

INSURANCE ISSUES IN INDUSTRIAL AND OFFICE LEASES - PART 2

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In the last issue of the *SIOR Report*, we highlighted several insurance provisions in commercial leases, including: Reasonable Limits for Comprehensive General Liability (CGL); Certificates of Insurance (“COI”) and Notice of Cancellation; Subrogation; and Business Interruption (BI) and Extra Expense (EE) Insurance. In this second part, we discuss the Landlord’s side of the equation, Rental Insurance and issues that arise in the event of a casualty loss.

1. Rental Insurance:

a. What does rental insurance cover in the event of a casualty? Loss of Rents/ Business Interruption will replace the Landlord’s loss of rental income resulting from the casualty.

b. Who should have this coverage? For many landlords their significant exposure to loss of revenue is primarily “Loss of Rents.” This then translates to the Landlord’s “Business Interruption” limit. It is recommended that the Landlord carry loss of rents coverage, especially when rent abatement clauses are granted in a tenant’s lease. Just because rent may be abated as a result of a casualty, mortgage payments are not suspended.

2. Landlord Insurance Issues in the Event of a Casualty Loss:

a. What if insurance proceeds are insufficient to rebuild a partially or wholly destroyed property?

Replacement Cost Coverage (RC) valuations for property insurance, by definition, pay for what it would cost to replicate the lost property in “today’s” market. This coverage focuses on the

actual cost of like kind and quality of building materials. It does not pay for the ultimate cost an insured incurs to actually replace or rebuild the property. Consider and determine whether or not it covers current labor costs as well.

b. What if the mortgage lender claims the insurance proceeds? If the lender is identified on the policy as a “Loss Payee,” insurance proceeds will either be paid to the lender or to both the lender and the insured. It is usually up to the lender and the insured to determine use of proceeds. For example, if the Landlord did not carry sufficient Loss of Rents coverage in order to cover its tenant’s discontinued rent payments, the Landlord may not be able to meet its debt service obligation to the lender. Accordingly, the lender may apply recovery first to Landlord’s failure to keep current on the mortgage, prior to any proceeds being applied to rebuilding or replacing the building. Adequate coverage is paramount in order to allow the Landlord to replace or rebuild and stay current on its mortgage obligation.

c. What if the insurer won’t adjust the claim in time to get started on restoration as the lease requires?

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While most insurers promise to adjust claims in a timely fashion, delayed adjustment could result from inability to process a larger than normal claim, volume of claims in a wide-spread disaster, or the insurer's liquidity issues. This concern highlights the importance of the Tenant's or Landlord's upfront efforts in structuring and purchasing quality coverage from A-rated insurance providers. Further, the Landlord's obligation to rebuild or restore the leased premises should be within a reasonable but definite period – but that period should commence on date of adjustment of the insurance claim, not the date of the loss.

If a party focuses only on the cost of insurance without considering proper limits and risk assessment, then disasters could occur in the event of a loss. According to Mr. Weil, over 60 percent of businesses fail to resume operations after a large property loss, causing significant business interruption. This is primarily due to lack of preparation and planning, not because insurance limits were too low.

Insurance provisions in a lease are not usually addressed by brokers, they are

often handed over to the attorneys, but the broker's insight and experience could add value. Your client's insurance professional is often the key advisor on these provisions. We again acknowledge and thank Dan Weil, Senior Vice President, Property & Casualty Group, of Chicago-based Alliant/Mesirow Insurance Services, who contributed to these articles. ▾