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So you thought you had the right insurance.

People and Property: Insurance Clauses Revisited

Emanuel B. Halper



AT 2:15 P.M. ON FRIDAY, March 14, I was strapping myself to the seat of an airplane that was about to leave Mobile, Alabama, en route to Atlanta. To say the least, I was sick of traveling and physically weary. I usually like to read or write when I fly, but I was so exhausted that I could do nothing but feel sorry for myself. The last few days it seemed as if I were constantly rushing, by various modes of transportation, from meeting to meeting.

You will recall from the previous episodes of this saga that it all started on Wednesday, March 12 in New York. I had tried to be in two places at the same time and failed. First, presidential adviser Dean Mitchell Halderlich had invited me to a posh political banquet at 8:00 P.M. in New York. But I had to catch a 9:30 P.M.

flight to Atlanta and thence to a yacht in Howe's Bayou, Louisiana, because my most demanding client, real estate developer Harry Paine, wanted me at his side as he negotiated the fire insurance and destruction clauses in a package deal of twenty small-store shopping center leases.

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When I arrived in Atlanta, I learned that Harry had postponed his trip and I arrived in Howe's Bayou alone. After spending a colorful day negotiating with Ken O'Hara, president of Kineahora Oriental Imports, while a Dixieland band played and beautiful models cavorted nearby, I resolved most of the problems of the lease. Then Harry arrived. He sent me home into the teeth of a massive snowstorm that was approaching the Northeast. Could I beat the storm home?

Part of my physical discomfort was caused by my load of two large bags containing three changes of clothes. I always take a lot of stuff with me when I travel, and the multiple meetings and climates of this trip mandated an unusually large assortment.



The flight from Mobile to Atlanta ended uneventfully. I was in Atlanta's mammoth airport once again. I was still trying to beat the storm, and I found a seat on a flight of another airline that was scheduled to leave in only fifteen minutes. Unfortunately, the departure gate for that flight was on the other side of the airport.

You should have *seen* me trying to wheel my formidable load of luggage through the airport. You would have laughed. You should have *been* me. You would have cried.

I sprinted the last few hundred feet to the departure gate. Fortunately, the plane was still there. I figured that I had beaten the system and would certainly beat the beginning of the snowfall by many hours. I knew I had challenged destiny and won, so I relaxed.

My neighbors were friendly and chatty. Their names were Sally, Joe, Willy, and Carole. They had boarded the plane in central Florida and were returning from a month-long vacation. Amused by the huge mound of luggage that I was carrying, Joe and Willy began to tease me.

Joe: "How long have you been away, a couple of years?"

I: "Nope, only a couple of days."

Willy: "You must'ov bin huntin' elephants."

I: "Nope, but I was surrounded by an alligator and a bunch of politicians."

Willy: "Only refugees and trinket salesmen carry so much luggage. What do you do in real life?"

I: "I'm a hired gun for an aggressive millionaire—I sell protection."

Carole: "You sell protection? Who's gonna protect you?"

I: "From what?"

Carole: "From getting a hernia!"

All four erupted in convulsive laughter as I found myself tongue-tied and spent the moment licking my wound. I excused myself and began work on a memo on insurance clauses I had promised to put together for Harry Paine and Ken O'Hara. Here's a copy of the memo for you.

THE MEMO

Although insurance can be carried to protect against the consequences of most catastrophes, shopping center owners have customarily carried insurance against only a limited group of potential hazards. This memo is not a guide to all insurance needed by a shopping center owner and tenant. It deals only with insurance as it affects the duties of landlords and tenants under a shopping center lease.

FIRE INSURANCE WITH EXTENDED COVERAGE ENDORSEMENT

It is standard practice for most shopping center owners and net lessees to carry a fire insurance policy with an *extended coverage* endorsement. An *extended coverage* endorsement increases the coverage of a fire insurance policy by providing insurance against a group of additional potential catastrophes (other than fire). The additional potential catastrophes (or perils) usually are damage arising from windstorm, hail, explosion, riot, riot attending a strike and civil commotion; and damage caused by aircraft, vehicles, and smoke.

Property owners who limit their property insurance to a fire policy with an extended coverage endorsement ignore the possibility that the property can be destroyed by causes other than fire or the extended coverage items. Extended coverage doesn't insure the property owner against everything.

Insurance companies like to collect premiums and don't like to pay claims. (Who can blame them?) To this end, they interpret the provisions of their policies as narrowly as they can. If you file a claim for damage

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caused by hail, the insurance company might inform you that the natural phenomenon you thought was hail was really sleet. There *is* a distinction—at least I think there is, but the average shopping center developer can't understand it.

Although an extended coverage endorsement provides insurance against damage from explosions, not every explosion is covered. The following types of explosions and explosion-like catastrophes are customarily excluded.

- Explosions of steam boilers, steam turbines, or steam engines owned, operated, or controlled by the insured.
- Ruptured or bursting pipes.
- Rupture or bursting due to expansion or swelling of contents of a building caused by water.
- Rupture, bursting, or operation of pressure relief devices.

You may want coverage against damage to your property from aircraft, so you carry an extended coverage endorsement to get it. But what do you have? Extended coverage endorsements don't cover losses caused by sonic boom. The only loss from aircraft that an insurance company will voluntarily compensate you for is a loss that arises when the airplane itself or an object from the plane plops on your building.

Many potential catastrophes that are not covered by an extended coverage endorsement can wipe out an entire shopping center and all of the merchandise in it. How does a developer best protect himself against these risks?

COVERAGE AGAINST SPECIFIC ADDITIONAL PERILS

First, let's explore the idea of buying additional coverage against *specific* risks with which you may be especially concerned.

Sonic Shock Wave Endorsement

If you were upset to learn that the extended coverage endorsement does not extend the protection of a fire policy to damage caused by sonic boom, you can find relief by buying another endorsement. There's an endorsement to deal with damage caused by sonic boom itself, and it won't cost you a fortune.

Vandalism and Malicious Mischief Endorsement

Vandalism and malicious mischief coverage is usually considered important and is required by many mortgages and leases. But extended coverage endorsements don't provide insurance against vandalism and malicious mischief. If you want this protection, you need an additional endorsement or a different policy.

Unfortunately, you probably get less from these endorsements than you think you get, and you can expect a fight from many insurance companies if the cause of your loss doesn't fit squarely into their definition of vandalism and malicious mischief. Some insurance companies take the position that vandalism involves damage to works of art—something that few shopping centers can legitimately claim to be.

As for malicious mischief, some insurance companies will reject your claim for loss if the damage is caused by a willful act but without malicious intent. You can press your claim in court (without any guarantee of success from me).

Not all losses resulting from malicious acts are covered either. Burglary is usually considered a malicious act. But many acts of burglary are excluded from malicious mischief coverage. Vandalism and malicious mischief endorsements cover only the damage to the building caused by burglars when they enter and leave. Then again, many insurance companies won't pay off voluntarily on a vandalism and malicious mischief endorsement for a claim based on damage to a wall caused when a burglar forcibly removes a built-in appliance from the wall or other equipment attached to the wall. Moreover, vandalism and malicious mischief endorsements contain an exception for damage to plate glass.

When you add up the coverage you don't get from a vandalism and malicious mischief endorsement because of the exclusions from coverage, you may decide to save some money by passing up this endorsement. On the other hand, I wouldn't discontinue this coverage thoughtlessly. Shortly after you cancel, a thrill-seeking mob may attack the walls of your building with mallets and crowbars.

Sprinkler Leakage Endorsement

Sprinkler systems are often installed as part of a program to qualify buildings for lower insurance premium rates. But because of human error or mechanical failure, something other than a fire may set off the sprinkler mechanism. Not only merchandise in a store building but the building itself may be damaged by the sprinkler leak. Be forewarned that the damage is not usually covered by an extended coverage endorsement.

Consequently, sprinkler leakage endorsements insure against losses from a sprinkler system—any sprinkler system—yours or the one in an adjacent building.

Sprinkler systems consist of many elements, including sprinkler heads, pipes, valves, fittings, and pumps. Coverage extends to each of the elements. Water tanks and fire protection mains used in connection with the systems are also covered.

On the other hand, sprinkler leakage endorsements have their limitations, and many potential losses are excluded from coverage. Here are some examples. If there's no basement, foundations below ground are usually excluded. If there is a basement, foundations below the undersurface of the lowest basement floor are usually excluded. Also usually excluded are underground pilings, piers, pipes, flues, wiring, and drains.

A property owner, who expects to do alterations or repairs to walls or roofs (and who doesn't), should consider adding an "alterations and repairs" clause to the sprinkler leakage endorsement. Otherwise, the endorsement will exclude sprinkler leakage losses caused by repairs or alterations of a wall or supports to a wall or roof after fifteen days of work.

COMPREHENSIVE ADDITIONAL ENDORSEMENTS

A property owner who is dissatisfied with the coverage of a fire insurance policy with an extended coverage endorsement might find greater peace of mind than that offered by these specific risk endorsements by buying endorsements that reach beyond specifically named risks.

Two alternatives the insurance industry provides are special extended coverage and difference-in-conditions coverage.

Special Extended Coverage

Many lawyers who draft insurance clauses in shopping center leases have learned all they know about insurance by reading the leases and mortgages drafted by an earlier generation of lawyers. Unfortunately, old leases aren't a good source of knowledge. One reason is that the last generation of lawyers must have relied on the equally ignorant work of the generation before them. Another reason is that insurance policies change all the time, and lease specialists must stay abreast of the continuing changes in insurance company practices.

This small but important digression leads me to the *special extended coverage endorsement*.

Many leases include special extended coverage as one of the items in a list of endorsements that landlord or tenant must carry. The list also usually includes extended coverage, vandalism and malicious mischief, and sprinkler leakage endorsements. The drafters apparently believe that special extended coverage is something that you add to extended coverage, vandalism and malicious mischief, and sprinkler leakage, like adding oregano and thyme to salt and pepper.

It isn't. Special extended coverage includes everything you already get in the extended coverage, vandalism and malicious mischief, and sprinkler leakage endorsements. It also includes a good deal more.

A special extended coverage endorsement extends the coverage of a fire insurance policy so that a fire policy with this endorsement is virtually the same as an all-risk policy. Despite its versatility, its use is not popular, and some insurance professionals believe that it's archaic.

Difference-in-Conditions Coverage

A landlord or tenant seeking broader coverage than he can get with fire and extended coverage might find it effectively and economically by adding *difference-in-conditions* coverage. Difference-in-conditions (DIC) coverage extends what you get with extended coverage even further. Like special extended coverage, DIC extends a fire policy with an extended coverage endorsement so far that you have almost the equivalent of an all-risk policy as a result.

One important difference between an all-risk policy and a fire insurance policy with extended coverage and difference-in-conditions coverage is that all risk covers vandalism and malicious mischief and sprinkler leakage, and a fire policy with an extended coverage and difference-in-conditions coverage usually does not.

But what is really different is that a fire policy with extended coverage and difference-in-conditions coverage can cost less than an all-risk policy for some shopping centers. There seems no logical reason for this. I've been told that the people in charge of difference-in-conditions coverage are more daring than all-risk people. Who knows? Check the rates yourself, and get the best coverage you can get for the lowest price.

Difference-in-conditions coverage is not available for everyone at an affordable premium. It's a good idea to find out if you can get it at a favorable price. However, if no insurance company is willing to accommodate you in this respect, you won't have been the only one who will have failed.

When you are able to find a willing insurer, check the form of the endorsement or the policy offered to see if it fits in your insurance scheme.

ALL-RISK POLICIES

It's a sad fact that not all labels are literally true. Among the labels that are definitely not true is "all-risk policy." All-risk policies do not protect an insured against all risks. What all-risk policies do is to insure the property of the insured against *all* direct physical

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loss up to the face amount of the policy (except for specific itemized exclusions).¹

Every all-risk policy contains a long list of hazards against which the policy doesn't insure and a list of types of losses that are excluded from coverage. The list of exclusions embraces some events that few business people would think could be covered. For example, damage caused by wear and tear or by deterioration is excluded.

On the other hand, some of the losses that are excluded from the coverage of an all-risk policy are significant. Here's a list of sixteen perils excluded from Industrial Risk Insurers' form of all-risk policy used in 1983 that should concern many shopping center owners and net lessees.

- Earthquake
- Landslide
- Volcanic eruption
- Other earth movement
- Flood
- Surface water
- Mudslide
- Waves
- Tidal water or tidal wave
- Overflow of streams or other bodies of water
- Release of water compounded by a dam
- Explosions of steam, steam turbines, steam engines, some steam pipes, and gas turbines (if owned or operated by the insured)
- Rupture, bursting, burning or boiling of steam boilers, steam turbines, steam engines, some steam pipes, hot water boilers, pressure vessels, and gas turbines (if owned or operated by the insured)
- Nuclear reaction
- Hostile or warlike action in peace or war by a government or sovereign power; by an authority maintaining or using military, naval, or air forces; by any military, naval, or air forces; or any of their agents
- Insurrection, rebellion, revolution, civil war, or usurped power

Most of these exclusions are also exclusions in difference-in-conditions coverage and special extended coverage. But don't be depressed excessively.

If there is a buck to be made, the insurance industry will rise to the occasion and protect the public. As we will see later, you can always buy flood insurance, earthquake and sinkhole insurance, boiler and machinery, and war risk insurance.

The importance of the all-risk policy is that the risks that aren't excluded *are* covered, and the insurance company is less likely to find an excuse not to pay. It's much easier for an insurance company to claim that a loss is not covered when the insuring clause of the policy consists of a list of covered perils than when the policy says that risks or all risks are covered but for a large list of exclusions.

Unfortunately, it is not always advantageous to rely on general clauses that describe the coverage of an insurance policy. In some cases there's only a thin line separating the language of the clauses that provide for the insurance from the language of the clauses that set forth the exclusions from coverage. Under these circumstances, having a policy that specifically includes coverage of the peril in question can be a distinct advantage for the insured.

Collapse Coverage

Collapse coverage is usually not included in extended coverage. But it is included in an all-risk policy or a package that includes difference-in-conditions coverage.

Until 1983, all-risk policies included collapse coverage that covered the collapse of all but air-supported structures. In 1983, the Insurance Services Office changed its all-risk policy forms so that collapse coverage now applies only to collapses caused by a relatively small number of catastrophes.

As a result of the change, the insured now has the burden to show that the collapse was caused by one of the named catastrophes. One group of these catastrophes are perils normally insured by fire and insurance policies with extended coverage endorsements: fire, lightning, windstorm, hail, explosion, smoke, aircraft, vehicles, riot, and civil commotion. Another group of perils to which the collapse coverage of the revised all-risk policy applies are vandalism and malicious mischief; breakage of glass; falling objects; weight of snow, ice or sleet; and water damage. Still another group is hidden decay, hidden insect or vermin damage, weight of people or personal property, and weight of rain which collects on a roof. A collapse that occurs during the course of construction, remodeling, or renovation as a result of the use of defective materials or methods in construction, remodeling, or renovation is also covered.

However, don't get too comfortable with collapse coverage. Insurance companies interpret the word

¹ The Insurance Services Office (an organization owned by the stock insurance companies) is changing the all-risk policy. It will no longer insure against "all direct physical loss" except for loss arising from excluded perils; it will insure against "direct physical loss." Notice that the word "all" is missing. The purpose of the change is to reduce confusion, so that fewer insureds will believe that an *all-risk policy* insures against *all* risks. Perhaps what we have become accustomed to call an "all-risk policy" will become known as a "risk policy" in the future.

“collapse” narrowly. An insurance company claims department might agree that your building has collapsed only if all or a part of it ends up as a heap of rubble. Fortunately, courts don’t always agree with this view. So litigation may make it possible for an insured to recover on even a less spectacular collapse loss. Some insurers have a more liberal attitude. One client of ours recently collected more than a quarter of a million dollars when a couple of beams cracked. The client convinced the insurer that the cracking constituted a *constructive collapse*.

All-risk policies and insurance policies that include collapse coverage also have clauses that provide for exceptions to the coverage. Accordingly, you will find insurance policies that cover collapse that also specifically exclude from coverage losses that result from “earth movement” or “subsurface water pressure.” The earth movement exclusion itself has an exception in that policies with collapse coverage do insure against direct loss from fire, explosion, or theft caused by earth movement.

INSURING AGAINST WHAT ALL-RISK COVERAGE DOESN'T COVER

We must now face the reality that neither fire insurance with an extended coverage endorsement nor an all-risk policy insures against some perils that are very real threats to property owners.

Some hazards that are excluded from all-risk coverage are beyond the scope of any policies offered by the insurance industry on a normal commercial basis. On the other hand, other hazards not covered by an all-risk policy can be insured easily by purchasing additional coverage.

Boiler and Machinery Coverage

Steam boilers or other pressure vessels can explode. Although all-risk policies and fire insurance policies with extended coverage endorsements insure against damage arising from explosions, they do not cover explosions of steam boilers or other pressure vessels owned or operated by the insured except “direct loss resulting from the explosion of accumulated gases or unconsumed fuel within the firebox or combustion chamber.”

However, you can buy *boiler and machinery* coverage as an endorsement to an existing policy, as a separate policy in combination with an all-risk policy or a fire policy with extended coverage endorsement (with or without difference-in-conditions endorsement), or as a completely separate policy.

Steam boilers and other pressure vessels present a greater danger than hot water boilers and consequently

are a much greater risk for insurance companies. So insurance companies are relatively brave about insuring against exploding hot water boilers, but they are quite cautious about insuring steam boilers. Boiler insurance carriers employ teams of sophisticated boiler inspectors. Inspectors inspect and report on the age and observable condition of the equipment and assist in evaluating the risk. Steam boilers come in many varieties, and some are riskier than others. Needless to say, some boilers are in such bad shape that insurance companies refuse to insure them at all.

Don’t get the idea that you are fully protected when you combine all-risk with boiler and machinery coverage. Boiler and machinery policies are really an entire family of insurance policies. Many losses are excluded from boiler and machinery coverage unless the insured purchases special endorsements to the boiler and machinery coverage.

Flood Insurance

Extended coverage endorsements don’t extend to floods. One of my clients discovered this only after a large part of his inventory was submerged. He spent a few years in the bankruptcy court as a result. Even all-risk and difference-in-conditions coverage ordinarily excludes flood damage. The insurance industry does offer insurance against floods as part of a package of insurance. An endorsement to all-risk and difference-in-conditions coverage can broaden coverage to embrace flood damage. However, insurance companies sell this endorsement only for property located where a flood is unlikely to occur.

Because the insurance industry has been unable to devise insurance protection against catastrophic losses caused by floods, Congress passed the National Flood Insurance Act of 1968, which established the National Flood Insurance Program. This federal program makes it possible for owners of property situated in “flood plains” to purchase insurance against a calamity that is not entirely a remote expectation.

Federal flood insurance does not cover losses resulting from burst pipes and other plumbing problems that are not caused by the irrational force of nature. For water damage that does not result from a natural phenomenon, a property owner might (and might not) find solace in an all-risk policy.

Earthquakes and Sinkholes

Many of us think that earthquakes are phenomena that occur only in exotic places like Tibet, Japan, and San Francisco. But earthquakes occur from time to time in every region of the United States. They don’t always cause devastation that calls for television coverage, but they do damage buildings.

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Earthquakes are not included among the perils against which extended coverage endorsements insure. They are mentioned—but as exclusions. If you add difference-in-conditions coverage to extended coverage, you are still faced with an earthquake (and earth movement) exclusion. The earthquake exclusion also stares at you from the small print of the all-risk forms.

But insurance companies are usually willing to charge you for earthquake coverage if you want it. The premium rates vary widely, because the risk varies widely. Earthquake insurance is available as an endorsement to other property hazard policies. You can also buy a separate earthquake insurance policy.

Although relatively few shopping centers are located in the shadow of a volcano, owners and tenants of any that might be will be pleased to note that earthquake endorsements usually insure against direct losses arising from volcanic eruption. On the other hand, the earthquake endorsement won't stretch to cover the ultimate catastrophe. Nuclear explosions are excluded.

Current earthquake endorsements don't usually cover foundations or excavations. You must buy still another endorsement if you are determined to insure your foundation against the risk of earthquakes. Except for stucco, exterior masonry veneer on wood framed walls is also excluded.

If your shopping center is in the state of Florida rather than California or Washington, you are probably more concerned about potential damage from sinkhole collapse than earthquakes or volcanic eruptions. Sinkholes are large underground caverns. They are created by the erosion of limestone or other rock formations. As sinkholes increase in size, the surface of the earth may cave in, and a sinkhole collapse occurs.

Sinkhole collapse isn't covered by the extended coverage or difference-in-conditions endorsements or by all-risk policies. It's excluded as part of the earth movement exclusion.

However, if worrying about this possibility is keeping you awake, buy a sinkhole endorsement and sleep well. But don't sleep too well. Although a sinkhole endorsement will compensate you for damage to an insured structure, it won't cover the cost of filling the sinkhole.

War Damage Insurance

Some shopping center leases require the landlord or tenant to carry "war damage" insurance. Why lawyers draft such provisions is puzzling. War damage coverage hasn't been offered as a regular line on real property by insurance companies since they counted the claims they paid after the Spanish Civil War (1939).

Although an extended coverage endorsement insures against riots and civil commotions, the distinction between riot and civil commotion and war has become fuzzy in an era of undeclared military conflicts and sophisticated terrorist acts.

A U.S. government agency, Overseas Private Investment Corp., does insure property owned by American investors in developing countries against war damage in order to encourage American investment in developing nations. But the premiums are high, and the insurance covers only new projects and expansion of old ones.

WHAT SHOULD AN OWNER INSURE?

An owner or lessor should insure every part of the premises or building with minor customary exceptions. The exceptions vary for different types of coverage. For example, the walls of a finished basement are not covered by a flood insurance policy issued pursuant to the National Flood Insurance Program, but they are insured against fire by a standard fire insurance policy. An extended coverage endorsement insures plate glass against the explosion of a water heater not owned or operated by the insured; but a vandalism and malicious mischief endorsement does not insure against breakage of plate glass (except for damage caused by a burglar to gain entry).

Consequently, any party to a shopping center that agrees to carry fire insurance with extended coverage and the endorsements with respect to the entire "shopping center" or a building in the shopping center will probably be in default on the first day of the term of the lease and forever thereafter.

When tenants make alterations and attach their equipment to the premises, serious questions may be raised. Are the alterations and the installed equipment to be covered by the policy that covers the building itself? Are they covered by the policy that covers the contents of the building?

If both policies can be interpreted so as to cover the alterations, the insurance companies might fight with each other over their respective responsibilities. Both might deny coverage. One or both might assert a right to apportion the loss. (The apportionment clause of an insurance policy limits the liability of the insurer to a proportion of the total insurance carried.) The insurance buyer should seek clarification and negotiate with the insurance companies about these problems when he purchases the policies. A party to a shopping center lease should ascertain that its insurance company agrees in advance that its policy covers losses to alterations or equipment that is to be replaced by the party.

HOW MUCH INSURANCE?

Insurance companies worry when a property is over-insured, and they lose income when property is under-insured. The industry has developed standard approaches to cope with each of these problems: actual cash value and coinsurance.

Insuring for Too Much—The Moral Risk

When you pay a fire insurance premium, you are gambling that your building will burn down. If you could insure it for more than its “value,” you might be tempted to burn it down in order to collect the insurance proceeds.

The ancient wise men of the insurance industry developed a concept called the “moral risk.” The moral risk is simply the risk that the temptation to destroy your own insured property might be overwhelming. The insurers concluded that the temptation is resistible only when the potential recovery does not exceed the value of the building. Imagine what could happen if a small neighborhood shopping center could be insured against fire for \$100 million.

Thus, the insurance industry savants also developed the concept of “actual cash value.” This is a rule that says that even if the building is insured for ten times the cost of rebuilding it, the most that an insurance company will pay on any claim (unless special endorsements are purchased) is the lower of actual cash value and the actual cost of replacement. Even the special endorsements do not materially increase the temptation to seek a profit by causing a fire or insured catastrophe; the endorsements merely provide a new building to replace a damaged old one.

How is actual cash value defined? Current fire insurance policies don’t define the phrase, despite the crucial role it plays in determining the amount of insurance that should be carried. The 1886 and 1918 New York standard fire insurance policies stated that actual cash value should be ascertained with proper deductions for depreciation. Many knowledgeable insurance professionals still define actual cash value that way. However, insurance appraisers have considerable discretion in the determination of depreciation and are not bound by generally accepted accounting principles. They aren’t bound by the Internal Revenue Service’s depreciation rules either. One insurance consultant in whom I have great confidence tells me that, in his experience, the industry recognizes a rule of thumb that real property depreciates at approximately 1.25 percent annually and stops depreciating when the cumulative depreciation reaches 30 percent as long as the property is functionally useful.

Be careful. There is no single formula for depreciation because many variables are taken into account, and you could be surprised by what might happen in court. Moreover, insurance companies themselves have claimed that the actual cash value of obsolete buildings and buildings about to be demolished should be measured by their *market value*.

Insureds who actually suffer losses may happily discover that in some jurisdictions statutes require insurance companies to pay the full amount of the policy in case of a total loss without regard to depreciation.

Insuring for Too Little—Coinsurance

Property owners discovered many years ago that buildings are seldom destroyed entirely by fire or catastrophe. They realized that they could save money by carrying insurance for a value that was a fraction of the property value.

The insurance companies were dismayed. To combat this dangerous tendency, fire insurance companies labeled such customers as “coinsurers,” and they punished coinsurers severely. They provided that an insured would be penalized if it insured a building against fire for less than 80 or 90 percent of its actual cash value.

The coinsurance penalty works this way: Suppose a shopping center has an actual cash value of \$2 million. If the coinsurance provisions of the fire and extended coverage policy require the insured to carry at least 80 percent of actual cash value, the owner must carry at least \$1,600,000 of insurance. The owner decides to carry only \$800,000 of coverage. When a loss occurs, the insurance company imposes the coinsurance penalty. It pays the insured only 50 percent of the loss, the proportion of the actual insurance to the required insurance. If the building suffered a loss of \$100,000, the insured would recover only \$50,000.

Replacement Cost Endorsements

Most property owners are more concerned about having sufficient funds to repair or replace fire damage than they are about saving a few dollars on insurance premiums. To meet this need, insurance companies offer them the option of insuring buildings for actual replacement cost. The proceeds of fire insurance with a replacement cost endorsement should provide sufficient funds to replace damage to aged and worn elements of a building with new elements of like kind and quality. That sounds terrific. You get new lamps for old—like Aladdin.

The question whether to insure for the actual cash value of property or its replacement cost must be faced for *each* line of property insurance separately. If a

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property owner who wants replacement cost coverage carries both an all-risk policy *and* a separate boiler and machinery policy, he needs a replacement cost endorsement on each policy. Replacement cost endorsements add to the premium cost significantly because they increase the coverage limits of the policy.

Increasing coverage limits (and premiums) by adding a replacement cost endorsement changes the coinsurance obligation. Without a replacement cost endorsement, coinsurance clauses in fire policies require that a percentage (usually 80 percent) of the *actual cash value* be covered. With a replacement cost endorsement, coinsurance clauses require that the insured carry insurance for a percentage (usually 80 percent) of the replacement cost.

The downside of adding a replacement cost endorsement is that it increases the danger of getting hooked by the coinsurance clause unwittingly. Building costs have escalated rapidly in recent years, and the cost of replacing damaged property rises quickly. If the cost to replace a shopping center destroyed by fire jumps and you don't increase the amount of insurance fast enough and a fire occurs, you might end up regretting that you added the replacement cost endorsement.

Underinsuring has severe consequences. First, you certainly won't recover any greater amount than the amount for which you are insured. Second, you'll get even less because the coinsurance clause reduces the proceeds severely. When you underinsure, you might end up with nothing more than you would have had if you insured for the correct percentage of the total cash value. Third, you'll have the painful memory that you paid wasted premiums for the part of the insurance that could not be collected because of the coinsurance penalty.

To deal with this problem, insurance companies issue "agreed amount endorsements." The endorsement provides that the company agrees that the replacement cost of the insured property is the amount specified in the endorsement. An agreed amount endorsement nullifies the effect of a coinsurance clause. The endorsement is issued only after the insured submits appropriate evidence of replacement cost such as a report of an appraisal organization to the company on its findings. Agreed amount endorsements expire annually, but they can be renewed after the appraisal report of other evidence is brought up to date.

Demolition and Increased Cost of Construction

So what more could a prudent developer want? Believe it or not—even more insurance. Replacement cost endorsements might not go far enough. Consider this example of a shopping center that was developed twenty years ago. It is prosperous but a little older and

sorrier than it was at the beginning. Now it burns to the ground. Of course the developer wants to rebuild, and the insurance company is willing to bear the cost of rebuilding *the building that was destroyed*. However, there is a problem. Under a new building code, the owner does not have the legal right to rebuild the *building that was destroyed* without making significant changes. A new code requires sprinkler equipment that the old building didn't have. Inexpensive materials that were used in the destroyed building are now prohibited. Moreover, part of the remains of the old building must be demolished because of new setback rules. The replacement cost endorsement doesn't cover this kind of loss; and the insurance is inadequate to build the structure that is now required.

To solve this problem, the insurance package should include *demolition and increased cost of construction* endorsements. These endorsements expand the coverage to provide the funds needed to demolish parts of the building when it is necessary to do so in order to comply with legal requirements. They also cover funds needed to pay for building elements that were not included in the original building but must be included in order to comply with new legal requirements. Accordingly, these endorsements enable an insured to exchange the old building for a technologically superior and safer one. Demolition and increased cost of construction endorsements won't cost you much and will help you sleep better.

SELF-INSURANCE

Many insureds are still determined to keep premium costs down. Some of them have hit on a method to do that and make the insurance company happy as well.

The coinsurers of yesterday irritated the insurance companies of yesterday by insuring against small losses and forgetting about the relatively remote prospects of total destruction. If insurance companies are burdened with minor losses such as \$100 claims for fixtures or carpeting singed by a match, they pass the administrative costs of filing, investigating, and processing these claims on to the insured in the form of higher premiums.

Modified self-insurance solves this problem. The self-insurer willingly bears losses arising from minor damage by fire and catastrophe and pays premiums to cover big losses that might be too much for him to bear himself. The part of a risk that is self-insured is called a "deductible" by insurance brokers. These self-insured amounts are subtracted from the proceeds of insurance losses. Losses that do not exceed the deductibles are not covered by the policy. Usually a deductible is an agreed, fixed dollar amount. In the case of earthquake insurance, the deductible is a per-

centage of the actual cash value of the insured property.

Self-insurance is now a customary feature of property hazard insurance. Even homeowners' policies contain deductible clauses for most kinds of coverage. Not unexpectedly, insurance premiums go down as deductibles go up. Relatively few shopping center lease insurance clauses permit the party required to carry the insurance to self-insure any part of a potential loss. Because of the growing popularity of self-insurance, the absence of such permission often results in a technical default under the lease.

BACK TO THE FLIGHT

We were circling LaGuardia Airport by the time I finished the memo. The passengers, some of them on their third drink, were chatting with good humor and the flight attendants were collecting headsets and glasses. There were mild groans when the captain announced that traffic was a bit congested and that we'd be circling about for a while. Some time later the groans turned to muttering and sputtering. A few passengers were bad-mouthing the airline, the flight controllers union, Ronald Reagan, and Fidel Castro (in that order).

I urged everyone to stay calm. Sooner or later every airplane descends—hopefully safely and gracefully. Why get excited? Sit back, relax, read a book. And I did just that. I read a book I had been carrying around for a long time.

Half an hour later, the pilot announced that the descent to LaGuardia was about to begin. Several passengers congratulated me for my self-control and cheerful personality. Seatbelts on again! Seats forward again, no smoking! It didn't faze me a bit. My seat is always forward, and I never smoke. So I can keep reading and mind my own business.

We were still in the air an hour later, and I was getting sick and tired of reading and flying. I cornered a flight attendant and insisted upon some frank information. Were we about to die? Would there be a crash landing at sea? She assured me that we would land in a little while.

Then the captain announced that the plane would land in a little while all right, but not at LaGuardia. We were bound for Bradley Field, a not entirely modern facility, that lies between Springfield, Massachusetts and Hartford, Connecticut.

The plane landed at Bradley, but it didn't taxi to the terminal. It just stood still about three quarters of a mile away—for a long time. Babies and little children began to cry. Protest committees were formed. Sally and Joe were screaming at a flight attendant. Willy was nursing a highball.

The primitive atmosphere eroded my normally stoic demeanor. What about my family? Would they be worried? What about my partner, Walter Gumbinger? His work load would increase and his income would be reduced if I were lost. He certainly must be worried. And Harry Paine, poor Harry Paine, who would jump to his commands? I had to get off the plane to let everybody know that I hadn't perished after all.

I demanded an audience with the captain in the cockpit. No problem. Go right in. The officers and flight attendants were gossiping and sipping goodnaturedly. After I told them that I was a lawyer, they chuckled and told a few lawyer jokes. Then they invited me to sit with them and listen to the messages they were receiving on the radio. In this way I could be of help if any legal issues came up. When they heard that I had just written an article on insurance clauses in shopping center leases, they were really excited.

We finally got off the plane. The airline provided a bus that was going to take us to a hotel in the most exciting part of Hartford, Connecticut.



Mumbling and grumbling, we left the plane to board the bus. Because of the snow drifts, the bus was unable to park near the airplane. The passengers debarked from the oppressive heat of the plane to the fury of driving wind mixed with snow and sleet.

Carole, still wearing open-toed, high-heeled shoes, short skirt, and a flimsy topcoat, stepped into a foot-

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high drift of snow. Joe's golf slacks were unable to prevent the wet snow from climbing up his legs. All the passengers faced the elements bravely. Handkerchiefs were adapted as head coverings, and newspapers served as umbrellas.

For me, bravery was unnecessary because I was *prepared*. With an air of triumph, I emerged from the jumbo jet ready to deal with the elements. The other passengers stared longingly when they observed my overcoat, hat, boots, earmuffs, scarf, and umbrella.