What You Need to Know About Insurance In The World of Commercial Real Estate

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Contracts are a way of life in the commercial real-estate world. Nearly every aspect of our business necessitates a written contract. Aside from memorializing "the deal", the main purpose of a contract is to allocate risk between the parties. Risk allocation is done in various ways, such as through warranties, representations, assumptions of liabilities, and indemnification. But the most common and cost effective way to mitigate risk is a contractual requirement to obtain insurance. If done properly, insurance can be a very thankful safety net when something goes haywire with your tenants, vendors, or construction projects. Billionaire investor Warren Buffett once said, "Risk comes from not knowing what you're doing." That is certainly true in real estate. Merely having insurance isn't enough – you must ensure that your tenants and contractors have the correct coverage. This article addresses some "must know" points.

Self-Insurance & Self-Insured Retention

Many companies claim to be "self-insured". But ordinarily this just means that the company with "self-insurance" pays for any claims from their available cash. In those rare situations when you are dealing with a very solid credit company with an abundance of cash, this might be an acceptable position. Most of the time, however, this will not be the case, and even if you're dealing with a solid company that "self-insures", success can be fleeting – as we've all witnessed during the economic downturn over the past several years. If a financial hardship occurs, they may not have the ability to pay a claim if they self-insure. Before doing business with a company that claims to be "self-insured", check to see that they have established a restricted and encumbered fund or a reinsurance program. That fund or reinsurance program should be investigated to see how secure it is, perhaps with some sort of "financial means" tests and monitoring program to ensure they stay financially healthy. Your contract should also contain some minimum requirements for the self-insurance program. Furthermore, especially in long-term contracts, such as a lease, the self-insurance right should be limited to the named entity, and should not extend to any of their successors or assigns. A self-insured retention, or "SIR", is a dollar amount specified in an insurance policy that the insured (the party obtaining the insurance) pays before the policy kicks in. A SIR is generally larger than a deductible, and can help the insured reduce the cost of its premiums. If you're dealing with a company that has a large SIR, you need to ensure that they have the financial wherewithal to cover any claims that fall within the self-insured retention limit.

Additional Insureds

Generally speaking, an "additional insured" is a person or organization that enjoys the benefits of being insured under an insurance policy, in addition to the insured that purchased the policy. The protection kicks in when the additional insured is sued for the acts of the named insured. For instance, if a lease agreement requires the tenant to name the landlord as an additional insured, and the tenant's customer slips and falls on the proverbial banana peel, the tenant's policy should cover the tenant (the original named insured) and the landlord (the additional insured). An additional insured also has the right to make a claim against the named insured's policy. The insurance company must provide the additional insured with a legal defense of a covered claim. If you are a landlord, you want all of your contractors, tenants, and your tenants' contractors to provide an endorsement listing you as an additional named insured. Likewise, if you are a tenant, you will want your vendors to provide this protection for you, and you may ask the landlord to do the same. The key to allocating risk is to "pass the buck" – literally – and require the party who is most likely to be responsible for an incident to be the same party whose insurance pays to clean up the mess, so to speak. In order to obtain additional-insured status, you must confirm that the other party's policy provides this coverage through an endorsement. (An endorsement is an amendment to an insurance policy/contract.) These endorsements allow the policyholder to basically add an additional insured to the policy upon request. Another approach is to have your tenants, vendors and contractors purchase insurance that contains a "blanket additional insured" endorsement. It's also important to note that the additional insured does not automatically receive notices of policy cancelations, unless you obtain an endorsement to the policy.

Certificates of Insurance

Many real-estate professionals believe that Certificates of Insurance are ironclad proof that another company has insurance, and has identified you as an "additional insured". Be careful! Generally, these "certificates" are just evidence of the coverage the policyholder has at the very moment the certificate is issued. It says that on the face of the certificate. Further, courts have held that the certificates confer no rights on the certificate holder. Most insurance policies specify that if you want to change the policy language, you must actually change the policy. This is dangerous because oftentimes these certificates are prepared at the last minute, or at 4:45pm on a Friday afternoon, by an insurance agent who may slip up when it comes to actually getting the insurer to provide the coverage. So, if your intent is to be listed as an additional insured on your tenants' or vendors' policies, it might not be satisfied if the underlying policy was not changed (endorsed) to provide the coverage. You should request proof of this change to ensure it was done properly. Recently, Texas passed a law that says only certificates approved by the Texas Department of Insurance may be issued. If an insurance company wants to use a non-standard form, they may file it with the Department, pay a fee, and wait for approval. However, you cannot ask your tenants or contractors to add specific provisions to insurance certificates "on the fly". This reinforces the need to require tenants, contractors and subcontractors to provide owners and property managers with a copy of their insurance policy(ies) so you can see the specific coverage they have. You should check the policy's declarations page(s), and ask for a copy of an endorsement showing you (and your agents) are additional insureds.

Wrong or outdated language

In 1986 the insurance industry overhauled its policy forms. This dramatically impacted certain coverage's and created different terminology. Even though it's been nearly 30 years, many professionals – even lawyers and risk managers – still use outdated language, and this outdated language still appears in contracts all the time. Here are some examples: Property Insurance. Terms like "fire insurance", "extended coverage", "vandalism and malicious mischief", and "special extended coverage" are gone. Instead, we now use terms like "basic causes of loss", "broad causes of loss", and "special causes of loss". Additionally, the term "all risk" is seldom used because many courts have held that the term "all risk" gives consumers the impression that the policies cover "all risks", when in fact they do not. A "basic causes of loss" policy is just that – basic. A "broad causes of loss" policy offers broader protection, and a "special causes of loss" policy is what most insurance professionals think of as "all risk". Liability Insurance. The phrase "comprehensive general liability" has been phased out and the more common term now is "commercial general liability" insurance (a/k/a "CGL"). The difference is that the "comprehensive general liability" was very basic and required the policyholder to purchase multiple endorsements; however, "commercial general liability" includes many of the coverage's that typically were excluded under the old form. Not only does this allow the insured to receive greater protection, but the shift in policy types allows insurance companies to increase premium charges for their "standard" policies without worrying about whether or not their insureds elect o cut corners by skimping on endorsements. In that regard, since most CGL policies now cover the same types of claims that pre-1986 policies obtained through "blanket" or "broad form" coverage, the terms "blanket" or "broad form" should not be used.

Contractual Liability Insurance

Another common tool to shift risk in a contract is an indemnity clause. An indemnity clause requires one party to protect the other party for things that "go wrong". The indemnity clause identifies who is to be responsible if liabilities arise. But if the party providing the protection does not have the financial ability to satisfy the claim, then the indemnity is meaningless. This is akin to buying an insurance policy from an insurance company that goes broke. In order to protect against this risk, contractual liability insurance can fund all or a portion of certain indemnities. Contractual liability insurance applies to bodily injury and damage to tangible property only. If available, contractual liability coverage is subject to the policy limits, and you cannot just assume that this coverage is in the CGL. You should ask for your tenants, contractors and vendors to provide the endorsement showing the coverage is in place.

What is Subrogation?
Why do we waive it?

From a legal standpoint, "subrogation" means that one party has the right to "step into the shoes" of another party for the purposes of suing someone to recover damages. Property-damage claims are the most commonly subrogated claims. Not all claims may be subrogated. How does subrogation work? Suppose your tenant or your vendor damages part of the building. Unless your tenant or their insurance company pays for the damage, you may have to submit a claim to your insurance company. If your insurance company pays the claim, they will likely want to recover their out-of-pocket costs against the responsible party. In most states (including Texas), your insurance company becomes "subrogated" to your rights to sue the tenant or vendor. In essence, your insurance carrier "steps into your shoes". A waiver of subrogation clause minimizes lawsuits and claims among the parties because all the risk is shifted to the insurance companies, and the cost of the insurance coverage is contractually allocated among the parties. As a practical matter, if your contract requires the other party to waive subrogation, you must ensure that their insurance policy allows for such waiver.

Conclusion

These issues are extremely important for anyone in real estate. A misstep can have incurable consequences down the road. It is, therefore, critical to understand these concepts and seek assistance from your insurance broker or competent counsel.