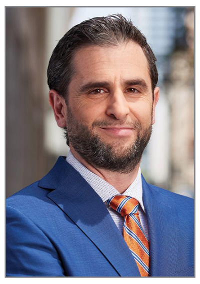
Leasing

The importance of lease insurance provisions

Commercial lease negotiations may feel, to property owners, like a burdensome hurdle prolonging cash flow or, to business owners, like a roadblock to getting operations up and running. However onerous, the negotiations by property owners and prospective tenants alike should include a firm understanding of the allocation of risks under a lease agreement to ensure a long and prosperous landlord/tenant relationship in spite of any unexpected liabilities and casualties.



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Commercial general liability coverage is a standard insurance product offering coverage against liability claims for bodily injury and property damage arising at the premises and from operations therein. All leases should obligate the insuring party to carry a CGL policy on an occurrence basis, as opposed to a CGL policy on a claims basis. The former provides lifetime coverage for claims arising during the term of the policy, while the latter provides coverage only for claims arising and reported during the term of the policy.

Property owners should ensure that a tenant's CGL coverage includes coverage for contractual liability, which covers the tenant's indemnity obligations under the lease. Depending on the nature of a tenant's operations, property owners also may require that a tenant's CGL policy includes coverage for products-completed operations, which insures against injury or damage that happens off of the insured premises but arises from the insured's work or products. Parties also should be aware of the limitations to bodily injury and property damage coverage. A CGL policy does not provide coverage for personal property in the care, custody or control of the insured, and it will not insure against losses resulting from the consequences of the insured's conduct, liquor-related accidents, injuries to employees, auto loss or pollution accidents.

The general aggregate limit establishes the maximum an insurer will pay for damages. Typical limits for many retail and office tenants range between $1 million and $5 million, but can go as high as $10 million or $20 million in more complex deals. Excess and umbrella liability coverage generally insure losses beyond the limits of underlying liability insurance policies.

Whenever a tenant is the insuring party under a commercial lease agreement, the property owner should ensure that the lease also requires a tenant to name a landlord as an "additional insured" on each of the tenant's liability policies. As an "additional insured," the property owner reserves a direct right to defense under the applicable policy and may obtain coverage even where a tenant's indemnity obligations are deemed unenforceable.

In addition to CGL coverage, commercial leases should provide for property insurance. Basic form property insurance provides coverage against losses arising from fire, lightning, explosion, smoke, windstorm, hail, riot, civil commotion, aircraft, vehicles, vandalism, sprinkler leakage, sinkhole collapse and volcanic action, while broad form property insurance insures those named perils, and also provides coverage for losses arising from falling objects, weight of snow, ice or sleet, water damage (from leaking appliances) and collapse from named causes. Special form coverage (formerly known as "all risk" coverage) offers expanded coverage whereby the insured must only prove that a loss was not excluded, and not that a specific peril occurred. Special form coverage excludes losses arising from boiler and machinery, earthquakes and flooding.

A commercial lease agreement should require such coverage to be carried by the party with responsibility for reconstruction. In a single-tenant building, the tenant typically is responsible for reconstruction and should be obligated to carry such coverage. However, in a multitenant project, the landlord often maintains coverage for casualty damage. Regardless of the insuring party with respect to casualty damage, a commercial lease should require a tenant to carry property insurance coverage for its personal property and improvements.

Most often, property insurance coverage employs the replacement cost valuation method, which insures the cost to repair or replace insured improvements with materials of the same or comparable quality – the calculation does not factor in depreciation, but excludes coverage for the costs of excavation, foundations and footings. Some property insurance utilizes an actual cash value valuation method, which functions in a manner similar to the replacement cost method but deducts depreciation. Functional replacement cost is a valuation method where a functionally equivalent improvement can be built for less than the original insured improvement – and in such event, the coverage may offer the policyholder significant cost savings.

The latest trend in insurance policies is cyber liability coverage, which insures parties against losses incurred when their information technology systems are compromised as a result of third-party malicious activity. Some companies have experienced heavy economic damages when their technology has been hijacked, lost or otherwise disrupted, and significant portions thereof can be recovered through cyber liability insurance, provided the company has implemented certain policies and measures as dictated by the insurance company. Look for these policies to be required by tenants for their businesses and landlords to protect sensitive information. ▲

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