiver of the landlord's fault likely arose primarily from concern about the landlord physically injuring the tenant and claiming that the tenant waived or released the claim against the landlord for such injury, leaving the injured party with no recourse. In addition, the perceived inequality of bargaining power between landlords and tenants may have been a factor in creating that public policy.<sup>12</sup> In either case, if risks of injury are covered by insurance and a properly drafted lease requires that the damages and expenses arising from the insured event be paid out of insurance proceeds, does that not make more sense than reverting to fault—a concept more in tune with retribution than with compensating people for their losses? If the sections in a commercial lease concerning required insurance and responsibility for insurable losses were drafted in terms of allocation of risks rather than fault, would that not pass muster with the guardians of public policy?

Still, eliminating fault entirely is not possible. As this Article will demonstrate, the allocation of risks is tied primarily to the types of insurance available to each party at commercially reasonable rates; the purpose is not to eliminate fault totally. The intent is to deal with the economics of the situation. By that measure, if tying liability to fault for one party and not for the other is appropriate, then fault should not be eliminated in that situation. Although the elimination of the liability of

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<sup>11</sup> *But see* Ominsky, *supra* note 2; Penn Ave. Place Assocs., 767 A.2d at 1124.

<sup>12</sup> I am not convinced that anyone takes seriously the argument that possible liability increases the degree of care exerted by landlords of commercial premises; the rationale may be more appropriate for residential leases. *See infra* note 43.

each party is not totally mutual, the concept, taken as a whole, is fair and equitable, as experience in negotiating leases with this language has shown.

The results of all these ruminations are set forth in two forms following this Article, entitled "Risk Allocation and Insurance." The first—Form 1—is for use in multi-tenant lease situations and accordingly, is more commonly used. Form 2 is for use in the single-tenant, net lease situation, in which there is no common area and the tenant purchases all the liability and property insurance for the premises.<sup>13</sup> An analysis of these forms is appropriate.

#### D. Drafting the Concept – The Introductory Rationalization

The first requirement in drafting a Risk Allocation and Insurance Form is to include language that immediately informs the reader of the purpose of the parties which, to reiterate, is to allocate certain risks to insurance carriers. Thus, Forms 1 and 2 begin with the following language:

The parties desire, to the extent permitted by law, to allocate certain risks of personal injury, bodily injury or property damage, and risks of loss of real or personal property by reason of fire, explosion or other casualty, and to provide for the responsibility for insuring those risks. It is the intent of the parties that, to the extent any event is insured for or required herein to be insured for, any loss, cost, damage or expense arising from such event, including, without limitation, the expense of defense against claims or suits, be covered by insurance, without regard to the fault of Tenant, its partners, shareholders, members, managers, directors, officers, employees or agents (the "Tenant Protected Parties"), and without regard to the fault of Landlord, its beneficiaries (if Landlord is a land trust), Agent, their respective partners, shareholders, members, managers, directors, officers, employees and agents (the "Landlord Protected Parties"). As between the Landlord Protected Parties and the Tenant Protected Parties, such risks are allocated as follows . . . ."<sup>14</sup>

The reader will note that the quoted language contains the immediate qualifier, "to the extent permitted by law." This phrase recognizes the possible application of the underlying public policy issue discussed

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<sup>13</sup> In many net lease situations, the landlord insures the building, and in those cases, a hybrid of the two forms may be required.

<sup>14</sup> *Infra* Form 1 at 499 and Form 2 at 503.

above.<sup>15</sup> This qualifier allows a court to reincorporate the concept of fault into the lease, without negating the entire allocation of risk concept.

Form 1 then contains four subsections that allocate risks for injury or damage to third parties, and for property damage suffered by the parties to the lease. Each subsection cross-references subsequent subsections in Form 1, which detail the insurance each party is required to carry.

#### E. Allocation of Risks—Liability to Third Parties

A comparison of subsections (a) and (b) of Form 1 shows an apparent disparity. Subsection (a) places all risk on the tenant for injuries that occur on or about the leased premises, regardless of who is at fault, whereas in subsection (b), the landlord's assumption of risk is limited to injuries in the common areas caused by the wrongful act or omission of the landlord. While fault liability enters the lease here, the purpose is not to create a double standard between the landlord and the tenant. Rather, the inclusion of fault liability is dictated by the type of insurance obtainable by each party at commercially reasonable rates. The tenant can ordinarily insure against any liability that arises on or about the premises, regardless of who is at fault. However, the landlord will find it difficult and expensive to insure against injuries occurring in the premises of the various tenants or injuries occurring in the common areas by persons other than the landlord. A description of the liability insurance required by each party in that situation is provided for later in Form 1, but is cross-referenced in the allocation-of-risks section.

Another exception to the no-fault aspect of the forms is the "Notwithstanding" language at the end of the allocation-of-risks section.<sup>16</sup> This language provides that if the liability exceeds the amount of the coverage required to be carried, or such greater coverage as is actually carried, the excess liability is to be paid by the party at fault. This language is important for several reasons. First, fairness dictates that the tenant not be required to indemnify the landlord for the landlord's wrongful acts except to the extent that the tenant's insurance covers the indemnity. Second, the language is consistent with the underlying purpose of the public policy—that the tenant not pay for the landlord's tortious conduct. Finally, language placing the risk of liability because of the landlord's fault on the tenant (beyond the tenant's insurance against this risk) would not be consistent with the goal of allocating risks based on the insurance carried

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<sup>15</sup> See *supra* notes 2-3 and accompanying text.

<sup>16</sup> See *infra* Form 1 at 499 and Form 2 at 503.

by each party.

### 1. Liability Insurance Requirements

In Form 1, the tenant is required to insure the “Tenant Protected Parties,”<sup>17</sup> and to insure the “Landlord Protected Parties,”<sup>18</sup> as a “named insured.” The acts of the named insured are covered by the insurance policy.<sup>19</sup> A named insured is contrasted with an “additional insured,” who is only insured and to be defended against the acts of the named insured. In other words, if the landlord is an additional insured and the tenant alone is at fault, a landlord sued in connection with the event would be defended under the tenant’s policy. In the unlikely event of a judgment against the landlord when the landlord is not at fault, the tenant’s insurer would pay the judgment. If the landlord is adjudged at fault, its liability would not be covered as a mere additional insured.<sup>20</sup>

In the single-tenant building situation, the tenant may add the landlord as a named insured without difficulty. In the multi-tenant building situation, the tenant may not be able or willing to provide that insurance. Accordingly, Form 1 provides that if the tenant is unable to have the landlord designated as a named insured, the tenant is required to indemnify the landlord against any claims, including those arising from the landlord’s fault, but only “to the extent of the amount of the insurance required to be carried under this [subsection] or such greater amount of insurance as is actually carried.”<sup>21</sup> The indemnity is then required to be insured under a standard provision in the tenant’s liability policy, which insures against risks assumed by contract—the so-called “contractual liability clause.”<sup>22</sup> Thus, the indemnity is fully covered by the insurance carried by the tenant, customarily without additional cost.

In other respects, the insurance requirements are similar to those that might be required in a more customary lease, although most leases, being

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<sup>17</sup> See *infra* Form 1 at 499.

<sup>18</sup> See *infra* Form 1 at 499.

<sup>19</sup> The named insured is also liable for the premium, but the tenant is required under the lease to bear the cost of the insurance.

<sup>20</sup> Incidentally, an “additional named insured” does not exist. That phrase, which is seen in many leases, reflects an inadequate understanding of insurance terms.

<sup>21</sup> *Infra* Form 1 at 500.

<sup>22</sup> See ISO Commercial Risk Services, Inc., Commercial General Liability Coverage Form, Commercial General Liability, CG00 01 07 98, § I(2)(b) at 1 (1997), or other updated versions of the same. (“This exclusion does not apply to liability for damages . . . [a]ssumed in a contract or agreement that is an ‘insured contract,’ . . .”) Section V(9)(a) reads “Insured contract means: A contract for a lease of premises.”

drafted by landlords, do not require the landlord to carry insurance at all. Form 2 does not require the landlord to carry insurance for the reasons outlined above. Form 1 does require the landlord to carry liability insurance, but of course, the tenant pays for the insurance as part of its rent or as additional rent. As noted above, the insurance the landlord must carry is more limited than the tenant's insurance. The landlord must insure against liabilities arising from, related to, or connected with, the real estate "other than premises leased to tenants."<sup>23</sup> In other words, the landlord is insuring only against events that occur in the common areas of the property. It is not necessary to state in the lease that the insurance covers only the landlord's acts, because the landlord cannot purchase insurance covering the acts of third parties, and the allocation-of-risks section limits the landlord's liability to the wrongful acts or omissions of the Landlord Protected Parties.

Nonetheless, the landlord can still insure against liability arising in the various tenants' premises from a tort of the landlord. In fact, most landlords do carry such insurance for their own protection, in the event the tenant defaults on its obligation to carry the insurance, or the tenant's company proves insolvent. So why does the landlord seek to have the tenant insure the landlord's torts, when the landlord is insuring itself? Isn't a major purpose of the allocation of risks the avoidance of duplication of coverage and duplication of expense?

Actually, the tenant carries that insurance and bears that risk for a good reason. The event causing the liability is often unclear. Does a person fall in the premises because the landlord's cleaning service used a slippery polish, or because the tenant's employee dropped toner on the floor? If the landlord's fault is not covered by the tenant's insurance, each party would have its own insurance carrier providing the defense, and each would accuse the other of being at fault. The tenant's insurer defending both parties avoids the dispute between carriers and between the parties themselves.

Many large tenant companies self-insure liability, or carry large deductibles, which they fund out of a self-insurance plan or simply pay out of their general revenues. These companies have a strong (and legitimate) complaint about assuming the risk of the landlord's fault. After all, they are not looking to an insurance carrier to pay the claim; they are paying it themselves. In that situation, departing from the above requirements may be appropriate. The same circumstances may exist in the single-tenant

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<sup>23</sup> *Infra* Form 1 at 501.

building, but in that case, the landlord may not carry liability insurance. After all, the landlord may have no responsibility for maintenance and repair of the property; it may be a mere “coupon clipper.”<sup>24</sup> In that scenario, the landlord may purchase “building owner’s coverage” to protect itself from liability. This coverage is no less expensive than ordinary liability insurance, but the landlord may require the tenant to pay for it. Self-insurance will be discussed further below.

### 2. *Allocation of Risks—Property Damage to the Property of a Party to the Lease*

Subsections (c) and (d) in section x.1 of Form 1 deal with property damage risks covered by the property insurance of the parties to the lease.<sup>25</sup> Using “bear the risk” language, these subsections are the equivalent of the waiver of claims provisions in a typical mutual waiver of subrogation. The actual waiver of subrogation requirement is handled in a later section. In Form 2, all property damage risks are borne by the tenant, because the tenant is insuring both the building and its contents.<sup>26</sup>

A lease that requires the tenant to bear the risk of loss to the contents of the premises may have unexpected consequences if the contents are not actually owned by the tenant. This situation arises in the case of goods held by the tenant on consignment, the public warehouse situation, and what is becoming increasingly important with purchases over the Internet— “third party logistics” or “3PL.” Forms 1 and 2 require the tenant to insure personal property of third parties in the leased premises that is within the tenant’s care, custody, or control.<sup>27</sup> This requirement may offer comfort to the landlord if the presence of this personal property is incidental to the tenant’s use of the leased premises. This type of insurance actually may not afford the landlord adequate protection if third parties’ personal property constitutes a major portion of the contents of the leased premises. Additional protection is required and is the subject of Part II of this Article.

### 3. *Property Insurance Requirements*

The tenant must insure the contents of the leased premises, on the form

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<sup>24</sup> A so-called “net and bond lease” is one under which the landlord simply collects rent and services its debt.

<sup>25</sup> See *infra* Form 1 at 499.

<sup>26</sup> See *infra* Form 2 at 503.

<sup>27</sup> See *infra* Form 1 at 501 and Form 2 at 505.

known as a "Special Form," which is colloquially known as "all risk" insurance coverage. This form covers all risks of physical loss, subject only to specified exclusions.<sup>28</sup> The tenant is not required in Form 1 to insure its alterations. Each form also requires the tenant to obtain a waiver of the right of subrogation from its insurer.

Form 1 requires the landlord to insure the building.<sup>29</sup> Again, the insurance should be written on the Special Form,<sup>30</sup> covering at least ninety percent of the replacement cost, with an agreed endorsement amount that waives co-insurance. The tenant pays the premium as part of its rent or additional rent. There is no exclusion for the tenant's alterations; the landlord must insure "the improvements situated on the Real Estate."<sup>31</sup> Requiring the tenant to insure its alterations would involve double costs to the tenant because in all probability, the landlord is insuring the improvements "as they stand" and is most likely required to do so by its mortgagee. To require the tenant to pay for the landlord's insurance, as part of its rent or additional rent, and also to require the tenant to carry property insurance covering its alterations, is an unnecessary double expense to the tenant. Form 1 also requires the landlord to carry business income (rent loss) insurance and flood insurance, if required.<sup>32</sup>

Form 2 requires the tenant to carry the property insurance on the building, which is particularly appropriate if the tenant has the responsibility to rebuild after a fire.<sup>33</sup> The effect is to place on the tenant the risk of inadequate insurance coverage. The tenant is also required to carry insurance to pay the rent and other charges in the event of a loss.<sup>34</sup> In each form, the party carrying the property insurance is required to obtain a waiver of the right of subrogation from its insurer.

#### F. Self-Insurance

As noted above, many large companies self-insure risks of loss to others caused by their negligence and property damage to their own

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<sup>28</sup> See ISO Commercial Risk Services, Inc., Causes of Loss-Special Form, Commercial Property, CP10 30 06 95 (1994), or other updated versions of the same. Terrorism has recently been added as an exclusion.

<sup>29</sup> See *infra* Form 1 at 501.

<sup>30</sup> ISO Commercial Risk Services, Inc., Building and Personal Property Coverage Form, Commercial Property, CP00 10 06 95 (1994), or other updated versions of the same.

<sup>31</sup> See *infra* Form 1 at 502.

<sup>32</sup> See *infra* Form 1 at 503.

<sup>33</sup> See *infra* Form 2 at 504.

<sup>34</sup> See *infra* Form 2 at 505.

property. Self-insurance is a method by which companies deal with risks without recourse, or with reduced recourse, to insurance otherwise available from commercial insurance underwriters. Because self-insurance departs from the structure proposed in this Article, a digression to deal with this concept is appropriate.

Self-insurance plans frequently involve large deductibles. For example, a company may self-insure the first five million dollars of an occurrence and purchase insurance for losses in excess of five million dollars. Companies can create reserve funds to deal with future payouts or they can simply deal with payouts from current assets or revenue.

Self-insurance (or a large deductible) causes several special problems for the landlord. First, if the tenant is not carrying property insurance, the landlord will want to formulate language in the lease that will still give it the benefit of the waiver by the tenant of claims for property damage caused by the landlord. The costs of the landlord's negligence is not transferred to an insurance company, but to the tenant itself.

One possible way to satisfy the landlord's desire to transfer the cost and also satisfy the public policy concerns, is to provide that self-insurance of the tenant's property damage risks will be deemed the equivalent of insurance for the purpose of allocating the risk of property damage caused by the landlord's fault. The principle may be stated as follows: "Said self-insurance shall not be deemed to transfer or alter the allocation of risks set forth in Section X hereof." On the other hand, the tenant may not want to pay for the consequences of the landlord's negligence and may insist that risks that would have been covered by the tenant's insurance if the tenant were not self-insuring, be allocated based on fault.

Another issue that arises in connection with self-insurance, especially in regard to general liability exposure, is the possible change in the financial capacity of the tenant to self-insure. A landlord can deal with that contingency by inserting in the lease minimum net worth or credit requirements that the tenant must maintain for it to have the right to self-insure. A problem may arise if the tenant assigns the lease or subleases the premises. If the tenant does not remain an occupant of the premises, then it is most likely that the new occupant's acts, not the tenant's will give rise to a claim, and the landlord will look to the new occupant's insurance to recover. The landlord's concern here is that the assignee or subtenant not have the benefit of the right to self-insure unless that party has the financial capacity to do so. Therefore, the landlord should specify in the lease that the right to self-insure is personal to the named tenant, and cannot be succeeded to by an assignee or successor occupant unless certain financial

or net worth requirements are met.

In many cases, the landlord may be leasing the premises to a subsidiary of a large company. The parent may self-insure on its own behalf and on behalf of the proposed tenant, but the parent may not be willing to guarantee the obligations of its subsidiary under the lease. The effect on the landlord is that its tenant is requesting the right to self-insure but does not have the credit to self-insure. The best way for the landlord to deal with this issue is to request that the parent agree to guarantee the tenant's allocation-of-risks obligations, so long as the tenant is relying on the self-insurance of the parent to cover the risks allocated to the tenant in the allocation-of-risks section of the lease. If the parent company does not agree to this guaranty, then the landlord is essentially renting space to a tenant who does not carry insurance and does not have the financial resources to self-insure. An alternative, but risky resolution is to provide in the lease that the tenant may self-insure, but only so long as the tenant is a subsidiary of the parent, the parent has a specified minimum credit, and the parent's plan of self-insurance covers the acts or omissions and the property of the tenant. Of course, the landlord has very little capacity to police continuing compliance with the various conditions.

#### G. Conclusion to Part I

Forms 1 and 2 have been in use in substantially the same format for many years. Many lawyers raise questions about the forms and how they exculpate the landlord from responsibility for fault. Once the purpose has been explained, however, the concept has been accepted almost universally. Even risk management personnel in large companies have been persuaded to accept the idea—no mean feat.

What, again, is the purpose of exculpating a landlord from responsibility for damages caused by the fault of the landlord? The purpose is to transfer the risk of certain insurable losses to an insurance carrier who is paid a premium to assume that risk, thereby avoiding, as much as practical, the duplication of cost by both the landlord and the tenant, and reducing future disputes between the parties as to the cause of events or conditions causing injury to third persons or property. Experience has proven that these goals are accomplished by Forms 1 and 2.

**PART II: LIABILITY AND INSURANCE EFFECTS OF THE  
STORAGE OR HANDLING BY A TENANT OF GOODS OWNED  
BY PERSONS OTHER THAN THE TENANT**

A. The Problem

In most lease situations, the tenant occupies the space for the purpose of conducting business with the furniture, fixtures, equipment, and merchandise or other goods that it owns. Thus, a tenant leasing warehouse space will warehouse merchandise that it owns and expects to sell in connection with its business; a retail tenant will generally own its inventory; and an office tenant will own its furniture, fixtures, and equipment. If any property of third persons is located in the premises, its presence is occasional and incidental.

However, tenants may also often lease space for the primary purpose of selling, storing, and shipping goods owned by third parties. For example, an art gallery or a store selling antique jewelry may offer for sale goods it holds on consignment; a tenant operating a public warehouse will certainly be storing goods owned by third parties; or a company engaged in the cartage business will move goods through its warehouse and shipping rooms which are owned by the shippers or the consignees. In this time of e-commerce, many shippers of goods use what is called third party logistics or 3PL, to handle, store, and ship merchandise.<sup>35</sup> The operators of 3PL facilities may be tenants and not owners of their properties, and are thus analogous to public warehousemen.<sup>36</sup> In all these situations, special insurance considerations arise that are not frequently considered by landlords or tenants.

B. Usual Allocation of Risk of Property Damage Caused by Landlord's Fault

This subject matter is covered extensively in Part I. To recap briefly, the risk of loss of a tenant's goods because of fire or other casualty caused by the fault of the landlord is covered by the tenant's contents insurance and also by the landlord's property damage liability insurance. In nearly all leases, the parties attempt to allocate risk of loss or damage to their

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<sup>35</sup> See generally International Warehouse Logistics Association, at <http://www.warehouselogistics.org/home.asp> (last visited Oct. 25, 2002) (the International Warehouse Logistics Association sets standards and legal frameworks for acceptable practices in the warehouse logistics industry).

<sup>36</sup> See *id.*

property by including provisions dealing with waivers of claims and waivers of subrogation rights, or by providing for an allocation of risks as suggested in Part I. In any case, the purpose of these provisions is to shift the cost of loss of property resulting from a fire or other insured casualty to the insurance company, regardless of the party at fault.

### C. The Problem

The waiver of claims and waiver of subrogation rights provisions contained in leases, and the allocation-of-risks provisions described in Part I are obviously bilateral contractual undertakings by the parties to a lease. A problem can arise when a landlord leases premises to a tenant who intends to use it primarily to sell, store, or ship goods belonging to other parties. Because the third parties owning the goods are not parties to the lease, they are not bound by the waiver of claims, waiver of subrogation rights, or the allocation-of-risk provisions in the lease. The third parties, called bailors<sup>37</sup> or consignors,<sup>38</sup> have the rights at common law of any party whose goods are damaged by the tortious act of a third party, such as the landlord. The bailors or consignors have the right to sue the third party tortfeasor and recover their damages. Even if the bailors or consignors insure their goods, their insurer would be subrogated to their claim against the landlord. If the tenant is actually a "warehouseman," as defined in the Uniform Commercial Code,<sup>39</sup> it may limit its liability for loss or damage by providing for this limitation in the warehouse receipt or storage agreement. The landlord, however, is not a warehouseman under that definition and does not, in any case, have a contract with a bailor. As a result, the landlord has no way to effectively limit its liability to a bailor.

If the landlord's tortious acts cause goods owned by a bailor to be damaged or destroyed, the landlord's liability insurance covers that risk, but several problems exist. First, the value of the bailor's damaged property may exceed by many multiples the amount of the landlord's liability insurance. Second, in some situations, such as a net lease for an entire building, it is not unusual for a landlord's tort liability to be insured against in a policy purchased by a tenant, in which the landlord is named as

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<sup>37</sup> A bailor is "[t]he party who bails or delivers goods to another . . . in the contract of bailment." BLACK'S LAW DICTIONARY 142 (6th ed. 1990) (emphasis omitted).

<sup>38</sup> A consignor is "a shipper of goods," or "the person from whom the goods have been received for shipment." U.C.C. § 7-102(c) (1991). BLACK'S LAW DICTIONARY 307 (6th ed. 1990).

<sup>39</sup> A warehouseman is "a person engaged in the business of storing goods for hire." U.C.C. § 7-102(1)(h) (1991).

an insured. In this case, the landlord may be subject to an exclusion in the liability insurance policy for property in the tenant's care, custody, or control, unless the liability policy names the landlord as the "named insured with respect to the building."<sup>40</sup> The absence of identifying the landlord as a named insured, which is a technical defect, may result in the landlord not being insured for the loss of that property at all. Instead, the landlord may be forced to rely solely upon the tenant's policy language insuring contractual liability relative to any tenant's indemnity of the landlord.

We are left with an anomaly. The warehouseman accepting the goods and profiting from their storage, care, or shipment is permitted by statute to enter into an agreement limiting its liability. In fact, the warehouseman enters into this type of contract every time it accepts goods. On the other hand, the landlord who receives its profit solely in the form of rent for the use of the premises, and receives only limited and indirect benefits from the storage or shipment of the goods, is not in the same position to limit its liability. Further, once the warehouseman effectively limits its liability, it can cover that limited liability with "warehouseman's legal liability" insurance. Even if the tenant is permitted to name the landlord as an additional insured on the warehouseman's legal liability insurance, the proceeds from that policy are limited to the liability of the warehouseman and would not afford the landlord the full additional protection it needs under the circumstances.

#### D. Possible Solutions

I have developed a four-fold approach to attempt to solve the various problems raised in Part II of this Article. First, the tenant must provide in its liability insurance that the Landlord Protected Parties are named as the "named insured with respect to the building;" if the landlord is a named insured, the policy defense based on the exclusion for goods in the care, custody, or control of the insured would not apply because the goods are not in the care, custody, or control of the landlord. Second, the tenant must carry warehouseman's legal liability insurance and name the landlord as an additional insured. Third, the tenant who sells, stores, or ships goods owned by third parties must place in its warehouse receipts or consignment agreements a provision requiring the bailor, rather than the tenant, to insure the goods in the same manner as the tenant is required to insure its own

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<sup>40</sup> See ISO Commercial Risk Services, Inc., Commercial General Liability Coverage Form, Commercial General Liability, CG00 01 07 98 (1997).

personal property under the lease, and to obtain a waiver of subrogation rights from its insurer. Fourth, the tenant must indemnify the landlord against any liabilities to persons not party to the lease, that are imposed or sought to be imposed against the landlord for using the premises as a public warehouse or 3PL facility, or for the sale of consigned goods. Of course, the tenant is obligated to insure the indemnity. Suggested language regarding the four “solutions” is attached in Form 3.<sup>41</sup>

Each of these “solutions” raises problems, some legal and some practical. The first “solution” assumes that the tenant already has adequate liability insurance, because it merely overcomes a liability insurance policy defense.

The second “solution,” which requires the tenant to carry warehouseman’s legal liability insurance, also offers little help. The tenant may or may not be able to obtain this insurance to cover the landlord because the landlord is not really the warehouseman. If it does cover the landlord, it probably does not cover the full value of the goods, but only the amount that the bailee has agreed to accept as liability in its warehouse receipt or consignment agreement. Finally, naming the landlord as an additional insured does not provide coverage for the landlord’s acts.

The requirement of special language in warehouse receipts or consignment agreements, the third “solution,” is also problematic. How does the landlord police the actual inclusion of this provision in each document? Even if the provision is included in the tenant’s printed form of warehouse receipt or consignment agreement, it might be stricken in any given instance, particularly if the property stored is especially valuable. It is an administrative nightmare. The failure to include the provision may create a breach of the lease, but that does not protect the landlord from substantial claims if the tenant has a limited net worth.

The fourth “solution” affords the landlord the most protection, but raises two questions. First, is the tenant’s indemnification of the landlord against the landlord’s own negligence really enforceable? The law tends to frown upon agreements under which parties can escape the consequences of their wrongful act.<sup>42</sup> The concern is that if a party can transfer the

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<sup>41</sup> See *infra* Form 3 at 507.

<sup>42</sup> See *Schuster v. Plaza Pacific Equities, Inc.*, 588 F. Supp. 61, 64 (N.D. Ga. 1984) (finding contract provision immunizing landlord from liability for his own negligence is void as against public policy); *Cox v. Lumbermens Mutual Casualty Co.*, 439 N.E.2d 126, 129 (Ill. App. Ct. 1982) (holding indemnity provision in construction contract reduces motivation to lessen danger and is therefore void); *Pellegrino v. Walker Theatre, Inc.*, 511 N.Y.S.2d 372, 374 (N.Y. App. Div. 1987) (stating owner and tenant not allowed to escape

liability for its negligence, it will not exercise the degree of care that it would otherwise use.<sup>43</sup> While the result may vary from state to state, an agreement to indemnify a landlord for loss or damage resulting from the landlord's own fault, which is a very specific agreement that clearly evidences the intention of the parties, offers the best hope of being sustained. For that reason, I have provided the following language in Form 3, which serves as the introduction to the various other provisions dealing with the problems described herein:

It is understood that all or a part of the Leased Premises will be used for the storage and shipment of goods not owned by Tenant and that Landlord is unwilling to enter into this Lease unless adequate provision is made to protect the Landlord Protected Parties (as defined in this lease) against claims by the owner or the owners of such goods for damage to the same arising out of acts or omissions of the Landlord Protected Parties or any of them. In order to assure such protection against liability and as a material inducement to Landlord to enter into a lease with Tenant who will use all or a part of the Leased Premises for the sale, storage and/or shipment of goods not owned by Tenant, Tenant hereby agrees as follows. . . .<sup>44</sup>

However, covering the loss by indemnity does not dispose of the risk for the landlord. The indemnity is only as good as the insurance that backs it or, if the insurance is not available or adequate, the credit of the tenant. If a tenant agrees to such an indemnity, but has no net worth and only one million dollars of contractual liability insurance coverage, then the indemnity is only worth one million dollars. What if the tenant then accepts for storage a museum collection of artifacts, the landlord's janitor causes a fire, and the bailor has inadequate insurance or its insurance carrier seeks to enforce its rights of subrogation? In that situation, the landlord is protected only to the extent of the tenant's insurance coverage, the tenant's limited net worth, and the landlord's own insurance. The indemnity language in the attached forms reads in part: "Tenant agrees that at all times during which it shall, in the Leased Premises, store or ship

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liability for their own negligence because of New York law). A few jurisdictions (California, Georgia, Illinois, Florida, Massachusetts, Maryland, and New York) have adopted statutes limiting or prohibiting an indemnification against one's own negligence.

<sup>43</sup> If that rationale were really sensible, would not the purchase of insurance, which spreads the risk of carelessness among all policy holders, be against public policy?

<sup>44</sup> See *infra* Form 3 at 507.

goods not owned by it, it shall insure the risk undertaken by it pursuant to subsection (d) in a manner reasonably satisfactory to Landlord.”<sup>45</sup>

Admittedly, this language is extremely vague, especially because the parties to the lease may never have a firm understanding of the value of the goods stored from time to time. However, the language offers a starting point for a discussion of the issues.

There is a fifth “solution,” not listed above, which may be a useful alternative. The solution requires the landlord to carry excess liability or “umbrella” liability insurance covering the value of the materials to be stored from time to time in the premises. This necessitates having some estimate of the value of the goods, which may vary greatly, depending on what is stored. This solution has the same disadvantage as “solution” four, but it has one great advantage—it puts the landlord in charge of its own destiny. The landlord can evaluate the risk and carry enough insurance to protect itself against that risk. If the landlord’s bargaining power is sufficient, it can even require the tenant to bear the cost of the additional insurance as additional rent. This result seems fair because the tenant’s business is causing the additional expense.

#### E. Conclusion to Part II

Decisions on behalf of landlords and tenants in situations of 3PL, public warehouses, trans-shippers or retail consignment must be made on a lease-by-lease basis, depending on the credit of the tenant and other relevant factors. There is no easy or fool-proof solution to the problem which, although a serious one, seems to have received very little attention.

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<sup>45</sup> See *infra* Form 3 at 507.

**Form 1****RISK ALLOCATION AND INSURANCE**

**x.1 Allocation of Risks.** The parties desire, to the extent permitted by law, to allocate certain risks of personal injury, bodily injury or property damage, and risks of loss of real or personal property by reason of fire, explosion or other casualty, and to provide for the responsibility for insuring those risks. It is the intent of the parties that, to the extent any event is insured for or required herein to be insured for, any loss, cost, damage or expense arising from such event, including, without limitation, the expense of defense against claims or suits, be covered by insurance, without regard to the fault of Tenant, its partners, shareholders, members, managers, directors, officers, employees or agents (the "Tenant Protected Parties"), and without regard to the fault of Landlord, its beneficiaries (if Landlord is a land trust), Agent, their respective partners, shareholders, members, managers, directors, officers, employees and agents (the "Landlord Protected Parties"). As between the Landlord Protected Parties and the Tenant Protected Parties, such risks are allocated as follows:

- (a) Tenant shall bear the risk of bodily injury, personal injury or death, or damage to property of third persons occasioned by events occurring on or about the Leased Premises, regardless of the party at fault. Said risks shall be insured as provided in Section x.2(a).
- (b) Landlord shall bear the risk of bodily injury, personal injury, or death or damage to the property of third persons occasioned by events occurring on or about the Real Estate (other than premises leased to tenants), provided such event is occasioned by the wrongful act or omission of any of Landlord Protected Parties. Said risk shall be insured against as provided in Section x.3(a).
- (c) Tenant shall bear the risk of damage to the contents, trade fixtures, machinery, equipment, furniture and furnishings in the Leased Premises arising out of loss by the events required to be insured against pursuant to Section x.2(b).
- (d) Landlord shall bear the risk of damage to the building on the Real Estate arising out of loss by events required to be insured against pursuant to Section x.3(b).

Notwithstanding the foregoing, provided the party required to carry insurance under Section x.2(a) or Section x.3(a) hereof does not default in its obligation to do so, if and to the extent that any loss occasioned by any event of the type described in Section x.1(a) or Section x.1(b) exceeds the coverage or the amount of insurance required to be carried under said

Sections or such greater coverage or amount of insurance as is actually carried, or results from an event not required to be insured against or not actually insured against, the party at fault shall pay the amount not actually covered.

**x.2 Tenant's Insurance.** Tenant shall procure and maintain policies of insurance, at its own cost and expense, insuring:

- (a) The Landlord Protected Parties (as "named insureds"), and Landlord's mortgagee, if any, of which Tenant is given written notice, and the Tenant Protected Parties, from all claims, demands or actions made by or on behalf of any person or persons, firm or corporation and arising from, related to or connected with the Leased Premises, for bodily injury to or personal injury to or death of any person, or more than one (1) person, or for damage to property, in an amount of not less than three million dollars combined single limit per occurrence/aggregate. Said insurance shall be written on an "occurrence" basis and not on a "claims made" basis. If at any time during the Term, Tenant owns or rents more than one location, the policy shall contain an endorsement to the effect that the aggregate limit in the policy shall apply separately to each location owned or rented by Tenant. Landlord shall have the right, exercisable by giving written notice thereof to Tenant, to require Tenant to increase such limit if, in Landlord's reasonable judgment, the amount thereof is insufficient to protect the Landlord Protected Parties and the Tenant Protected Parties from judgments which might result from such claims, demands or actions. If Tenant is unable, despite reasonable efforts in good faith, to cause its liability insurer to insure the Landlord Protected Parties as "named insureds," Tenant shall nevertheless cause the Landlord Protected Parties to be insured as "additional insureds" and in such event, Tenant will protect, indemnify and save harmless the Landlord Protected Parties from and against any and all liabilities, obligations, claims, damages, penalties, causes of action, costs and expenses (including, without limitation, reasonable attorneys' fees and expenses) imposed upon or incurred by or asserted against the Landlord Protected Parties, or any of them, by reason of any bodily injury to or personal injury to or death of any person or more than one person or for damage to property, occurring on or about the Leased Premises, caused by any party including, without limitation, any Landlord Protected Party, to the extent of the amount of the insurance required to be carried under

this Section x.2(a) or such greater amount of insurance as is actually carried. Tenant shall cause its liability insurance to include contractual liability coverage fully covering the indemnity hereinabove set forth.

- (b) All contents and trade fixtures, machinery, equipment, furniture and furnishings in the Leased Premises, including contents which are the property of third parties but which are in the care, custody or control of Tenant, to the extent of at least ninety percent (90%) of their replacement cost under Standard Fire and Extended Coverage Policy and all other risks of direct physical loss as insured against under Special Form (“all risk” coverage). Said insurance shall contain an endorsement waiving the insurer’s right of subrogation against any Landlord Protected Party, provided that such waiver of the right of subrogation shall not be operative in any case where the effect thereof is to invalidate such insurance coverage or increase the cost thereof. Tenant shall promptly give Landlord written notice thereof. Landlord shall have the right, within thirty (30) days following such written notice, to pay any increased cost, thereby keeping such waiver in full force and effect.
- (c) The Tenant Protected Parties from all worker’s compensation claims.
- (d) Landlord and Tenant against breakage of all plate glass utilized in the improvements on the Leased Premises.

**x.3 Landlord’s Insurance.** Landlord shall procure and maintain policies of insurance insuring:

- (a) All claims, demands or actions made by or on behalf of any person or persons, firm or corporation and arising from, related to or connected with the Real Estate, other than premises leased to tenants, for bodily injury to or personal injury to or death of any person, or more than one (1) person, or for damage to property in an amount of not less than three million dollars combined single limit per occurrence/aggregate. Said insurance shall be written on an “occurrence” basis and not on a “claims made” basis. If at any time during the Term, Landlord owns more than one location, the policy shall contain an endorsement to the effect that the aggregate limit in the policy shall apply separately to each location owned by Landlord.
- (b) The improvements at any time situated upon the Real Estate against loss or damage by fire, lightning, wind storm, hail storm,

aircraft, vehicles, smoke, explosion, riot or civil commotion as provided by the Standard Fire and Extended Coverage Policy and all other risks of direct physical loss as insured against under Special Form ("all risk" coverage). The insurance coverage shall be for not less than ninety percent (90%) of the full replacement cost of such improvements with agreed amount endorsement. Landlord shall be named as the insured and all proceeds of insurance shall be payable to Landlord. Said insurance shall contain an endorsement waiving the insurer's right of subrogation against any Tenant Protected Party, provided that such waiver of the right of subrogation shall not be operative in any case where the effect thereof is to invalidate such insurance coverage or increase the cost thereof. Landlord shall promptly give Tenant written notice thereof and Tenant shall have the right, within thirty (30) days following such written notice, to pay any increased cost, thereby keeping such waiver in full force and effect.

- (c) Landlord's business income, protecting Landlord from loss of rents and other charges during the period while the Leased Premises are untenable due to fire or other casualty (for the period reasonably determined by Landlord).
- (d) Flood or earthquake insurance whenever, in the reasonable judgment of Landlord, such protection is necessary and it is available at commercially reasonable cost.

**x.4 Form of Insurance.** All of the aforesaid insurance shall be in responsible companies. As to Tenant's insurance, the insurer and the form, substance and amount (where not stated above) shall be satisfactory from time to time to Landlord and any mortgagee of Landlord, and shall unconditionally provide that it is not subject to cancellation or nonrenewal except after at least thirty (30) days' prior written notice to Landlord and any mortgagee of Landlord. Originals of Tenant's insurance policies (or certificates thereof satisfactory to Landlord), together with satisfactory evidence of payment of the premiums thereon, shall be deposited with Agent at the Commencement Date and renewals thereof not less than thirty (30) days prior to the end of the term of such coverage.

**Form 2****RISK ALLOCATION AND INSURANCE**

**x.1 Allocation of Risks.** The parties desire, to the extent permitted by law, to allocate certain risks of personal injury, bodily injury or property damage, and risks of loss of real or personal property by reason of fire, explosion or other casualty, and to provide for the responsibility for insuring those risks. It is the intent of the parties that, to the extent any event is insured for or required herein to be insured for, any loss, cost, damage or expense arising from such event, including, without limitation, the expense of defense against claims or suits, be paid out of insurance, without regard to the fault of Tenant, its partners, shareholders, members, managers, directors, officers, employees or agents (the "Tenant Protected Parties"), and without regard to the fault of Landlord, its beneficiaries (if Landlord is a land trust), Agent, their respective partners, shareholders, members, managers, directors, officers, employees and agents (the "Landlord Protected Parties"). As between the Landlord Protected Parties and the Tenant Protected Parties, such risks are allocated as follows:

- (a) Tenant shall bear the risk of bodily injury, personal injury or death, or damage to the property, of third persons, occasioned by events occurring on or about the Leased Premises, regardless of the party at fault. Said risks shall be insured as provided in Section x.2(a).
- (b) Tenant shall bear the risk of damage to the improvements on the Leased Premises and to the contents, trade fixtures, machinery, equipment, furniture and furnishings in the Leased Premises arising out of loss by the events required to be insured against pursuant to Sections x.2(b), (d), (e) and (g).

Notwithstanding the foregoing, provided Tenant does not default in its obligation to carry insurance under Section x.1, if and to the extent that any loss occasioned by any event of the type described in Section x.1(a) exceeds the coverage or the amount of insurance required to be carried under said Section or such greater coverage or amount of insurance as is actually carried, or results from an event not required to be insured against or not actually insured against, the party at fault shall pay the amount not actually covered.

**x.2 Tenant's Insurance.** Tenant shall procure and maintain policies of insurance, at its own cost and expense, insuring:

- (a) The Landlord Protected Parties (as "named insureds"), and Landlord's mortgagee, if any, of which Tenant is given written notice, and the Tenant Protected Parties, from all claims, demands

or actions made by or on behalf of any person or persons, firm or corporation and arising from, related to or connected with the Leased Premises, for bodily injury to or personal injury to or death of any person, or more than one (1) person, or for damage to property in an amount of not less than three million dollars combined single limit per occurrence/aggregate. Said insurance shall be written on an "occurrence" basis and not on a "claims made" basis. If at any time during the term of this Lease, Tenant owns or rents more than one location, the policy shall contain an endorsement to the effect that the aggregate limit in the policy shall apply separately to each location owned or rented by Tenant. Landlord shall have the right, exercisable by giving written notice thereof to Tenant, to require Tenant to increase such limit if, in Landlord's reasonable judgment, the amount thereof is insufficient to protect the Landlord Protected Parties and the Tenant Protected Parties from judgments which might result from such claims, demands or actions.

- (b) The improvements at any time situated upon the Leased Premises against loss or damage by fire, lightning, wind storm, hail storm, aircraft, vehicles, smoke, explosion, riot or civil commotion as provided by the Standard Fire and Extended Coverage Policy and all other risks of direct physical loss as insured against under Special Form ("all risk" coverage). The insurance coverage shall be for not less than one hundred percent (100%) of the full replacement cost of such improvements with agreed amount endorsement, and building ordinance coverage, all subject only to such deductibles as Landlord shall reasonably approve in writing. The full replacement cost of improvements shall be designated annually by Landlord, in the good faith exercise of Landlord's judgment. In the event that Tenant does not agree with Landlord's designation, Tenant shall have the right to submit the matter to an insurance appraiser reasonably selected by Landlord and paid for by Tenant. The insurance appraiser shall submit a written report of his appraisal and if said report discloses that the improvements are not insured as therein required, Tenant shall promptly obtain the insurance required. Landlord shall be named as the insured and all proceeds of insurance shall be payable to Landlord. Said insurance shall contain an endorsement waiving the insurer's right of subrogation against any Landlord Protected Party or any Tenant Protected Party, provided that such waiver of the right of subroga-

tion shall not be operative in any case where the effect thereof is to invalidate such insurance coverage or increase the cost thereof. Tenant shall promptly give Landlord written notice thereof and either party shall have the right, within thirty (30) days following such written notice, to pay any increased cost, thereby keeping such waiver in full force and effect.

- (c) Business income, providing funds for the payment of rents and other charges during the period while the Leased Premises are untenable due to fire or other casualty (for the period reasonably determined by Landlord).
- (d) Flood or earthquake insurance whenever, in the reasonable judgment of Landlord, such protection is necessary and it is available at commercially reasonable cost.
- (e) All contents and trade fixtures, machinery, equipment, furniture and furnishings in the Leased Premises, including contents which are the property of third parties but which are in the care, custody or control of Tenant, to the extent of one hundred percent (100%) of their replacement cost under Standard Fire and Extended Coverage Policy and all other risks of direct physical loss as insured against under Special Form ("all risk" coverage). Said insurance shall contain an endorsement waiving the insurer's right of subrogation against any Landlord Protected Party, provided that such waiver of the right of subrogation shall not be operative in any case where the effect thereof is to invalidate such insurance coverage or increase the cost thereof. Tenant shall promptly give Landlord written notice thereof and Landlord shall have the right, within thirty (30) days following written notice, to pay such increased cost, thereby keeping such waiver in full force and effect.
- (f) Tenant Protected Parties from all worker's compensation claims.
- (g) Landlord and Tenant against breakage of all plate glass utilized in the improvements on the Leased Premises.

**x.3 Form of Insurance.** All of the aforesaid insurance shall be in responsible companies. The insurer and the form, substance and amount (where not stated above) shall be satisfactory from time to time to Landlord and any mortgagee of Landlord, and shall unconditionally provide that it is not subject to cancellation or nonrenewal except after at least thirty (30) days' prior written notice to Landlord and any mortgagee of Landlord. Originals of Tenant's insurance policies (or certificates thereof satisfactory to Landlord), together with satisfactory evidence of payment of the

premiums thereon, shall be deposited with Agent at the Commencement Date, and renewals thereof not less than thirty (30) days prior to the end of the term of such coverage.

**Form 3****GOODS BELONGING TO THIRD PARTIES**

**Goods Belonging to Third Parties.** It is understood that all or a part of the Leased Premises will be used for the storage and shipment of goods not owned by Tenant and that Landlord is unwilling to enter into this Lease unless adequate provision is made to protect the Landlord Protected Parties (as defined in this Lease) against claims by the owner or the owners of such goods for damage to the same arising out of acts or omissions of the Landlord Protected Parties or any of them. In order to assure such protection against liability and as a material inducement to Landlord to enter into a lease with Tenant who will use all or a part of the Leased Premises for the sale, storage and/or shipment of goods not owned by Tenant, Tenant hereby agrees as follows:

- (a) The liability insurance carried by Tenant shall name the Landlord Protected Parties as the “named insureds” with respect to the Building.
- (b) In addition to the insurance otherwise required of Tenant in this Lease, Tenant shall procure and maintain, at its own cost and expense, policies of insurance insuring the Landlord Protected Parties and Tenant for warehousemen’s or carriers’ legal liability to the extent of the value of goods (other than goods which are the property of Tenant) stored in the Leased Premises.
- (c) Tenant agrees that its warehouse receipt, bill of lading, consignment agreement or other agreement with persons depositing goods with Tenant for storage or shipment will require such persons to insure those goods substantially in the same manner as Tenant is required hereunder to insure its own personal property in the Leased Premises.
- (d) Tenant will protect, indemnify and save harmless the Landlord Protected Parties from and against any and all liabilities to persons not party to this Lease imposed against them by reason of the use of the Leased Premises or part thereof for the storage and shipment of goods not belonging to Tenant, notwithstanding the fact that such liabilities were caused by acts or omissions of any one or more of the Landlord Protected Parties. Tenant agrees that at all times during which it shall, in the Leased Premises, store or ship goods not owned by it, it shall insure the risk undertaken by it pursuant to this Subsection (d) in a manner reasonably satisfactory to Landlord.