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Landlord and tenant must balance protection, cost, and lender requirements.

People and Property: Insurance Clauses in Shopping Center Leases

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WHAT'S THE DIFFERENCE BETWEEN an experienced and sophisticated businessman and a neophyte? You say you can't answer that question in a few words? You need time to consider the problem?

Don't fret. I'm here to help.

The main difference between an experienced and sophisticated businessman and a neophyte is that the experienced businessman knows how to intimidate his lawyer and the neophyte doesn't.

It takes years of practice to learn to intimidate your lawyer. But when you finally perfect this skill,

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there are many advantages. If you've goofed, you can blame it on your lawyer and be absolved from guilt. When you just feel rotten, don't yell at your secretary or make fun of her. She may quit or, even worse, ask for a raise. Don't yell at your wife or make fun of her. She may yell back or make fun of you. Find someone completely defenseless and yell at or make fun of him. Abuse your lawyer.

This principle was observed by Brent V. Firestone, President and Chief Executive Officer of Walley Juniors. Walley Juniors is a chain of specialty clothing stores that concentrates its outlets in obscure communities where the level of consumer consciousness is low.

Brent V. Firestone's lawyer, Terry Trayf, was ailing. Because of ulcers and nervous tension, Trayf decided to take an extended vacation and spend six months in Paris.

Brent called my office and asked me to help him complete a lease negotiation for a new Walley Juniors Store. The store was to be part of a new shopping center that our old crony, Sal Briccone, Jr., was building on the west side of Yennervelt, Mississippi. Terry Trayf had negotiated much of the lease already.

When Brent's secretary ushered me into his office, I caught the tail end of a telephone argument between Brent V. Firestone and Terry Trayf. Brent made sure I heard both sides by keeping his speakerphone on.

Firestone: You know you are deserting me in the middle of a deal.

Trayf: My doctor said that if I don't go away for a while I might get a heart attack.

Firestone: What do those crazy doctors know? How can you take advice from them when you see them buying our syndication units all the time?

Trayf: They must know something. They went to medical school.

Firestone: What does that mean? You went to law school, and you don't know anything!

Trayf: I've got to go. My plane leaves in two hours.

Firestone: You realize that you're killing the deal for my second store in Yennervelt. You're jeopardizing our relationship! Your whole career is at stake! . . . Ah, Halper, come in. It's so nice to see you.

I: Hi Brent. How're you feeling?

Firestone: How can I feel when I've been stabbed in the back? (To the telephone.) You're making a big mistake. Goodbye, and give my love to the wife. (Turning to me.) Where was I?

I: He stabbed you in the back.

Firestone: Darn right he stabbed me in the back. You can see the blood dripping on the floor.

I: What can I do for you?

Firestone: Finish the lease. Everything is settled except for fire insurance and destruction clauses. Terry says I need a lot more fire insurance in the lease than Briccone wants to carry. Here's Terry's memo to me.

Terry's opposite number in this deal, Mitchell Gozlin, who represented Sal Briccone, Jr., was a crusty old war-horse. He wasn't going to let anything get by him. He and Terry were fighting over the following issues:

☐ Would the landlord or the tenant be required to carry fire insurance with respect to the premises?

☐ What kind of insurance would be carried?

☐ Would there be assurances that coverage limits of the insurance would be increased when necessary?

☐ Who would get the insurance proceeds?

I: I can see you've got problems.

Firestone: Problems? What kind of problems? Just lawyers' double-talk. I want to get out there and do business. All you lawyers know is how to charge money.

I: I'm sure we'll be reasonable.

Firestone: You'd better be reasonable, or we'll never use you again. (Pointing to my suit, shirt, and tie.) That outfit you're wearing, where did your wife buy it?

I: My wife? I get everything myself. My wife doesn't shop for my clothes.

Firestone: You know something? She should!

When Brent V. Firestone finished laughing at his own joke, we made an appointment to meet with

Mitchell Gozlin and Sal Briccone on the following Monday.

The Monday meeting was long, drawn-out, and full of table-pounding. Little progress was made. But the prospect of making money kept us together through eight more turgid sessions until finally the bargain was struck.

I suspect you would be fascinated by a blow-by-blow description of the proceedings. But I have digested the problems for you, and here is the digest.

THE INSURABLE CATASTROPHES

You can buy insurance to protect yourself against the consequences of most catastrophes. It is standard practice for most landlords to carry insurance against fire and a whole series of perils, which insurance companies bunch together under the label "extended coverage." Not all extended-coverage endorsements are the same. The standard extended-coverage endorsement Number Four is the most popular endorsement carried by shopping center owners. Landlords also customarily carry vandalism and malicious-mischief endorsements.

Some shopping center landlords mistakenly believe that if they carry insurance against fire, the perils covered by the extended-coverage endorsement, vandalism, and malicious mischief, their property is fully protected against damage by all catastrophes. It isn't. Even with all this coverage, some "catastrophes" won't be covered.

You can get broader coverage with an "all risk" policy, but, of course, it costs more money. One of the confusing things in life is that not all labels are literally true. Among the labels that are definitely not true is "all risk" policy. An all-risk policy doesn't protect you against all risks. In fact, a very substantial part of an all-risk policy is a list of casualties against which the policy affords no protection.

War damage is a risk which isn't protected by any coverage I know of. On the other hand, insurance against damage caused by flood or earthquake is available.

Here is a list of types of perils which are often insured against but which are not covered by some of the popular packages of fire and extended coverage:

☐ *Vandalism and malicious mischief.* A vandalism and malicious-mischief endorsement is considered important by many. However, since this coverage does not extend to plate glass, a shopping center owner or tenant could probably save some money by passing up this endorsement with respect to insurance for the building itself.

☐ *Sprinkler leakage.* A sprinkler system is a wonderful device for reducing fire damage. Sprinkler systems permit buildings to qualify for lower premium rates. But it is possible that human error or mechanical failure may set the sprinkler mechanism off when there is no fire. When this happens, watch out. The tenant will have plenty of damaged merchandise. There'll also be damage to parts of the building itself, and that could be a problem for the landlord. Building owners usually insure only a small percentage of the building's replacement cost against sprinkler leakage.

☐ *Boiler explosion.* Most extended-coverage endorsements do not cover pressure boiler explosion. That's why separate boiler policies or separate boiler endorsements are sometimes necessary.

It's not necessary to cover every element of a building with insurance. For example, footings seldom get damaged even in the worst catastrophes. Similarly, shopping center owners find it unnecessary to insure the parking lot against damage by fire or other catastrophe.

WANT TO GAMBLE? THE INSURANCE COMPANY MAKES THE ODDS

Early state legislatures were concerned that an insurance contract might turn into a gambling arrangement. If the beneficiary could insure his building for more than its "worth," he might be tempted to burn it down in order to collect the insurance proceeds. The temptation is a lot smaller when the recovery is only the "value" of the building.[1]

Thus, the concept of "sound insurance value" was developed to reduce temptation. It doesn't matter if you insure the building for ten times the cost of rebuilding it. When you make a claim to your insurance company, the most they'll pay you is the cost of repairing the damage plus related expenses.

It is very expensive to insure for an amount sufficient to replace a building completely. If you agree to insure for replacement cost minus "actual physical depreciation," the premium is lower. The maximum amount of actual physical depreciation

[1] Of course, some people have burned down their buildings anyway, in order to collect fire insurance proceeds.

calculated by the insurance company is approximately 30 percent of replacement cost.

When property owners discovered that buildings are seldom destroyed *entirely* by fire or casualty, they realized that they could reduce premiums substantially by carrying insurance only for a fraction of the replacement cost of the building. This discovery was quite unpleasant for the insurance companies.

The fire insurance companies, in turn, labeled customers who insured their buildings for less than 80 or 90 percent of "full" or "sound insurable value," as "co-insurers" and penalized co-insurers severely. When the co-insurance penalty operates, the insurance company pays only a portion of the loss, which is equal to the ratio of the amount of insurance actually carried, divided by the amount of insurance that should have been carried in accordance with the co-insurance clause. Suppose it would take $2 million to replace the buildings in your shopping center, but you insured those buildings against fire and extended coverage for only $800,000. If the co-insurance provisions of the policy require the insured to carry insurance in the amount of at least 80 percent of full insurable value, you are carrying only half the insurance which you are required to carry. If the building suffered a loss of $100,000 you would recover only $50,000, or half of your loss.

Self-Insurance

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. With modified self-insurance, the self-insurer chooses not to be compensated for losses resulting from minor fire and casualty damage. He pays premiums to cover only the big losses that might be too much for him to bear.

INSURANCE RATES

The cost of a shopping center's insurance premiums must rise over the years because the cost to replace existing buildings is constantly rising. Of course, sometimes the premium *rate* rises too. Owners and tenants may obtain especially favorable rates from some actions which reduce the insurer's risk. But most factors affecting rates are beyond their control.

Carriers who belong to the Factory Mutual Group and a carrier known as Industrial Risk Insurers are able to charge especially low premiums because of the low loss record of the properties they insure. This superb record is made possible by strict standards in selecting insureds and by requirements specifically designed to reduce fire hazards. Factory Mutual encourages fire-resistant construction, the installation of central station communications, the installation of automatic fire and smoke detection equipment, and the installation of sprinkler systems.

Many other factors affect fire insurance rates. Environment and location are important factors. If local teen-agers are known to engage in arson from time to time, fire insurance premiums are bound to be high. The distance of the shopping center from the closest fire department and from fire hydrants affect rates. The use made of a building is another factor. Dry-cleaning establishments (which use volatile fluids) and restaurants often are assessed at higher rates than candy stores.

WHO SHOULD CARRY THE INSURANCE?

Leases offered by shopping center owners often say nothing about insurance. Why should they? Almost everyone assumes that landlords carry proper insurance. Landlords' lawyers know that their clients have insurance obligations to mortgagees. Why should they invite trouble by offering a similar obligation to the tenants? Nevertheless, an experienced tenants' lawyer in a gross lease negotiation should insist on a provision that requires the landlord to carry proper insurance on the entire shopping center.

Of course, insurance premiums are a cost that may be assumed by either party in return for rent concessions. Some tenants may prefer to have a lower rent and provide the insurance coverage needed by the landlord. In a "net lease" the tenant agrees to bear the cost of fire and extended-coverage insurance in addition to the regular rent payments. The parties should consider carefully whether it is more appropriate for the landlord or tenant to carry the insurance.

When the demised premises consists of a small store in a row of similar units, it is best for the insurance to be carried by the landlord. It would be foolish for the landlord or the mortgagee to have to negotiate with twenty or thirty different insurance companies if a fire damaged the whole row of stores. All sorts of problems would arise. Suppose a fire started in one store and spread to another. Which fire insurance company would be responsible for the party wall or any other facilities used in common?

The insurance companies would fight with each other and would probably battle with the landlord and tenant as well.

On the other hand, when the demised premises is a free-standing building, it makes sense for the tenant to carry the insurance and to cover the interest of the landlord. A chain department store or supermarket may carry insurance under blanket policies that cover all or many of their stores. The blanket policy may be cheaper. Furthermore, the tenant is in a position to use the same carrier to cover the real estate, the leasehold improvements, fixtures, and merchandise inside the demised premises.

Use of a single carrier to insure both real estate and personal property makes it possible to avoid a lot of disputes. Insurance companies are fond of fighting with each other over whether damaged property is real property insured under the landlord's policy or personal property insured under the tenant's policy. If the lease requires the landlord to insure the building and the tenant wants to avoid the possibility that the landlord's insurance company and the tenant's insurance company will fight over which company insures the tenant's leasehold improvements, there is another way for the tenant to handle the problem. He can negotiate this question with his own insurance company when the insurance is placed. There is a good chance that an insurance company that insures the "contents" of a building, if asked in advance, will agree that its coverage extends to the tenant's improvements regardless of whether these improvements are considered to be the landlord's property under the lease.

WHAT COVERAGES ARE REASONABLE?

If a net lease is being negotiated and the tenant is expected to carry the insurance, the landlord's aim is to make sure that the lease requires the tenant to cover each peril that the landlord's mortgagee has specified for coverage. Unfortunately, most shopping center mortgages require landlords to carry such insurance "as may be required by the mortgagee from time to time." The landlord would love to pass this entire obligation on to the tenant.

A conscientious negotiator representing a tenant should refuse to place this burden on the tenant. Suppose the mortgagee wants the tenant to carry insurance against the prospect that its employees will contract venereal disease?

The tenant can be adamant in his refusal. Unfortunately, the landlord can't go back to his mortgagee and insist on changing the clause that requires him to carry any insurance the mortgagee wants. Few mortgagees will even take the trouble to listen to arguments that their favorite clauses are unfair. They'll just lend their money to someone else.

So if the lease calls for the tenant to carry insurance, the job of the landlord's negotiator is to get the tenant to carry insurance meeting reasonable mortgagee requirements. Most institutional mortgagees now require the following:

- Fire insurance.
- Vandalism endorsement.
- Malicious-mischief endorsement.
- Extended-coverage endorsement.
- Pressure vessel insurance.
- Flood insurance, when appropriate.

Some mortgagees also require sprinkler leakage coverage; others may require coverage against earthquake damage, if and when available.

Because we are talking about long-term leases, the landlord should require the addition of any other insurance coverage that becomes customary for similar kinds of properties.

When the lease requires that the landlord carry the insurance, the tenant's concern is that the landlord insure the premises against likely perils. Although the interest of the tenant is different from the interest of the mortgagee, the coverage he requires a landlord to carry is roughly the same as the coverage the landlord would require of him were the positions reversed.

HOW MUCH INSURANCE IS ENOUGH?

Mortgagees usually insist that insurance protection against fire and other casualties be not less than the original mortgage debt. When the lease requires the tenant to carry the insurance, the landlord should insist that the mortgagee's requirement be met.

The minimum amount of insurance that the lease

should require is the higher of 80 percent of sound insurable value or an amount sufficient so that in case of a partial loss the insurance company would have to pay for the entire loss up to the face amount of the policy. Remember that sound insurable value is the insurance company's estimate of replacement cost minus the actual physical depreciation. It is therefore a smaller amount than "actual replacement value new."

Because the tenant must ultimately bear the insurance cost as an element of rent even when the lease requires the landlord to carry the insurance, tenants should avoid forcing a landlord to carry more insurance than is necessary.

On occasion it is useful for the landlord to agree to provide insurance greater than 80 percent of sound insurable value. If a tenant is concerned about whether the landlord's resources are sufficient to restore the project after a major casualty loss, it might pay the landlord to agree to insure the premises for 100 percent of actual replacement value new even if he cannot pass the additional premium on to the tenant. It really doesn't cost much more, and it's a lot better than losing the deal.

Lease negotiations regarding who bears the cost of rebuilding a damaged building when the insurance proceeds are inadequate can be quite acrimonious. The party that is responsible for the restoration may refuse to have his responsibility for expenditures exceed the amount of the insurance proceeds. The landlord is anxious to see that the restoration gets finished because he is required to do so under the mortgage. The tenant is under pressure to see that the restoration is finished because he cannot do business from a partially restored building. This dispute can be solved by providing that the insurance carried be 100 percent of the actual replacement value of the building new.

Cautious landlords and tenants may be interested in endorsements that insure against the risk that subsequently enacted legal requirements will require costly changes to the original building if it must be restored following a casualty. If sufficient insurance is carried, it isn't likely that there will be a deficiency.

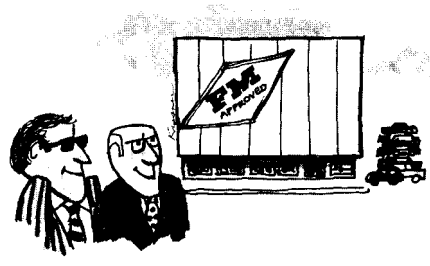
Since the actual replacement value of buildings is rising constantly, the lease should provide that the amount of insurance coverage be reviewed periodically—at least every three years. The review should be conducted by the insurance company itself under the supervision of qualified insurance consultants.

When a tenant pays the insurance premiums, the tenant may insist on self-insurance for losses which do not exceed agreed-upon amounts. A company with good credit should be able to bear losses from fire and other catastrophes that do not exceed 5 percent of the cost of replacing the entire structure. Self-insurance is accomplished with "deductible provisions." They save money.

ADJUSTING THE CLAIM

Three parties are interested in what happens to the insurance proceeds: the landlord, the tenant, and the mortgagee. Even when the tenant carries the insurance, the landlord usually insists that the insurance claim be adjusted by the mortgagee. That's because the landlord anticipates that the mortgagee will insist on this right. A department store tenant in a strong bargaining position or a tenant of a free-standing store building may refuse to give the mortgagee the sole right to adjust insurance proceeds. If this tenant also has the obligation to rebuild the building, the lease can allow the tenant to adjust insurance claims, subject to the approval of the mortgagee. If the tenant carries the insurance but the landlord is required to rebuild, it is appropriate for insurance claims to be adjusted by the mortgagee, subject to the approval of both tenant and landlord. The parties who have the right of approval should agree not to withhold their approval unreasonably.

In those arrangements in which the landlord is required to carry insurance and to restore any damage by fire or casualty, tenants seldom insist upon getting involved in the process of insurance adjustment. Occasionally, tenants do insist upon this right because they worry that there will not be enough money to pay for the restoration.



WHO GETS THE INSURANCE PROCEEDS?

Mortgagees would like the option to decide whether insurance proceeds will be used to pay off the balance of their debt or to restore the buildings.

As a rule, a mortgagee is not likely to be tempted to grab the insurance proceeds from a partial loss because it is unlikely that a partially destroyed building could generate income adequate to pay off the balance of the debt. However, if there is a total loss or if the loss is so large that the insurance proceeds are greater than the unpaid balance of the mortgage, the mortgagee may be tempted to apply the insurance proceeds to the debt, leaving no money to pay for the restoration. If so, the tenant's formerly prosperous retail business will die for lack of a place from which to operate.

The mortgagee's decision about whether or not to apply insurance proceeds to the debt is affected by other factors such as the relationship between the mortgage interest rate and current market rates. However, unless the lease provides to the contrary, there is little hope that the needs of the tenant will play any role at all in determining whether the store will be rebuilt.

Nor is the tenant protected by a lease provision requiring the landlord to rebuild in case of fire or casualty. If the mortgagee grabs the insurance proceeds, a landlord who has agreed to rebuild won't have the money to do it.

A tenant who expects a landlord to rebuild a partially or completely destroyed store building should insist that the lease contain these points:

☐ The landlord must rebuild the demised premises if they are destroyed by fire or other casualty.

☐ The landlord must carry appropriate insurance (except where the parties decide that the tenant will carry the insurance).

☐ The insurance policies should require that no insurance claims be adjusted without the tenant's approval.

☐ The insurance policy itself should indicate that the proceeds must be used for restoration of damage.

☐ Insurance proceeds should be regarded as trust funds.

☐ Insurance proceeds should be payable to an insurance trustee. If the tenant is a creditworthy company, the tenant itself could be the trustee. Otherwise, the mortgagee (if there is one) would be the trustee. Some tenants insist that only an institutional mortgagee can be the insurance trustee.

☐ Insurance proceeds should be paid to the party required to do the restoration only as the restoration progresses.

The tenant cannot protect himself if the premises are encumbered by a mortgage at the time the lease is signed, or if the lease provides that the lease is or will become subordinate to the lien of future mortgages. To avoid this problem the tenant must insist that any mortgagee agree that insurance proceeds be applied in accordance with the provisions of the lease instead of the provisions of the mortgage.

THE LAST WORD

By the time I had concluded my first experience in representing Brent V. Firestone, my wife noticed that I had some unusual new habits:

- Cracking my knuckles.
- Twitching my left eye every two minutes.
- Reaching for my wallet every five minutes and checking every credit card.
- Tying and untying my shoelaces whenever I sat down.

Mrs. Halper: I'm putting my foot down—we're going on vacation.

I: Yes dear. Where shall we go?

Mrs. Halper: Let's go to Paris. We haven't been there since 1963, and I'd like to experience it without the five-dollar-a-day book under my pillow.

I: Oh dear, I can't go to Paris now. Brent V. Firestone has two new deals going, and he'd be furious.

To make a long story short, I gave in. It was a really nice vacation. We went shopping at all the famous stores. Then we toured all the shopping centers. Then we went shopping. We visited friends. And finally, we went shopping. I bought a new hat.

When I returned, I was greeted with an urgent message from Brent V. Firestone. I rushed to his office. He looked at me, scowled and blamed me for the demise of two deals.

Firestone: I see that you stopped cracking your knuckles and blinking your eye.

I: Thanks to my vacation.

Firestone: You lawyers! Let's get going. We have an appointment with a developer who's building a new shopping center in an exciting growth area in Ozark, Kentucky. Get your coat and hat (with a grimace). . . . For heaven's sake! Where did you get that *hat*?

I: I picked it up in Paris.

Firestone (pursing his lips and settling his face into a judicious expression): Ohhhh! It looks very nice.