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People and Property: Waiver of Subrogation Clauses

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IT WAS 9:30 P.M. on Wednesday, March 12. I was passing through a boarding area at LaGuardia Airport to an airplane that would take me to Atlanta, Georgia. Harry Paine was scheduled to join me there for a trip to Howe's Bayou, Louisiana.

With my left hand I was dragging a hand truck stacked with luggage and carrying an overcoat. My right hand was supporting a paper plate that contained a chef's salad and two apples. I was dressed in a formal black suit and a red velvet bow tie. You say this is strange? I say you have a bad memory, or you forgot to read the last issue. So I will refresh your memory about what happened earlier that day.

I was wearing a tuxedo because of my client Harry Paine. Harry, a wealthy real estate developer, has had persistently good fortune. Things just go his way. It never rains when he throws an outdoor party. Stock that he buys always rises in price. When he speculates on land purchases, he is prone to discover oil, phosphates, fuller's earth, and coal. Some of his casual

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purchases have preceded announcements of major highway construction or the relocation of important industries.

Harry's good fortune includes the ability to govern his own time schedule and to intrude on mine. Despite my ardent desire to attend a $1,000-per-plate political banquet in New York on the evening of March 12, Harry insisted that I meet him in Atlanta at 11 A.M. the next morning. From there we would board a scheduled flight to Mobile, Alabama and then take a private seaplane to a yacht anchored in Howe's Bayou, Louisiana. There, meeting with the yacht's owner, Ken O'Hara, we would negotiate the destruction and insurance clauses for a package of twenty store leases with O'Hara's fast growing chain of gift shops, Kineahora Oriental Imports.

Harry's trusted assistant, "Big Irving" Gross, was already in Louisiana working on the deal, but Harry proclaimed that the job would not get done unless he and I joined Big Irving. He added that my sobriety, patience, and pessimism were necessary counterpoints to his own charisma, enthusiasm, and creativity and to Big Irving's euphoria.

I was carrying a chef's salad onto the airplane because I had left my $1,000-a-plate dinner before the meal was served. Two stewardesses greeted me as I entered the aircraft. They noticed my tuxedo and red tie, my luggage and my chef's salad. They remarked that I was the cutest thing they had seen all day, but they made no move to assist me. So I left my luggage, the overcoat and hand truck on the bulkhead seat in the first-class section and walked with my chef's salad to my economy-class cabin seat.

Some of my fellow passengers apparently concluded that the airline finally came up with a new and bold promotion scheme. They figured that I was an elegant flight attendant. Several demanded that I get them chef's salads also. I received requests for cocktails, highballs, and beer. And after I deposited the salad plate on my seat, I had to help several elderly passengers obtain pillows and blankets from the overhead luggage compartment.

My next move was to retrieve my own luggage from the first-class section. So I asked the passenger sitting in a neighboring seat to guard the salad, telling her that I had eaten nothing since noon. She swore eternal vigilance and declared that no one would ever touch my salad except me.

I squeezed my way back to the first-class cabin, deposited the luggage in a closet and took a warmup suit from my garment bag. Have you ever tried to change clothes in an airplane lavatory as the plane taxis along to the runway? No? You haven't missed a thing.

I returned to my seat dressed in my running suit. I was beyond hunger, but, at last, the chef's salad was within reach. A small but powerful hand grabbed my wrist. The appointed guardian of the salad was defending the plate against me. "It's me," I said. "No!" she insisted. The owner of the salad plate was an elegant man dressed in a formal suit—perhaps the great actor, Jack Lemmon.

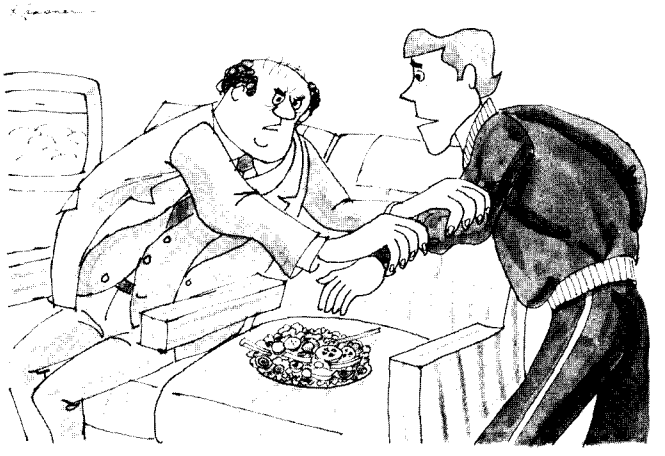
After I displayed my airline ticket, tuxedo, and Nassau County Park Leisure Pass, she permitted me to take my seat and have my dinner. When I finished eating, I realized that now was an ideal time to work on a memo that Harry wanted me to prepare. The purpose of the memo was to brief Harry on issues that might be raised during the negotiation. Here's what I wrote on the plane.

WHAT IS SUBROGATION?

There's much confusion about the word "subrogation." Many lawyers confuse this word with subordination. They shouldn't.

An insurance company has a right of subrogation when it pays an insurance claim. When it pays a claim to its insured, it inherits all of the rights its insured may have had against the person who caused the damage.

A shopping center lease example of subrogation follows: You are a tenant of a 2,000 sq. ft. bookstore in a shopping center. One of your employees throws a lighted cigarette into a pile of packing materials. The packing materials burst into flames, and the fire spreads so violently that the whole shopping center burns down. The insurance company pays your landlord immediately, and he quickly rebuilds the shopping center. Then the insurance company sues you for the cost of the entire replacement. That, my friend, is subrogation, and you are a pretty sad fellow if you are the one being sued. The right of subrogation is the insurance company's right to sue the person who caused the fire, and the insurance company gets this right because it paid the claim.



Not only tenants, but landlords should be concerned about the possibility that insurance companies will assert rights of subrogation against them. Tenants customarily carry fire insurance on their fixtures and merchandise. The tenants' fire insurance companies also have rights of subrogation. If the electrical wiring for a store is installed faultily, the landlord might be held to be liable for a fire, and the tenants' insurance companies would have a right of subrogation against the landlord.

Subordination is a different animal entirely. When a tenant subordinates, usually it is agreeing that the lien of the landlord's mortgage is superior to the tenant's rights under the lease. The mortgagee has rights against the demised premises because of its mortgage, and the tenant has rights against the demised premises because of the lease. When these rights conflict, the subordination documents determine whether the mortgagee or the tenant gets its way. If the lease is subordinate to the mortgage and the landlord defaults under the mortgage, the mortgagee might be able to evict the tenant from the demised premises after the mortgage is foreclosed. On the other hand, if the mortgage is subordinate to the lease, the mortgagee would not have this right, and each provision of the lease would prevail in case of a conflict between the lease and the mortgage.

WAIVERS BETWEEN LANDLORD AND TENANT

It seems to make sense for the landlord and tenant to waive liability against each other if the liability arises from a cause covered by insurance. They would seem to have everything to gain and nothing to lose. However, sometimes there is a problem. Some insurance policies prohibit the insured from waiving rights if the waiver wipes out the insurance company's rights of subrogation.

When the Insurance Company Does Not Consent to a Waiver

Most insurance companies that insure shopping centers do permit the insured to waive rights to sue their landlords or tenants for compensation for acts or omissions that cause a fire or other catastrophe covered by insurance. This practice is so widespread that it is surprising when any insurance company refuses to go along with a waiver. But because it is always possible that an insurance company will refuse to accede, some lease draftsmen insist that the waivers of subrogation rights should not apply when the insurance companies refuse. Thus the parties customarily agree that waivers will not apply if the insurance policies would be void as a result of the waivers.

But, this robs the parties to the lease of a major protection. The danger that a landlord or tenant will be exposed to an enormous liability to the insurance company when that company asserts its subrogation rights is so great that the negotiating parties may be wise to insist on changing insurance companies rather than deal with one that refused to approve waivers.

Or the parties that are confronted by an insurance company's refusal to agree to a waiver should consider getting the insurance company to insure both parties. I'd be a bit surprised to see an insurance company attempt to assert a right of subrogation against its own insured.

Sometimes, an insurance company demands an extra premium as consideration for acceding to a waiver. Shopping center lease clauses customarily take note of the parties' options in such a case.

Limiting the Applicability of a Waiver

Some negotiators don't want to give away any more than is absolutely necessary to make the waiver of sub-

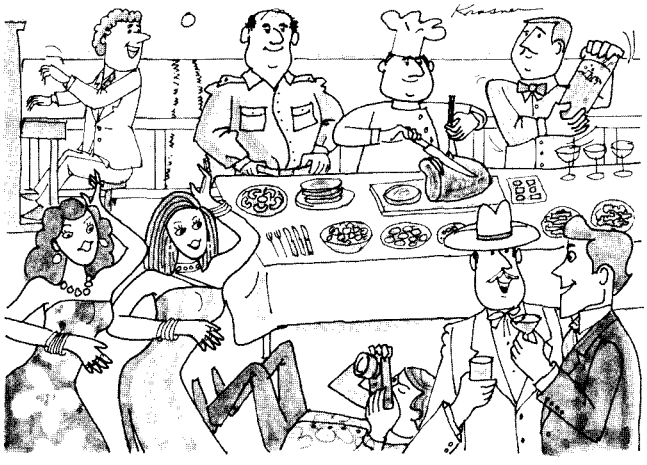
rogation clause work. They are willing to waive liability for perils covered by insurance, but they agree to waive this liability only to the extent of actual insurance proceeds recovered. (They grant a waiver only for the amount that the insurance company is entitled to recover under its right of subrogation. The insurance company has a right of subrogation only to the extent that it actually pays claims.) Thus the parties preserve possible rights against each other in the event of damage by fire or other catastrophe for which there is no insurance recovery.

Limiting the applicability of the waiver of subrogation clause may suit the needs of some parties to a shopping center lease, but it certainly is not the best policy for everyone. Some large chain-store organizations don't carry insurance and profess to be "self-insurers." Some landlords or tenants limit their potential insurance recovery by agreeing to huge "deductible" clauses in their policies. A "deductible" clause requires the insured to bear all losses in amounts less than an agreed upon "deductible" threshold. And, of course, it's not unusual for a shopping center landlord or tenant, burdened with the obligation to carry insurance pursuant to a lease, to carry less insurance than appropriate under the circumstances. The coverage limits might be too low; a peril against which insurance is customarily carried might be uninsured; an endorsement that should be added to the policy might not be added.

In each of these circumstances, a party obliged to carry insurance has purposely or negligently failed to provide enough insurance coverage to completely discharge the cost of repair or replacement of the part of the premises or the piece of equipment that he is insuring.

Why should such a party retain the right to sue the other to make up the difference between the cost of repair and replacement of the damage (the amount of insurance that could have been carried—presumably at reasonable cost) and the proceeds of the insurance actually carried?

Imagine that you are a tenant of a 5,000 sq. ft. restaurant in a one million sq. ft. regional enclosed mall shopping center. The landlord is required to insure the shopping center against fire, vandalism, and malicious mischief. The mortgagee also requires him to carry extended coverage and other endorsements. (Don't worry about this landlord; he's happy to agree to carry all of this because he requires all of his tenants to reimburse him for the cost of the policies.) But the landlord neglects to carry enough insurance to meet the entire cost of replacing fire damage to the shopping center. One fateful evening, your chef, who has been charcoal-broiling hamburgers, has a few drinks more than usual



and disposes of the charcoal in a trash basket. The flames spread and engulf the entire shopping center. Fortunately, no one is hurt, but the cost of repairing the damage is $60 million, an amount which exceeds the amount of insurance by $4 million.

When the landlord discovers that he won't recover enough from the insurance company to complete the repair, he turns to you for the difference. You say that's incredible? It is *usual*. Almost every shopping center tenant is in that position today because the waiver of subrogation clauses that are typically used protect the party that isn't required to carry insurance only to the extent of the actual proceeds received; they do not protect him to the full amount of insurance coverage that should have been carried under the circumstances.

What's to be done? Don't go along with the customary clause. It leaves you with too much exposure. Negotiators who are sensitive to this exposure should try to change what has become accepted practice to what used to be called a "mutual release clause."

MUTUAL RELEASE CLAUSES

Mutual release clauses focus on protecting the parties to a lease from liability to each other instead of potential liability to an insurance company. In effect, the mutual release clause states that if the tenant's premises, the shopping center, or both are damaged by fire or by a cause against which a party is *required* to carry insurance, the party required to carry the insurance can't sue the other party for negligence. Of course, that means that the insurance company can't assert a right of subrogation either. However, be careful. If you use the mutual release approach, the party required to carry the insurance must be certain that the policies won't be adversely affected by the release.

Waiver of subrogation and mutual release clauses aren't mutually exclusive. You need both. Suppose the

lease contains a mutual release clause and the shopping center is damaged as a result of a tenant's negligent act. Suppose also that the damage is covered by insurance that the landlord carried, but that that insurance was not required pursuant to the lease. If the mutual release clause is concerned solely with insurance *required* to be carried, the landlord's insurance company would still have a right of subrogation under these circumstances. To plug this gap, a lease needs a release between the parties as to insurance *required to be carried* and a waiver of subrogation as to insurance *actually carried*.

Waivers as to Employees and Officers

Releases in a lease should not be limited to the parties to the lease. What's to stop an irate landlord from suing a store manager for negligence of the store manager? What's to stop a tenant from suing the president of a corporate landlord personally for the personal negligence of the president? Both landlords and tenants need an additional clause to provide real protection for individuals in their organizations against exposure to potentially overwhelming liability for acts and failures to act that result in damages customarily expected to be covered by insurance. The waiver or release clause should extend its embrace to *officers* of corporate landlords and tenants. The waiver or release should also extend to *directors, shareholders, employees,* and *agents*.

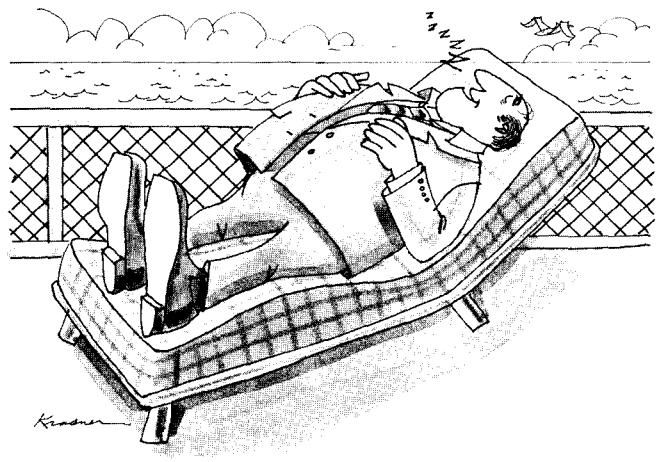
Waivers Among Tenants

Customary waiver of subrogation and mutual release clauses in leases ignore another huge potential for exposure. The customary clauses provide for waivers or releases with respect to the landlord and the tenant but don't deal with the potential liability of the shopping center tenants to each other or the potential liability of a shopping center tenant to another tenant's fire insurance company.

The possibility of liability among tenants of a shopping center arises whenever a tenant carries fire insurance on its premises or its inventory. Tenants carry fire insurance on their inventory almost all of the time, and leases for free-standing buildings usually require the tenant to carry fire insurance on the building as well.

It's easy to see that an insurance company that insures a supermarket adjacent to a department store against fire damage would be subrogated to the supermarket tenant's rights against the department store tenant if the supermarket were destroyed by a fire caused by the department store tenant's negligence. A fire insurance company that isn't inhibited by a waiver of subrogation would not hesitate to attempt to recoup a part of its loss by suing the department store tenant, its officers, and its employees.

Of course, some or all of this kind of exposure is or can be covered by liability insurance. But that doesn't mean there's no exposure. Many retailers self-insure for relatively small losses that would be normally covered by liability insurance, and others self-insure for all losses normally covered by liability insurance. The coverage limits on the liability insurance of many tenants are much less than the cost to replace a large department store or supermarket and its inventory.



So it's a very good idea for shopping center tenants to attempt to negotiate mutual release and waiver of subrogation agreements with each other. An excellent vehicle in which to accomplish this goal is the shopping center lease. A tenant might propose a clause pursuant to which the tenant commits itself to enter into a mutual release or waiver of subrogation agreement with any other tenant of the shopping center. The tenant's obligation to fulfill this commitment to each other lessee of the shopping center would be conditioned on

busy mixing and shaking, and Sam O'Hara was captaining. The models were busy dancing as they displayed the inexpensive jewelry that Ken was importing from Thailand and Burma. The photographer chased them all over as he snapped and directed.

Ken, Alphonse Whitehood, Big Irving and I sat down at a small, gaily set table and began our negotiations. As we talked, the band continued to play and the models replenished our mint juleps.

I'm not sure whether it was the motion of the vessel, the subject matter of the discussions, or the mint juleps, but Big Irving got seasick on the virtually still waters of the Bayou. Ken fed him a remedy of herbs and spices. And the negotiations continued. We argued and compromised and our discussions were mirrored in heated exchanges between the clarinet and trumpet.

Big Irving was getting more uncomfortable, and in addition, he was overwhelmed with drowsiness as a result of taking the folk medicines for his illness.

When we rose from our negotiations at 11:30 P.M., Big Irving didn't rise. He appeared to have no interest in moving at all; he was out of it. Sam O'Hara, the bartender, and the chef carried him to bed.

On Friday morning, March 14, Ken, Alphonse, and I (without Big Irving) continued the negotiations over breakfast. We settled many problems that seemed impossible to deal with the night before. There were still a dozen open points. I knew that Harry would insist upon negotiating these issues himself. But that was perfect. Harry was coming soon, and I had to get back to New York.

At noon Harry's secretary, Marlene, called and told me that Harry was now in the seaplane and would arrive in person in about one hour. She also warned me that I was returning to no picnic. A monumental snow storm was heading toward the Northeastern states. The weathermen were predicting three or four feet of snow.

We spent the balance of the hour waking up Big Irving and trying to keep him awake. If Harry realized that Irving had not monitored the whole negotiation, he would kill him after a prolonged period of excruciating emotional torture. To keep Big Irving awake we sat him amidst the band, with the trumpet in his left ear, and the band ran through its jazz repertoire.

Just as they launched into "I'm Just Wild About Harry," in walks Harry Paine. Positive in his belief that he was walking into a ceremony to celebrate his arrival, Harry postured his arms in a politician's victory pose. He hugged Big Irving and Ken briefly and then each of the models somewhat more leisurely.

As I boarded the seaplane to begin the journey to New York, Harry commented that his timing was excellent as usual. Here he was on the Bayou, escaping what he feared would be the worst snow storm to hit the Northeast in fifty years. I meditated upon the difference between my fate and his, and began the first phase of my return voyage to the Northeast.