



CAMBRIDGE
PROPERTY & CASUALTY

ISSUES RELATED TO TENANTS PURCHASING PROPERTY INSURANCE ON A LANDLORD'S BUILDING

Lease agreements will often require that the tenant insure the landlord's building asset. This approach has a number of serious disadvantages for both the landlord and the tenant.

- First of all, let us look at this from the tenant's standpoint. A tenant should never want to insure a landlord's building asset because if the policy is not properly negotiated and the landlord does not receive proceeds that will make the landlord whole in the event of a serious building loss, the tenant is likely to be responsible for the deficiency. The tenant will not have insurance to cover this type of error.
- As a rule of thumb, each party should be required to insure its own assets independently and to assume the responsibility for the adequacy of their individual insurance programs.
- Second, let us examine this issue from the landlord's standpoint. The landlord, if insured under the tenant's property insurance policy, will be standing in the tenant's coverage shoes. If the tenant violates a policy provision and the loss is denied, the loss will be denied for the landlord as well.
- One example of this is the Protective Safeguards endorsement, which is typically part of a property insurance policy for a sprinklered building. This endorsement would allow an insurance company to deny a property insurance loss if a sprinkler system is not maintained in good working order. The landlord does not have control over the sprinkler system, and a loss to the entire building could be denied because there is no severability on a property insurance policy between the landlord's and the tenant's interest.
- A second example of a policy provision relates to vacancy. An insurance company could deny a loss if the vacancy provisions of the policy are not met. The vacancy provision essentially says that if a building is 70% vacant, the insurance company can deny water damage, vandalism, and theft losses as well as reduce property insurance losses by 15%. A landlord may not be aware if a leased building complies with the vacancy provisions of the tenant's policy.
- A third example relates to coinsurance. If a policy has a coinsurance clause and it has not been waived by way of an agreed value endorsement, the landlord will be subjected to any penalties as a result of the application of that clause. For example, a 100% coinsurance clause would require the tenant to insure 100% of the replacement cost of the building. If after the loss, the insurance company determines that this clause was not complied with, the landlord would receive a

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reduced payout on a partial building loss. For instance, if the actual replacement cost on the building as determined after a loss was \$2,000,000 and the tenant insured only \$1,000,000, there would be a 50% deficiency which would reduce the partial loss by the same amount.

- A fourth example is ordinance or law issues. Property insurance policies typically provide only a minimal amount of coverage for ordinance or law changes. Under this provision, the insurance company would pay the replacement cost (assuming replacement cost coverage was provided under a policy); however, “replacement cost” means the replacement cost of the building prior to the loss, not as it has to be rebuilt after a loss. If the policy does not build in an adequate additional limit for ordinance or law changes, the landlord will not be able to rebuild.
- From a perils standpoint, property insurance policies vary widely in the area of property insurance exclusions. For instance, there are three standard cause of loss forms: Basic, Broad and Special. If a lease is not specific as to the Cause Of Loss form, a tenant could purchase less than the Special form leaving the landlord with limited coverage. Even the Special form (all risk) varies between insurance carriers. For example, some policies do not have any collapse limitations, but other policies do have these limitations. Some policies provide ensuing loss, such as sprinkler leakage from an earthquake, but others do not. The landlord is in a better position to control the quality of its own property insurance.
- If a tenant has blanket building and personal property coverage, which means one limit for both building and personal property instead of two limits, the landlord risks the possible inadequacy of the blanket limit. For example, if the tenant purchases a blanket limit of \$5,000,000 for building and personal property and it turns out that the personal property portion of the loss was \$5,000,000, the landlord would have nothing left for the building claim.
- Property insurance policies typically do not have provisions for landlords as additional insureds. As a matter of fact, there is no standard endorsement that provides for property insurance “additional insureds.” There is an endorsement that allows a landlord to be a “loss payee.” This simply means that the landlord will be listed on the loss payment draft. Again, the landlord stands in the tenant’s shoes and only has the rights of the tenant. If the tenant does not get paid, the landlord does not get paid either, even if it is listed as a loss payee.
- Furthermore, the loss draft will be made payable to the first named insured on the policy and any loss payees and mortgagees. If the tenant has multiple loss payees on machinery and equipment that it owns or leases, those names would also be on the loss draft, assuming the payment is for building and personal property. In any event, the landlord has to negotiate to get endorsements on a multiple payee loss draft so that it can get its piece of the payment in order to rebuild. This could result in a standoff and certainly could delay the landlord’s rebuilding process.
- Another issue regarding allowing a tenant to purchase insurance on a landlord’s asset is that in the event of a major loss, the likelihood of a tenant having financial problems is increased dramatically if the tenant is unable to recover. If a tenant files bankruptcy, any loss payments become part of the bankruptcy estate. In this case, the landlord becomes an unsecured creditor and may not be able to be paid for all or even a portion of its losses.

- These same issues apply to business interruption insurance. The landlord's loss of rental income needs to be paid under a business interruption form that includes loss of rents, or there needs to be an independent loss of rental income form added to the tenant's policy. If not, the landlord's rents will not necessarily be paid under the tenant's business interruption insurance because in the typical lease, the rent abates in the event the building cannot be occupied, which means the tenant would not have an obligation to pay rent. This in turn means that the business interruption carrier would not have an obligation to pay the landlord as well.

If a separate loss of rental income form is added to the policy, there would need to be a loss payee clause added that would make the loss of rental income coverage payable to the landlord and not the tenant. This could be a problem because the typical loss payee clause on a property insurance policy is specific to personal property, not business interruption. Also, as we indicated earlier, the policy requires that losses be made payable to the first named insured, and the landlord will have no assurance of being paid for loss of rents. Of course, business interruption loss of income coverage is also subject to the terms and conditions issues discussed above, such as coinsurance, vacancy, protective safeguards, etc.

- In the event the policy is cancelled, unless there is a clause added to the policy that specifically requires notice to the landlord in the event of cancellation, the landlord has no assurance of receiving notice of cancellation. Even if there is a clause that does require specific notice to the landlord in the event of a cancellation, this clause is unlikely to require notification in the event of material change.
- Certificates of insurance issued by insurance agents for landlords showing that they are covered under the tenant's policy do not typically provide enough detail to determine the terms and conditions to the policy in order to analyze the adequacy of the tenant's insurance program as respects the landlord. Furthermore, an insurance agent's liability for certificates of insurance is limited.
- The administrative burden on the landlord of following up to be certain that the policies are properly issued and renewed is onerous. Insurance agents usually will issue policies not cognizant of all of the issues involved in insuring someone else's assets. The constant follow up necessary to get the documents right is an expensive proposition for the landlord and seldom is favorably concluded.
- In the event a tenant insists on negotiating a property insurance policy for a landlord's assets, it should be on a stand alone policy in the landlord's name alone as well as the landlord's mortgagee. Also, it should have the landlord's address as the mailing address and should avoid all of the terms and conditions issues that we have mentioned.

As a general rule, landlords should avoid at all costs allowing someone else to purchase protection for its assets. This type of arrangement is dangerous to say the least.