

Commercial Insurance Update

Topics Affecting Buyers of Commercial Insurance

MSP C 08/2007 – “Managing Lease Exposures”

August, 2007

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Managing Real Property Exposures

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Entering into a building lease can create major financial loss exposures for landlords or tenants. The approach a business takes with regards to a real estate lease should mirror its overall risk management philosophy. The following discussion will give some background and an overview of the risk management issues involved in the real estate lease exposure.



Background

A real estate lease is a written or oral (not recommended) contract in which the landlord (lessor) transfers the use of all or part of its real property to the tenant (lessee) for a certain period and for a certain consideration (rent). The main objective of a lease agreement is to determine the legal rights and duties of the parties involved. It is important to remember that provisions contained within a lease can be written to yield the maximum economic benefit to each of the parties. It is imperative you are aware of the liabilities you have assumed, especially if the other party has any leverage in the negotiation.

Indemnification Provisions

Most leases require tenants to assume responsibility for liability arising out of an occurrence in connection with the leased premises, except for liability resulting from the sole negligence of the landlord. This is referred to as an intermediate hold harmless agreement and is common in real estate leases. As an example, if a third party is injured on the property and the landlord was

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Published by

Cavnac & Associates
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10% responsible and the tenant 90% responsible, the tenant will be responsible for 100% of the injury. A fair approach would be that each of the respective parties would pay the apportioned amount but an intermediate form hold harmless agreement requires that the tenant pay 100% of the damages. Although not totally equitable, it is legal and typically insurable.

It is also important to be aware of broader and more inclusive indemnification wording. These indemnification provisions can knowingly or unknowingly transfer a wide range of liabilities. The wording could include phrases such as “*all loss, cost or damage occurring on or about the premises.*” This broad wording could include exposures such as damage to the leased property (which is not usually covered under a general liability policy), personal injury offenses, environmental pollution or other exposures that might or might not be insurable with respect to liability assumed under a contract.

Indemnification clauses are a primary risk transfer tool in real estate leasing. Because state laws vary on the appropriate scope and enforceability of indemnification provisions, you should always consult with your attorney before drafting or signing any type of indemnity agreement.

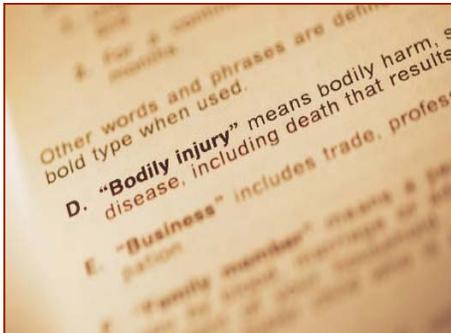
Insurance Provisions

The insurance requirements are typically contained in a separate lease provision. These requirements can vary based on a number of factors including the type of building and its intended use.

Landlords should always make sure that their lease requirements clearly articulate what insurance is required. Clear unambiguous language will help reduce your liability exposures under your own insurance program. Landlords should never assume that they have transferred all of their risk to their tenants, a separate insurance program written in the landlord’s name is still required.

Liability

Leases will typically require that the tenant carry commercial general and/or excess liability insurance to protect the landlord and tenant against claims arising out of the use of the premises. They will require that the tenant’s liability insurance include the landlord as an additional insured using the standard Insurance Services Office (ISO) Additional Insured Endorsement



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Wednesday September 19, 2007 — 12:00 PM - 5:00 PM
Thursday September 20, 2007 — 12:00 PM - 5:00 PM

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- Contact Darcee Nichols at dnichols@cavignac.com or 619-744-0596

CG 20 11. This endorsement provides additional insured status to the lessor or manager of the leased premises with respect to liability arising out of the ownership, maintenance, or use of that part of the premises leased to the named insured. It is important to note that this endorsement has limitations.

1. It does not cover losses arising out of the areas of the premises not leased to the tenant and not described in the endorsement. This could include common areas, maintenance and service facilities, adjoining sidewalks, etc.
2. Coverage is limited in that the landlord does not have protection for claims resulting from alterations and renovations, new construction or demolition operations performed on the landlord’s behalf to the leased premises.
3. The additional insured does not have coverage for losses arising out of an occurrence that takes place after the lessee is no longer a tenant.
4. This endorsement does not cover the stockholders, officers, directors or employees of the additional insured.

Property

A real property lease should clearly state which party has responsibility for damage to the premises as well as for providing insurance. These requirements are not typically contained in one clearly defined section of the lease so finding them can be a bit confusing.

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Who Is Responsible for Procuring Property Insurance?



In most cases, landlords should buy their own insurance covering the leased property. However, it is not unusual for the tenant to be required to provide the building coverage. Should the tenant be required to obtain property insurance on the building, the following guidelines should be followed:

1. The lease should require that the tenant obtain the landlord's approval of all the insurers and coverage characteristics (values, replacement cost provisions, additional coverages etc.).
2. The policy should name both the landlord and tenant as named insureds and cover the interests of any mortgagee.
3. The landlord should have notice of any cancellation, or other change in the status of the policy.
4. The landlord should retain an original copy of the policy.
5. A procedure for adjusting values over time should be implemented. Rather than having a fixed percentage, it is prudent to have the building amount adjusted annually subject to a specific building cost index such as Marshall & Swift or a formal replacement cost appraisal.

Rental Income

The lease should clearly spell out the tenant's obligations to pay rent in the event of damaged or impaired premises. If the lease is silent, state laws will step in to determine the applicability of rents. The law in most states provides that a lease can be canceled, abated or adjusted depending on the amount of damage to the premises.

The business income requirement can create a serious financial exposure for a tenant if they must continue to pay rent in the event of impaired or unusable premises. Building owners also face a loss of rental income if the lease provisions dictate rent abatement or even termination.



The standard ISO forms CP 00 30 and CP 00 32 are designed to cover these business income/rental income loss exposures. You should consult with your insurance agent to determine your business income/rental income exposure. Your insurance policy should include coverage to satisfy your obligation under the lease.

Please refer to our April 2007 *Commercial Insurance Update* newsletter (<http://www.cavignac.com/pdfs/CML0407.pdf>) for a detailed overview of business interruption insurance.

Tenant Improvements and Betterments (TIBs)

A potentially confusing area of the lease concerns tenant improvements and betterments. The difficulty lies in determining who is responsible for insuring them as well as the best way to insure them.

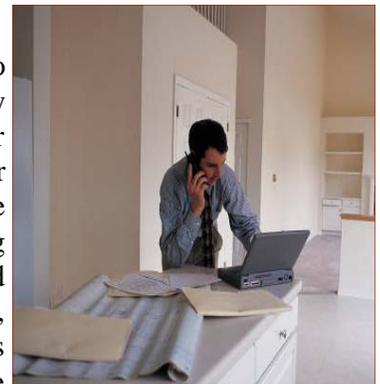
What Are TIBs?

A simple question to ask to determine if property is an improvement or betterment is whether or not the tenant can remove the item without damaging the building. This would include fixtures, alterations, installations or additions that are made a part of the building or structure the tenant occupies but does not own. Note that there are rules, laws and court decisions which will resolve many disputes when it comes to defining what TIBs are.

Not all leases are clear in regard to TIBs. Some leases will state that the landlord will insure and replace them when they are damaged. Other leases are silent on the issue. Still others state that the tenant is responsible for insuring and repairing them. It is important that the lease clearly articulates who is responsible for insuring the TIBs in the event they are damaged.

Another consideration when insuring TIBs is the "use" interest. What this means is that the amount of coverage for improvements and betterments is automatically reduced with the time remaining on the lease. Most property insurance policies stipulate that if following a loss, repairs are not made promptly, the insurer will only pay a portion of the original cost of the improvements based on the unexpired term of the lease.

For example, landlord and tenant enter into a ten year lease. In Year Five, the building is destroyed, and the owner decides not to rebuild per the terms in the lease. The tenant would recover at most only 50% of



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A quick note: In the event you are not able to negotiate a mutual waiver of subrogation, the tenant should procure Fire Damage Legal Liability (CP 00 40). This would provide a limit of insurance for the leased premises in the event the tenant is found legally liable (negligent) for damages to the landlord's property.

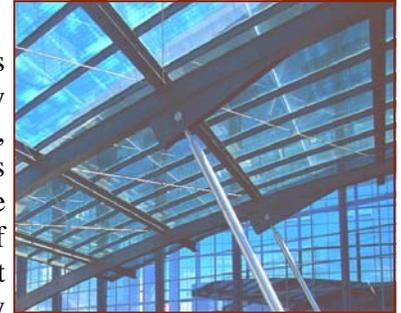
Boiler & Machinery

On occasion, tenants can be contractually responsible for insuring boiler and machinery. This generally pertains to the heating and air conditioning systems within their premises. Ideally this is insured by

the landlord as the equipment is generally considered a part of the building.

Exterior Plate Glass

Exterior plate glass should be insured by the landlord as well, although in some cases it will be required to be insured by the tenant. If the latter is the case, it must be specifically endorsed onto the policy or the tenant should verify with their insurance agent that plate glass is covered under their current property policy.



Leasehold Interest

Leasehold interest insurance covers the loss suffered by the insured tenant when a premises lease is canceled as a result of damage to the premises from a covered cause of loss, and the tenant must therefore lease replacement premises at significantly greater expense.

For example, a tenant is currently paying \$1 per square foot (s/f) on its premises lease of 5,000 s/f. The tenant is currently paying \$5,000 per month, and has one year left on the lease. The premises are damaged or destroyed by a covered peril, which gives the landlord the right to terminate the lease. The going rate for the same space is \$1.50 s/f. Our tenant must find similar space for which he will pay \$1.50 per square foot. If our tenant had one year left on the lease, he would pay 50¢ more per square foot ($\$5,000 \times \$0.50 = \$2,500 \times 12$ months). In other words, our tenant will have to pay \$30,000 more for rent for that year than they would otherwise have had to pay. This is insurable.

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the original cost of improvements, regardless of the limits carried.

From an owner's perspective, the TIB provisions of a lease create increased exposure. Unless the improvements and betterments are specifically excluded (by endorsement) from the landlord's building policy, the landlord's policy will pick up the TIBs, given they are permanently attached to the building. However, if the landlord's policy contains insurance to value provisions (coinsurance) and the landlord did not include the cost of the TIBs under the building policy, penalties (reduced settlements) could apply in the event of a loss.

Other Lease Exposures

Waiver of Subrogation

In the event a tenant causes damage to the landlord's property, the landlord's property insurer, in all likelihood, would pay for the loss (assuming it's covered) and subrogate against the tenant to cover what it paid. Similarly, if the landlord's negligence causes damage to the tenant's property, the tenant will turn the claim in to its property insurer; the tenant's property insurer would pay for the loss (assuming it's covered) and subrogate against the landlord.

The preferred way to handle this situation is with a mutual waiver of subrogation. With this provision, each party agrees to waive its rights against the other party to the extent it is covered by its own property insurance policy. This eliminates the need for expensive litigation, and it works to the advantage of both the tenant and the landlord. See the sidebar on page five for a sample waiver of subrogation provision that should be considered in a real estate lease agreement.

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Sample Waiver of Subrogation

In consideration of the benefits hereinafter described, _____, as Lessor, and _____, as Lessee, agree as follows as respects the property located at:

Each party hereby waives its rights of recovery against the other for damage to its property or to property in which it may have an interest where such loss is covered under valid and collectible insurance policies.

This waiver applies only when permitted by the applicable insurance company.

This waiver does not apply to any portion of a loss which exceeds that which is recoverable under the applicable insurance policy.

Lessor

Lessee

Date

Date

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Summary

This article addresses some of the major exposures presented to both the landlord and tenant when a real estate lease is signed. However, it does not address all of the exposures presented when entering into a real estate lease. All of these issues underscore the importance of reviewing and negotiating a lease agreement before it is signed to avoid any surprises in provisions which may be discovered at a later date. Your attorney should review the agreement from a legal perspective and you should also consult with your insurance agent to be sure you have secured the appropriate coverages in compliance with the insurance requirements. ✨

Before joining Cavignac & Associates, Account Executive Matt Slakoff (msslakoff@cavignac.com) spent five years as a Property & Casualty Underwriter with a Managing General Underwriter. He was responsible for marketing, risk analysis and claims management for a large number of retail brokerage accounts.

Matt's property and casualty underwriting background uniquely qualifies him for the design and implementation of risk management programs for clients in the real estate, development and construction industries. Matt also specializes in the analysis and placement of environmental risk.

Disclaimer: This article is written from an insurance perspective and is meant to be used for informational purposes only. It is not the intent of this article to provide legal advice, or advice for any specific fact, situation or circumstance. Contact legal counsel for specific advice.

The Average American Spends 18 Years in Retirement — Will You Be Prepared?

Article courtesy of Employment Benefits Department

1. **Know Your Retirement Needs** — Retirement is expensive. Experts estimate that you'll need about 70 percent of your pre-retirement income – lower earners, 90 percent or more – to maintain your standard of living when you stop working.
2. **Find Out About Your Social Security Benefits** — Social Security pays the average retiree about 40 percent of pre-retirement earnings. Find out more about your benefits at www.socialsecurity.gov.
3. **Contribute to a Tax-Sheltered Savings Plan** — If your employer offers a tax-sheltered savings plan, such as a 401(k), sign up and contribute all you can. Your taxes will be lower, your company may kick in more, and automatic deductions make it easy. If your employer does not have a plan, open an individual retirement account.
4. **Don't Touch Your Savings** — Don't dip into your retirement savings. You'll lose principal and interest, and you may lose tax benefits. If you change jobs, roll over your savings directly into an IRA or your new employer's retirement plan.
5. **Start Now, Set Goals, and Stick to Them** — Start early. The sooner you start saving, the more time your money has to grow. Remember, it's never too early or too late to start saving. So start now, whatever your age! ✨

Workers Compensation Bulletin

My Loss Experience Didn't Change, So Why Is My Experience Modification Factor Going Up?



By Jeffrey W. Cavnac, CPCU, ARM, RPLU, CRIS

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The Workers Compensation Insurance Rating Bureau (Bureau) is responsible for, among other things, calculating Experience Modifications (X-Mod) for every qualifying employer in the State of California.

An X-Mod is based on a number of factors, but it essentially compares actual losses to expected losses. (For a detailed description of X-Mods, see our April 2005 *Commercial Insurance Update* newsletter (<http://www.cavnac.com/pdfs/CML0405.pdf>). If an employer has an above-average experience compared with similar employers, a credit X-Mod (less than 100%) is awarded. If an employer has a below-average experience, a debit X-Mod (an X-Mod over 100%) is issued.

In the last four years, major reforms have substantially reduced loss experience in California as well as Expected Loss Rates (ELRs). ELRs are based on expected losses by classification per \$100 of payroll and are reflected on the X-Mod worksheet. ELRs are available on line at <https://wcirbonline.org>.

Because ELRs are decreasing, and assuming that actual losses remain unchanged, an employer will experience a higher X-Mod.

Let me give you an example. Let's assume ABC Company's expected losses were \$100,000, and its actual losses (as calculated on the worksheet) were \$60,000. \$60,000 divided by \$100,000 equals 60%. Now let's assume that the expected losses went down 20%, but actual losses remain unchanged. The denominator has decreased from \$100,000 to \$80,000. \$60,000 divided by \$80,000 equals 75%. In other words, ABC Company's actual losses have not changed, but its X-Mod has gone up.

If everything else remains equal, on average, X-

Mods will increase, but this will be more than offset by the decrease in base rates that most insurance companies are charging.

A recent renewal account of ours is a case in point. The employer's X-Mod went up 6% despite the fact that it did not have any claims in either experience period. At the same time, the employer's net rates (without taking into consideration the X-Mod) decreased 14%. Taking the X-Mod into consideration, the net rate actually decreased 9% ($100\% \times .86 \times 1.06 = 91\%$).

It is true that, in general, X-Mods are increasing. However, real net rates have decreased significantly during the past three years and may continue to decrease in the near future.

For additional information on this topic, access the WCIRB article at https://wcirbonline.org/spotlight/spotlight_2006_02.html. ✨

Jeff Cavnac is President and a principal of Cavnac & Associates. He specializes in risk management for design professionals, construction and commercial clients.

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Image of Proposed New Main Library
Courtesy of Rob Wellington Quigley, FAIA



Community Bulletin Board

"Neighbors helping neighbors in San Diego"

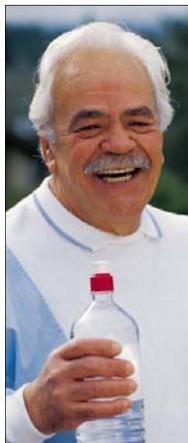


Senior Community Centers' Broadway Center is a designated San Diego County Cool Zone. Seniors can come to our center for meals, activities and to socialize with friends. Seniors are also able to visit a nurse and/or mental health professional, attain affordable housing and have access to social services.

The Broadway Center is located at 925 Broadway, San Diego, CA 92101. The center is within walking distance to the bus and trolley. For more information, call (619) 235-6572 or visit <http://www.servingseiors.org>.

Tips to Stay Cool

- Go to a cool zone site on hot days.
- Slow down – do any physical activities during the coolest part of the day, usually between 4-7 a.m.
- Stay indoors as much as possible. If air conditioning is not being used, stay on the lowest floor. Keep shades down and blinds closed, but windows slightly open.
- Electric fans do not cool the air, but they do help sweat evaporate, which cools your body.
- Take cool baths or showers.
- Avoid using the oven.
- Air out hot cars before getting into them.
- Wear lightweight, loose-fitting, light-colored clothing. Light colors will reflect away some of the sun's heat.
- Drink more fluids than usual even if you do not feel thirsty. Water is the safest liquid to drink during heat emergencies. **Avoid drinks with alcohol or caffeine** because they increase the heat's effects on your body.
- Eat small meals and eat more often. **Avoid foods that are high in protein** because they increase metabolic heat.
- If you take diuretics, ask your physician about a lower dosage during hot weather. ✨



Today there are more than 2,200 homeless children in San Diego. Monarch School works closely with the community and the San Diego County Office of Education to provide an accredited education to homeless and at-risk kids while caring for their basic needs such as health care, food, clothing and personal hygiene.

Upcoming Events



Do the RED Shoe Shuffle

The metro office of Keller Williams Realty invites you to make a difference in the lives of Monarch School's homeless students by joining them for the first ever **Red Shoe Shuffle 5K Walk**.

The walk begins in Marina Park and follows the beautiful Embarcadero in downtown San Diego. It will be followed by a health and lifestyle expo. Musical entertainment will be provided by the Steel Monarchs — Monarch School's talented steel drum band.



Come join the fun on **Sunday, August 12th** beginning at 8:00 a.m. in Marina Park. The cost to enter is \$25 – the cause is priceless! For more information, visit www.redshoeshuffle.com.



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2008

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The headliner for the 2008 "Diamond in the Rough Gala" at the Manchester Grand Hyatt will be the incomparable **Natalie Cole**! The earlier you reserve your seat, the closer to the stage you will be!

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