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"HOW TO STRUCTURE AND DRAFT SELF-INSURANCE PROVISIONS"

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I would first like to acknowledge and refer the reader to the paper presented by my partner, Dennis Daoust, at the Law Society's Six-Minute Commercial Leasing Lawyer seminar that took place on February 15, 2006. There is very little that I can add to his excellent and comprehensive work on the topic of self-insurance.

Why leases require tenants to insure

I will repeat this aspect of Dennis' paper - focusing on the reasons why standard lease forms require tenants to carry insurance:

- I. Protection of the landlord's interest in the property leased and its environs, as well as the leasehold improvements in the leased premises;
- II. Assuring the solvency of the tenant so that it can pay rent and perform its obligations;
- III. Protection of the landlord from claims by the tenant for damage to the tenant's property;
and
- IV. Protection of the landlord against claims for loss, injury etc. suffered by third parties as a result of the tenant's conduct/operations.

Typical coverage requirements

A typical commercial net lease requires the tenant to maintain (1) property insurance in respect of the premises, the leasehold improvements and all other property in the premises, (2) business interruption insurance to ensure its ability to operate when the premises are damaged, and (3) liability coverage to protect against claims arising from the tenant's conduct/operations at the property. Also typically, the landlord and any mortgagees of the property are required to be identified as additional insured parties on the tenant's policies. There are many other features of a typical commercial net lease insurance clause. A sample version is attached as Appendix A.

Additional typical commercial lease terms

Other typical features of a commercial net lease are release and indemnity clauses - these involve the tenant releasing the landlord from any claims relating to property damage (even if – or, in some leases, UNLESS - the landlord is at fault) and also indemnifying the landlord from/against claims arising from the tenant's conduct/operations at the leased property. Sample versions of these clauses are set out in Appendix B. The objective of the release is that the landlord is to be insulated against claims for damage to the tenant's property. This is usually reinforced by a lease requirement that the tenant obtain a waiver (from its insurer) of any subrogation rights that the insurer may have against the landlord¹. The objective of the indemnity is simply that the landlord be insulated from any third party claims arising out of anything in respect of which the landlord was not at fault. This is usually reinforced by the lease requirement that the landlord be identified as an additional insured on the tenant's liability policy (with respect to the activities of

¹ For example, see Section 10.02(ii) of Appendix A.

the tenant)²; further, the clause generally stipulates that the tenant's insurance policy must be primary³. Landlords justify these terms on the basis that if they are in place in all leases, the overall insurance scheme for the property entails lower risk, thereby reducing the cost of the landlord's insurance programme (in respect of which all tenants of the property pay a share as part of their contribution to the landlord's operating costs).

Principle of Immunity

No discussion of commercial lease insurance provisions can be complete without a consideration of the principle of immunity, as espoused by the Supreme Court of Canada. *Ross Southward Tire Ltd. v. Pyrotech Products Ltd.* (1975)⁴ held that if a party A to a contract (ie a lease) agrees with party B to place insurance to cover an asset, or party B contributes to party A's cost of insurance on an asset, then in the absence of clear language to the contrary in the contract, party B is released from liability for damage to the asset, even if damage was caused by the negligence of party B. A series of cases since the *Pyrotech* case has developed and expanded this principle⁵.

Where does self-insurance fit in?

Insurance markets swing from 'soft' (times when coverage can readily and affordably be obtained) to 'hard' (when coverage becomes almost prohibitively expensive). For example, in the immediate aftermath of 9-11, property insurance became very expensive and difficult to place. The task of placing coverage, usually carried out by a financial administrator or risk

² For example, see Section 10.02(viii) of Appendix A

³ For example, see Section 10.02(v) of Appendix A

⁴ 57 D.L.R. (3d) 248 (S.C.C.)

⁵ *Independent Tank Cleaning, a Division of By-Products Inc v. Zabokrzycki (c.o.b. Sign World)* [1997] O.J. No. 764 (Ont. Crt.) (Gen. Div.); *Tony and Jim's Holding's Ltd, v. Silva*, Ont. Gen. Div.[1997] O.J. No. 3744 (Ont. Crt.) (Gen. Div.) and the Ontario Court of Appeal case, *Madison Developments Limited et al. v. Plan Electric Co. et al.* [1997] 36 O.R.80

manager of a business, having regard to the needs of the business and the cost-benefit implications of what is offered by the market, is a complicated one. It becomes more complicated by an overlay of lease requirements. The additional features often required by commercial lease terms (such as including additional insured parties, waivers of subrogation, primary coverage clauses etc.) can also impose difficulty on the task of placing coverage.

While few businesses operate without any insurance whatsoever, it is nevertheless the case that sometimes a risk manager concludes that a particular coverage is too expensive to warrant purchasing it. A chain of retail clothing stores might decide that it does not particularly need to insure the inventory in its stores (although it may insure it through the delivery phase). A landlord may not especially care if that tenant insures its inventory because the tenant is bound to be able to supply sufficient inventory from its other stores in a short time should the need arise.

When a particularly strong (in financial and bargaining terms) tenant seeks “the right to self-insure”, it is sending its landlord a message that it wishes to have the flexibility to manage risk as it sees fit, ie it wishes to have *the option* to insure or not, despite the lease requirements. Some tenants purchase no formal insurance in respect of certain risks. Others purchase no formal insurance in respect of certain types of property. Some set aside pools of funds - internally - to be available to satisfy claims/losses as and when needed. Some do no such thing - they merely fund the claims/losses out of business operations, as and when the need arises (ie they absorb the expense).

If the landlord agrees to include a lease clause stipulating that the tenant may self-insure, it may discover that the entire scheme sought to be achieved by the landlord (through the required coverage and features thereof, as well as the releases and indemnities mentioned above) is lost.

(a) Liability Self-Insurance

It is worth noting first that even for tenant with a very strong financial covenant, it is rare for a landlord to permit the tenant to self-insure in respect of liability coverages. The effect would be that the landlord would have to rely solely upon its own liability insurer for claims arising out of the tenant's operations. The risk of insurance costs increasing (and, therefore, operating costs for other tenants also increasing) arises under this arrangement. This risk can be mitigated when the self-insuring tenant agrees to indemnify the landlord in respect of claims arising from its operations but, if such a tenant were to suffer financial ruin (or even just a multiplicity of claims at once), the indemnity may not be worth much when needed.

One possible solution might be to require the tenant to provide the same coverage to the landlord as a liability insurer would, but, that approach raises a list of difficult issues which make the arrangement untenable. For example, what would be the scope of coverage? Would the tenant self-insurer provide a defense to the landlord where the landlord is sued by a third party? What would be the deductible? What circumstances would entitle the landlord to make a claim for coverage under the tenant's self-insurer's obligation? Would statutory conditions apply? What form of liability coverage would be provided and what would be the exclusions from coverage? Would the tenant also provide coverage in favour of the landlord's mortgagee? Without policy wording, how would it be determined whether a claim arose from the tenant's operations or

otherwise? A liability policy would typically contain cross-liability and severability of interests endorsements. The cross liability coverages allow one insured under the policy to sue another and have that other's liability covered by the policy. The severability of interest clause would allow the several persons covered under the policy as insureds to be insulated from actions by the other insureds that would void or affect coverage. Would the self-insurance arrangement embody those concepts?

There is also the fact that the insurance limits in liability policies will typically be high (\$5 million is common). To support such a limit, the tenant would need very large sums of liquid assets.

Needless to say, landlords seldom allow a tenant to self-insure against liability exposures.

(b) Property Insurance

Self-insurance in connection with property insurance (e.g. all-risks, boiler & machinery, business interruption) is less complicated, but if it is not handled properly, it can result in adverse consequences. One version of a self-insurance clause simply states that the tenant may self-insure in respect of all types of property insurance, in which event the tenant will be deemed to have placed the required insurance and to have received all proceeds thereunder. Would this clause require the tenant to compensate the landlord for the landlord's interest in leasehold improvements if they are damaged?

Another way of dealing with self-insurance in connection with property insurance was reflected by the more comprehensive clause that was attached to Dennis' paper – a somewhat modified version of it appears here as Appendix C. Note the following features:

- (a) The tenant must demonstrate that it has the financial strength to support its self-insurance obligation.
- (b) The form of coverages is specifically provided for in Article 10.02(c) (note that it allows the landlord to supplement the coverage requirement during the term of the lease by revising the designated forms as typical insurance coverages get expanded);
- (c) The tenant expressly recognizes its obligation to provide the same complete protections and benefits to landlord that the landlord would have had had the tenant purchased the required policies.
- (d) Express provisions avoid any doubt that the landlord will obtain the same releases and indemnities that would otherwise have been provided to it had the tenant bought the required policies.

The fact is that most landlords are not in a position to administer the type of self-insurance regime that is contemplated in Appendix C. They might not have qualified personnel to conduct the required evaluation of the Tenant's financial circumstances, and they might be concerned that

by attempting to act as an approval agency, they may incur some exposure by virtue of having taken on a known risk.

It is becoming increasingly more common, in commercial leases, to provide for mutual releases in respect of all property damage/losses to the extent insured or required to be insured, and mutual indemnities to the extent insured or required to be insured (subject always to the releases). That being the case, when self-insurance is contemplated, the focus should be on preserving the risk management scheme that was sought to be achieved with insurance coverage, despite the absence of coverage. Another version of a self-insurance clause is provided in Appendix D. It attempts to address these concerns. Note that it not only seeks to place the risk of self-insurance squarely on the tenant, but it also attempts to override any application of the 'principle of immunity' that may arise by virtue of any lease provisions obliging the landlord to carry insurance at the expense of the tenant.

It must be said that none of these suggested clauses has been tested before a court.

Conclusion

Some businesses are so large and sophisticated that they have set aside realistic contingency funds to call upon in case of a catastrophe. Many such businesses continually feed money to the contingency fund and have something similar to an insurance programme in place. But, the programme is privately run and is therefore susceptible to being wiped out by a change in management philosophy, not to mention a catastrophic event.

The fact is that most businesses do not have such a programme in place; if they seek the right to self-insure, they are really asking for the right to not place the specified insurance at all. The rationale is, “funding a loss out of our own pocket happens so infrequently that it costs us less to pay the entire amount of the loss than to place the insurance coverage”.

Considering that the risk management provisions of the lease are generally predicated on insurance being in place, if the Tenant is to be allowed to self-insure, careful regard must be had to the lease provisions that are affected by this shift. Appropriate adjustments should be made to ensure that the remaining risk management provisions in the lease are not thrown off-balance by the decision/permission to “self-insure”.

APPENDIX A

SAMPLE INSURANCE CLAUSES

ARTICLE 10.00 INSURANCE

10.01 Landlord's Insurance

Landlord shall maintain (Landlord's cost of compliance with this Article 10.01 being included in Operating Costs) liability insurance, all risk property insurance, boiler and pressure vessel insurance, and other insurance on the Building and all property and interest of Landlord in the Building as determined by Landlord with coverage and in amounts that are comparable to coverages typically maintained by the owners of similar buildings in the vicinity of the Building.

10.02 Tenant's Insurance

Tenant shall maintain:

- (a) all risk property insurance in amounts sufficient to fully cover, on a replacement cost basis without deduction for depreciation, all Leasehold Improvements and all property that is not owned by Landlord, including without limitation Tenant's inventory, furniture and movable equipment, in the Premises;
- (b) if applicable, boiler and machinery insurance on a replacement cost basis to cover Leasehold Improvements and all property that is not owned by Landlord in the Premises;
- (c) liability insurance on an occurrence basis, against claims for bodily injury, personal injury and property damage in or about the Premises, contractual liability, tenant's legal liability, non-owned automobile liability, and owner's and contractors protective liability, in amounts which are from time to time acceptable to a prudent tenant in the community in which the Building is located, but not less than \$5,000,000.00 in respect of each occurrence;
- (d) business interruption insurance including loss of profits; and
- (e) any other form of insurance, in such amounts and against such risks, as Landlord may in its discretion require.

Policies for such insurance shall (i) be in a form, on terms and with an insurer approved by Landlord, (ii) require at least thirty (30) days' written notice to Landlord of termination or material alteration during the Term, (iii) waive any right of subrogation against Landlord and those for whom Landlord is at law responsible, (iv) contain a standard mortgage clause as required by any mortgagee, (v) contain a provision that Tenant's insurance is primary, (vi) not call into contribution any other insurance available to Landlord, (vii) contain a severability of interests clause and a cross-liability clause,

where applicable and shall not contain a co-insurance clause, and (viii) add Landlord and its mortgagees as additional insureds. If requested by Landlord, Tenant shall from time to time promptly deliver to Landlord certified copies or other evidence satisfactory to Landlord of such policies, and evidence satisfactory to Landlord that all premiums thereon have been paid and the policies are in full force and effect.

10.03 Tenant's Failure To Insure

Should Tenant fail to maintain the insurance required in Article 10.02, Landlord may elect to obtain the required insurance at Tenant's expense. Tenant shall upon demand pay to Landlord, as Rent, Landlord's cost of obtaining such insurance plus an administration fee of 15% thereof.

APPENDIX B

SAMPLE RELEASE AND INDEMNITY CLAUSES

ARTICLE 11.00 INDEMNITY AND RELEASE

11.01 Indemnity by Tenant

Tenant shall indemnify Landlord against any loss, claims, actions, damages, liability or expenses including legal fees and disbursements, relating to death, injury or loss of use of or damage to any person or property, arising from any occurrence in, on, or at the Premises, or from the occupancy or use by Tenant of the Premises, or any part of them, or occasioned wholly or in part by an act or omission of Tenant and its agents, servants, employees or anyone for whom at law it is responsible in the Premises or anywhere in the Building or on the Land or by anyone permitted to be on the Premises by Tenant. However, the Tenant is not required to indemnify the Landlord to the extent that any loss, claims, actions, damages, liability or expenses arise directly from the negligence of the Landlord

11.02 Release by Tenant

Landlord, regardless of negligence or any fault, default or willful act or omission of Landlord, shall not be liable for and is hereby released from any liability or claim related to any bodily injury or death of, or loss or damage to, or loss of use of any property belonging to Tenant or its agents, servants, employees or anyone for whom at law it is responsible in the Premises or anywhere in the Building or on the Land or by anyone permitted to be on the Premises. Without limiting the foregoing Landlord shall not be liable for any injury, death, loss or damage which is caused by moisture, mould, steam, water, rain, or snow which may be found, or which may leak into, issue or flow from part of the Building or the Land including the Premises or from the pipes or plumbing works thereof, or from any other place or quarter or for any damage caused by or attributable to the condition or arrangement of any electric or other wiring.

11.03 Extended Meaning

Any and all release and indemnity clauses which are included in the Lease for the benefit of Landlord are intended also to benefit the mortgagees and property managers and asset managers of Landlord and the officers, directors, shareholders, employees, and agents of each one of them, and, for the purposes of such clauses, Landlord is hereby acting as agent or trustee on behalf of and for the benefit of the persons or entities mentioned above.

APPENDIX C

SAMPLE SELF-INSURANCE CLAUSE

ARTICLE 10.00

10.01 Landlord's Insurance

[See Appendix A]

10.02 Tenant's Insurance

[See Appendix A]

10.03 Self-Insurance

So long as Tenant in legal and physical occupation of the whole of the Premises is [insert name of Tenant], Tenant may, by notice to Landlord, and subject to the requirements stated below, elect to not purchase from an insurer, the insurance policies required to satisfy its obligations under Articles 10.02(a), (b) and (d). This right (the "Self-Insurance Right") is subject to the following terms and conditions:

- (a) Tenant must demonstrate to Landlord that (i) it maintains financial reserves adequate to protect the Leasehold Improvements and all property referred to Articles 10.02(a) and (b) on a full replacement cost basis as well as the business interruption losses provided for in Article 10.02(d); (ii) it has a net worth of not less than [*], and (iii) it has net current assets of not less than [*].
- (b) Tenant must give to Landlord at least thirty (30) days' prior written notice of its intention to exercise the Self-Insurance Right, and must, at the same time as it gives its notice, provide to Landlord satisfactory evidence of its ability to meet the requirements in paragraph (a). The evidence must include separate, unconsolidated, audited financial statements issued not more than fifteen (15) months prior to Tenant's notice. If Landlord requires any additional information, Tenant will provide same immediately upon Landlord's written request. If Landlord does not confirm in writing that the evidence provided by Tenant to Landlord is adequate, in Landlord's sole discretion, then Tenant's exercise of the Self-Insurance Right shall be void.
- (c) Tenant will itself provide coverage and protection in accordance with the limits, extent, and types of coverage that would have been provided had Tenant purchased the insurance from an independent insurer in accordance with Article 10.02 using the following forms of policies: All-Risks [Insert description of specific form of policy], Boiler and Machinery [Insert description of specific form of policy] and Business Interruption [Insert description of specific form of policy]. Landlord may revise the designated forms from time to time, acting reasonably. This obligation to provide coverage includes the

obligation to provide to Landlord and its mortgagees all of the protections, benefits, rights, indemnities and payments that would have been provided had Tenant not exercised the Self-Insurance Right but had purchased the insurance policies provided for in Articles 10.02(a), (b) and (d) from an independent insurer.

- (d) In addition to, and without derogating from, or in any way limiting or restricting any other release or indemnity contained in this Lease, Tenant releases Landlord from any and all losses, costs and damages, and agrees to indemnify and hold harmless Landlord from and against every demand, claim, cause of action, judgment and expense and all loss and damage however caused arising from or pertaining to all or any of the events, risks, and perils which would have been covered under the insurance provided for in Articles 10.02(a), (b) and (d) if Tenant had purchased insurance policies and not exercised the Self-Insurance Right.
- (e) Nothing herein limits or diminishes the waiver of subrogation rights and obligations as provided for in this Lease or the rights that Landlord's insurance carriers would have had under "other insurance" or similar clauses in Landlord's insurance policies had Tenant not exercised the Self-Insurance Right.
- (f) If a sublease is made for any part of the Premises, as a condition of the sublease to the sub-tenant and the Landlord's consent to the sublease, the sub-tenant will not have the benefit of the Self-Insurance Right but will be required to purchase and provide evidence of insurance in accordance with Article 10.02 prior to the effective date of the sublease and prior to taking possession of the subleased Premises.
- (g) Tenant's Self-Insurance Right will cease if Tenant fails to provide to Landlord, at least annually, on the anniversary of the date Tenant first exercised the Self-Insurance Right, and, in addition, no later than ten (10) days after Landlord's written request from time to time, current evidence concerning the requirements described in paragraphs (a) and (b) above, or if Landlord advises Tenant in writing that it is not satisfied with the adequacy or content of such evidence.

APPENDIX D

SAMPLE SELF-INSURANCE CLAUSE

ARTICLE 10.00

10.01 Landlord's Insurance

[See Appendix A]

10.02 Tenant's Insurance

[See Appendix A]

10.03 Self-Insurance

So long as Tenant in legal and physical occupation of the whole of the Premises is [insert name of Tenant], and continues to reasonably satisfy Landlord from time to time that there has been no adverse material change in Tenant's financial position from the date of this Lease, Tenant may self-insure for business interruption and/or for loss or damage to items of personal property only, provided that in the event of a loss or claim, however caused, even if as a result of the negligent act or omission of Landlord, its agents, contractors or those for whom it is in law responsible, Tenant shall not make any claims against Landlord, its mortgagee and insurers and all parties related thereto, and hereby releases them from all claims and expenses in respect thereof, all of which shall be deemed to have been fully insured and compensated regardless of whether Tenant actually receives any compensation. Tenant shall indemnify and hold harmless Landlord from and against every demand, claim, cause of action, judgment and expense, in respect of business interruption and/or loss or damage to items of personal property, however caused, which would have been covered under the insurance policies provided for in Article 10.02 had Tenant placed same in accordance therewith. Notwithstanding any obligation of Landlord to insure under this Lease, Tenant is not entitled to and hereby expressly waives the benefit of any proceeds or coverage provided by such insurance, regardless of how any loss or claim arises.