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INSURANCE 101

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I N D E X

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INTRODUCTION

Insurance is a method to protect against financial loss. Generally speaking, there are two ways that losses may arise. First, your stuff may be damaged or destroyed. For example, a fire burns down your building. You suffer a financial loss equal to the value of your building. Second, you may be held liable for the damage or destruction of someone else's stuff. For example, a fire burns down your neighbour's building and you are found to be legally responsible. You suffer a financial loss equal to the amount you are required to pay to your neighbour.

The first type of loss arises from damage to any and all kinds of property, being: real property and personal property. The second type of loss arises from any and all sources of lability, being: tort liability (both in negligence and the intentional torts), contractual liability, statutory liability (for example, under the *Workplace Safety Insurance Act, 1997*[1] or the *Occupiers' Liability Act*[2]), and breach of trust. Broadly speaking, the first category also covers bodily injury and death. However, since businesses do not suffer bodily injury, we will consider the first category to cover only damage to property. Given that there are two relevant ways that businesses suffer a loss (i.e. damage to its property and liability for damaging someone else's property/causing bodily injury), it makes sense that there are two common policies used by businesses to respond to these losses. The policies are:

1. Property insurance, and
2. Liability insurance.

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[1] S.O. 1997, c. 16, Sched. A.

[2] R.S.O. 1990, c. O.2.

PROPERTY INSURANCE

All risks: Traditionally the type of insurance that would protect against loss from damage to property was referred to as “Fire and Extended Perils” insurance, or something similar. This insurance would provide coverage where a declared item of property was damaged by one of the listed perils. More commonly today, businesses maintain property insurance on an “all risks” basis. These policies work the opposite way; they cover property damage caused by any peril, except one that is listed as an exclusion. In many instances, damage caused by earthquakes and floods will not be insured under the standard policy. Coverage for these types of perils may be added by way of endorsement. In the USA, "all risks" policies have been replaced by "Special Causes of Loss" for many years now. (The coverage is equivalent, but the nomenclature is different.)

Boiler and machinery: One peril that is excluded from typical “all risks” policies (and not listed in the standard “fire and extended perils” policy) is loss arising from the breakdown or explosion of boilers and machinery. Do not be misled by the description as this form of loss does not simply exclude coverage arising from industrial boilers. Rather, it excludes any losses that arise from the breakdown or explosion of several types of commonly used and familiar equipment, including HVAC equipment, refrigerators and electrical equipment. Accordingly, if a business uses such equipment, a “boiler and machinery” policy should be taken out to supplement to the general “all risks” or “fire and extended perils” coverage. Where these policies are insured by different insurance companies (aka “insurers”), the business (aka the “insured”) may want to ask for a “joint loss agreement” which will establish a set amount that each insurer pays to the insured where there is damage to its property and it is not immediately clear which policy should respond. This allows the insured to get on with its business while the two insurance companies establish which insurer is required to cover the loss.

Business interruption: Similarly, a standard property insurance policy will only cover the loss of damage to physical property. However, when the business' property is damaged, it may be unable to operate to its full potential until the property is repaired or replaced. A business interruption endorsement will extend coverage offered under a property policy to cover the business' losses resulting from unavailability of the insured property. This may be provided on a “gross earnings” basis, which provides coverage for an insured’s reduction in gross earnings until the property is repaired or replaced; or on a “profits” basis, which provides the "gross earnings" coverage just discussed, but for an extended period of time until the business returns to normal levels.

Replacement cost: It is advisable for a property insurance policy to provide recovery on a “replacement cost” basis. Without this, the insured will only be covered for the "value" of the property at the time of the loss (which for most physical property is usually less than the replacement cost). In the case of a tenant, its lease will likely oblige it to fully restore the damaged property following a loss. Unless the insurance is on a “replacement cost” basis, the proceeds will be insufficient.

Co-insurance: When property is damaged, typically the entire property is not totally destroyed. (Partial damage is far more common than complete destruction.) Insurers set premiums based on insuring the full value of the property, taking into account the likelihood that the full amount will not be required. However, if an insured were to purchase insurance for less than the full value of its insured property, knowing that it will not need the full amount in most cases, the premiums collected by the insurer may expose the insurer to a shortfall. To avoid shortfalls, insurers include “co-insurance” provisions in their policies, which state, in essence, that if an insured states a value on the property that it insures, which value is less than the actual whole value of its property, proceeds will be paid in the same proportion. This provision removes the incentive to under-insure.

Further coverage: There are several other forms of coverage that may be advisable depending on the nature of an insured’s business. For example, losses resulting from: pollution, loss of information (i.e. valuable papers) and power failure are all often excluded under a general “all risks” policy, but may be desired coverages based on the nature of the particular business.

LIABILITY INSURANCE

The most common form of liability policy used in Canada today is known as the Commercial General Liability policy or “CGL”. This policy will cover liability that the insured incurs when it causes or contributes to someone else’s loss. The policy also requires that the insurer defend the claim on behalf of the insured.

The CGL policy is subject to a list of exclusions that may need to be covered by way of extension or additional policy based on the nature of the insured's business. The following are typical endorsements or additional insurance policies that are added:

- **Contractual liability endorsement:** a CGL policy will only cover liability that would legally arise from the insured's own actions or inactions. If the liability arises because the insured contractually assumed the risk (for example, because it agreed to indemnify another party), and not from the insured's conduct, the CGL will not respond unless the insured has obtained and paid for a "contractual liability endorsement." In order to grant such an endorsement the insurer will want to assess the risk the insured has assumed under the contract.

- **Tenant's legal liability:** This is often included in CGL policies, but deserves special mention because it is essential for any insured that leases space. Without it, the CGL policy will not respond to liability arising from property leased or rented by or occupied by an insured. Where a tenant's property policy is not written on a "replacement cost" basis, the difference required to repair the premises will only be provided by the tenant's lability policy if the lease requires the tenant to conduct the repair and the tenant's CGL policy has this endorsement. Even where the tenant's property policy is on a "replacement cost" basis, this endorsement will be required to fund the repair of property outside the premises (i.e. outside the scope of the tenant's property policy), but nevertheless within its "care, custody, and control" for the purpose of the insurance policy. Structural floors, walls, and ceilings are common examples.

- **Automobile insurance:** The CGL policy excludes coverage caused by automobiles. All automobile owners are required by law to place an "owned automobile" policy (covering liability for loss caused by the automobiles owned by the insured). Some businesses may also place a "non-owned automobile" policy (covering liability for loss caused by automobiles that the insured does not own but are used in the course of the business, for example, vehicles owned and used by an employee/contractor for business purposes).

- **Further coverage:** There are several other exclusions to the CGL policy that may prompt the insured to seek additional coverage. For example, the CGL policy will not provide coverage for the insured's liability to employees. Where the employer is not covered by the public provincial employment insurance program (as is the case for many office workers) an "employer's liability endorsement" should be added to the CGL policy. Similarly, liability arising from the release of pollution is typically excluded from the CGL policy. If environmental pollution coverage is required, it is often under an expensive stand-alone policy. Another example is the exclusion for vicarious liability resulting from contractors working in the business place. This can be covered by way of "owners and contractors" protection.

It is apparent that a general "all risks" property policy doesn't really cover all risks. It neither insures against all forms of peril, nor does it cover all losses that a business may suffer. Similarly, the many exclusions to CGL coverage leave several potential liabilities uninsured. Whether a particular loss is or is not covered by the insurance will depend on the terms of the insurance contract itself. These contracts vary from insurer to insurer.

Complicating the matter, the insurance contract is not drafted to provide insurance in wording that mirrors the legal language used to identify the loss. For example, the liability may be incurred as a result of negligence, but the insurance contract will address coverage for "accidents" that were "sudden or unforeseen." The lack of alignment between the wording used to describe the loss and the wording used to describe the coverage can lead to unintended exposure.

TYPICAL LEASE REQUIREMENTS

Tenant's insurance: A typical commercial lease will require that the tenant take out the following insurances:

a) all risks property insurance in an amount not less than the full replacement cost of all property owned by the Tenant, or for which the Tenant is legally liable, or installed by or on behalf of the Tenant, and located within the complex including, but not limited to, leasehold improvements, and the Tenant's inventory, furniture, and equipment;

b) broad form boiler and machinery insurance with a limit per occurrence of no less than the full replacement cost of all property listed above, including boilers, pressure vessels, air conditioning equipment and miscellaneous electrical apparatus relating to, or serving the Premises (except those operated by the Landlord);

c) business interruption insurance in an amount that will reimburse the Tenant for loss of earnings attributable to all perils insured against under the "all risks" property insurance described in subparagraph (a); and

d) liability insurance, including personal injury liability, contractual liability, tenant's legal liability, owned and non-owned automobile liability, and owners' and contractors' protective insurance coverage, with respect to the Premises and the Tenant's use of the Common Elements, with limits of no less than $5,000,000.00 per occurrence.

A landlord's rationale for requiring this insurance is to ensure that the tenant has sufficient means to meet its obligations under the lease despite an unexpected loss. Specifically, the landlord wants to ensure that the tenant can pay rent, restore the premises, and operate throughout the term of the lease. A tenant with these insurance coverages is much more likely able to sustain a loss without impacting its ability to meet its obligations under its lease. Additionally, even if the tenant fails to actually purchase or maintain such policies, the covenant to obtain the insurance may serve at law to release the landlord from the loss that should have been insured. This is often referred to as the "principle of immunity" and was restated concisely by the Ontario Court of Appeal in *Madison Developments Ltd. v. Plan Electric Co.*[3], as follows:

[3] 36 OR (3d) 80 [*Madison Developments*].

> *A contractual undertaking by the one party to secure property insurance operates in effect as an assumption by that party of the risk of loss or damage caused by the peril to be insured against.*[4]

The Court of Appeal went on to state that the rationale for the principle was that the covenant to insure is an obligation, the corresponding benefit of which is an implicit release of the counterparty for liability for the loss insured.[5] To date, the principle has only been applied in cases of property insurance under commercial leases. However, given the rationale provided by the Court, commentators have speculated that the principle would apply to liability insurance and should not be confined to leases.

Landlord's insurance: In a landlord's standard form of lease, typically the landlord is required to carry property insurance and liability insurance in amounts and for risks that it considers sufficient. Some tenants can persuade some landlords to commit to more.

ADDING THE LANDLORD:

Beyond stating the type of insurance that the tenant will be required to obtain, the lease will likely go on to require that the tenant add the landlord (as well as any owner, property manager, and mortgagee) as insureds to the tenant's policies. The rationale for such a requirement is to give these parties the benefit of the tenant's insurance coverage for their respective risks of loss.

Property insurance: In the case of the property insurance, adding the landlord will protect the landlord's interest in the insured property. This is the landlord's reversionary interest in the premises itself (including leasehold improvements, which become part of the premises upon installation). Where the landlord's interest has been mortgaged, adding the mortgagee as an insured will also protect its interest in the premises. The typical language used to indicate that each party's distinct legal interest in the premises is covered by the tenant's property insurance is the phrase "as their interests may appear."

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[4] *Ibid* at para 9.
[5] *Ibid.*

In most instances, the parties will agree that insurance proceeds are to be used to repair or rebuild the premises following an insured event. One issue that sometimes causes concern for tenants is section 6 of the *Mortgages Act*[6] (Ontario), whereby a mortgagee may direct insurance payments in respect of the landlord's mortgaged interest in the premises towards amounts owing under the mortgage loan. A tenant is justifiably concerned that the mortgagee waive its right to so direct the funds, since (other than in cases of substantial destruction where the lease is terminated) the tenant will still be responsible for the entire cost of the repair or rebuilding. However, few tenants have the bargaining strength to push the landlord to raise this matter with an existing mortgagee.

Where the damage is to such an extent that the lease is terminated, the landlord will be entitled to receive proceeds covering its reversionary interest in the insured property. (That is the current value of the landlord's ownership interest, taking into account that the tenant would have had the use of the premises until expiry of the term had the insured event not occurred.) The landlord may want to be noted as "loss payee" in order to exercise control over the proceeds.

Liability insurance: In the case of liability insurance, adding the landlord as an insured will provide the landlord with protection from liability arising from the tenant's operation of its business from the premises. In many cases where a third party suffers a loss arising in or from leased premises, it will sue both the tenant and the landlord. By adding the landlord as an insured under the tenant's liability policy, the landlord will be entitled to share in the protection.

General: Insuring more than one party under a single policy can have unintended consequences. For this reason, it is essential that when the landlord (as well as its property manager and mortgagee) is added to the tenant's insurance policies, the policies contain terms addressing the following:

[6] R.S.O. 1990, c. M.40.

- **Severability of interests:** Recovery under a policy is often conditional on several factors (such as timely notice of the loss, payment of premiums, etc.). This clause will allow each insured to be treated as though they are the only insured under the policy (except as to the limit) and therefore, failure of one insured to satisfy a condition to recovery will not jeopardize the protection provided to the other insured.

- **Cross liability:** In some cases, insurers have denied coverage where the loss is one for which one insured has a claim against the other insured. A cross-liability clause clarifies that even if the two insureds are suing each other for the loss, the insurance coverage applies.

- **Primary and non-contributing:** The tenant's policies should be noted as "primary" to any policies held by the landlord so that its own insurance policies will not be required to contribute when they cover the same loss.

- **Notice**: Landlords often want a clause in the policy making it plain to the insurer that it cannot change or terminate the policy, except on notice to the landlord.

Additional Insured: The issue of whether the landlord (and its property manager and mortgagee) should be added to the tenant's policies as "additional insureds" or "additional <u>named</u> insureds" has been debated and the consequences have been litigated. Some cases led commentators to believe that only the "named" insured (whether "additional" or not) could negotiate with the adjuster when a claim is made and obtain the funds when a claim is paid. In order to obtain these rights, the "additional insured" would have to become an "additional <u>named</u> insured," and with that change in status came the potential for joint liability of unpaid premiums.

However, the courts have not applied the terms "additional insured" and "additional named insured" in a manner that would indicate they are terms of art with specific legal meaning. Rather, each insurance policy is simply a contract that is to be interpreted in the usual way. Accordingly, the use of these terms in the insurance contract is essential to determining the rights and obligations attached to them.

The general industry usage of these terms indicates that the distinction is one of privity with the insurer. That is, the “named insured” is a party to the insurance contract. It is therefore the insured party that is able to enforce the benefits of the contract (i.e. the coverage) and the party that is subject to the obligations (i.e. the liability for premiums). The “additional insured” is most often a third party beneficiary. That is, a party to whom some benefits under the contract are said to accrue (i.e. coverage under the policy) but who is not party to the contract and therefore does not have the ability to enforce the contract to obtain these benefits in its own right.

However, that seemed to change with the Supreme Court of Canada Decision in *Fraser River Pile & Dredge Ltd. v. Can-Dive Services Ltd.*[7] where the court allowed a third party beneficiary to enforce an insurance policy, notwithstanding the lack of privity. This relaxation of the rules in very similar circumstances, coupled with an inconsistent use of the terms “additional insured” and “additional named insured” in various insurance policies, has reduced the importance of assessing whether the landlord should be “named” or not.

Adding the Tenant?: Tenants are not typically added to their landlord’s insurance policies as an insured party or loss payee. The tenant may not have a legal "interest" in the property covered by the landlord’s policy.

SOME QUIRKS

Self-insurance: Sometimes a tenant will argue that it should not be required to purchase the insurance policies set out in the landlord’s form of lease because the tenant is large (and/or institutional) and has its own “self-insurance” program. What this means is that the tenant will not be obtaining any insurance policy. Rather, it is asking the landlord to trust that the tenant has stashed away money for a rainy day and therefore in the event of a loss it will be able to weather the storm.

A landlord should approach this request with caution for at least three reasons. First, as set out above, one of the main motivations for requiring the tenant to take out the property and liability

[7] [1999] 3 SCR 108.

insurance set out in a standard form lease is to ensure that the tenant has sufficient means to meet its obligations under the lease in the event of a loss. The landlord will have to assess its confidence in the tenant on this matter in order to determine whether self-insurance provides the landlord with sufficient comfort.

Second, without an insurance policy, there is nowhere to name the landlord (as well as property managers and the mortgagee) as an additional insured. Usually, under the tenant's property policy, the landlord's reversionary interest in the premises is covered. Will the same apply where the tenant has self-insured? Will the tenant pay the landlord for its interest if the lease is terminated following substantial damage? Similarly, the landlord is protected under the tenant's liability policy. Will the same apply where the tenant self-insures? What will be the terms of the insurance? What losses will be covered? What will be excluded? Will the tenant be under a duty to defend the claims made against the landlord in connection with the tenant's use of its premises? How will claims be processed where there is no third party insurance administrator?

Third, on the basis of the "principle of immunity" discussed briefly above, the tenant's covenant to obtain insurance may serve as an implied release of the landlord for the losses insured. This release is an essential part of the risk allocation framework under a commercial lease and is an important part of determining the scope of the express release and indemnity provisions. Will the implied release apply where the tenant self-insures?

It is not out of the question to permit a tenant to self-insure, provided that the landlord is satisfied with the financial wherewithal of the tenant and not overly concerned about the absence of insurance (aka the presence of self-insurance). However, given the dependence of the release and indemnity clauses on the presumption that the landlord is being added as an insured and the implied release resulting from the covenant to insure, it becomes important to carefully analyze and revise the insurance, release, and indemnity sections of the lease so that all the pieces fit together and protection in favour of the landlord is not unintentionally sacrificed.

Blanket insurance: a similar line of concerns arises when a tenant refuses to name the landlord as an additional insured because it carries a blanket policy that covers all its operations at various locations. There are legitimate reasons why a tenant would pool its insurance into a blanket policy. However, if the landlord is not added under the tenant's policies, the landlord should use other means to ensure that it obtains the foregone protection. As noted, being named as an additional insured provides the landlord with insurance for its interest in the premises (including leasehold improvements) and protection from liability for claims arising from the tenant's use of the premises. The landlord may regain this protection by an express indemnity from the tenant for precisely these losses, together with an acknowledgement from the insurer that the tenant's contractual liability endorsement will cover the indemnity (notwithstanding that it was entered into after the policy was obtained).

Wavier of subrogation: When an insurer pays a claim to its insured, the insurer acquires the insured's right to sue the party who caused the loss, in an attempt to recoup the amount paid out to satisfy the claim. For example, your neighbour causes a fire that burns down your building. Your property insurer pays you the value of the building. Your property insurer then acquires your right to sue your neighbour for causing the loss. The acquisition of your right is called "subrogation." A waiver of subrogation is a relinquishment of the right, generally limited to particular person who is the recipient of the waiver or in whose favour the waiver is made. In this example, if your insurance company had waived its right of subrogation against your neighbour, it would not be able to sue the neighbour to recoup the proceeds that your insurer paid to you.

The insurance provisions under a lease will often require that the tenant's insurer waive its rights of subrogation against the landlord (as well as property managers and the mortgagee). These waivers are one of a few methods that landlords use to try to ensure that any loss covered by the tenant's insurance is not ultimately recouped from the landlord or its liability policy.

The landlord achieves the same effect simply by inserting the covenant to insure into the lease and thereby triggering the principle of immunity. (The immunity is a release of the tenant's claim and therefore leaves the insurer with nothing left to subrogate.) The landlord triples down on this effect by naming itself as an additional insured under the tenant's policies, because an insurer cannot sue its own insured.

ACT TWO

This paper is only half the story. The second half of risk allocation mechanisms in a commercial lease are found in the release and indemnity provisions. This topic is the subject of Jory Grad's paper in this plenary session.