Are you Sure you Understand Insurance Terms in Leases?

Darrell Gold, Partner
and
Rachel Puma, Associate
Robins Appleby LLP

February 25, 2019

I. INTRODUCTION

As you are aware, a typical commercial lease contains many different clauses intended to address common commercial issues and business points for both landlords and tenants including clauses dealing with defaults, remedies, transfers, alterations, restoration, damage and destruction, landlord and tenant insurance and many more.

Insurance clauses are all-to-often given passing attention by some lawyers on the review and negotiation of a lease – especially lawyers who do not specialize or at least do commercial leasing on a regular basis. That should not occur.

To give you an idea of how important the insurance clauses are in a lease - including their interaction with other lease clauses - there is an entire book dedicated to insurance in leases called "***Insurance and Risk Management in Commercial Leasing***" written in 2009 by Dawn Michaeloff now at Owens Wright LLP. You should have it in your office if you do commercial leasing.

One of the quintessential methods of risk management in commercial leasing is ensuring the commercial interests of the parties are adequately insured.

Most commercial entities do not have available funds to repair significant damage to their commercial interests.

If a commercial lease does not contain comprehensive insurance terms whereby each party is properly insured against reasonably foreseeable loss, a party or parties may find themselves in a situation in which they cannot satisfy their obligations under the lease which can lead to default, 3rd party claims and even bankruptcy.

Insurance terms are necessary in a commercial lease to clearly set out which party is required to obtain and maintain insurance for which risks.

Any risk that has a reasonable chance of occurrence *should* be insured against. When considering the insurance clauses, you must have regard to various factors including the location of the premises, prior and current uses, the age and condition of the premises and the building it is in, the improvements to be made to it and other considerations.

Subject to who has the leverage in the lease negotiations – which in my view is the single most important point to know in order to properly negotiate a lease - or for that matter any contract - your client needs to decide how much risk they are comfortable with and what the other party is requiring of them in terms of insurance coverages and terms.

A properly drafted lease should take into account, what types of insurance are required, the essential terms of that insurance which I will touch upon later - how much is required and who is required to obtain it. This freedom is, of course, restricted by the availability of such insurance from insurance providers.

Insurance terms are usually grouped together in a lease, but can also be found throughout the lease under separate clauses including releases, waivers and indemnification clauses.

When drafted properly, the interplay between the terms should provide a clear picture of how risk is managed and by which party.

After a brief overview of how insurance is put into place between the parties to a commercial lease, this paper will set out common insurance terms pertaining to three of the major types of insurance required in a commercial setting:

- property insurance,
- insurance for indirect loss, and
- liability insurance.

As a final point, a recent decision from the Ontario Court of Appeal (*Royal Host GP Inc. 1842259 Ontario Ltd.*, 2018 ONCA 467) will be canvassed in this paper, that highlights the importance of clearly and carefully drafting insurance terms in commercial leases.

II. THE ROLE OF THE INSURANCE ADVISOR

As lawyers are not insurance advisors, one of the first points to raise with your client – landlord or tenant - is whether they have received input from their insurance broker or risk management advisor on what insurance should be carried for the property, the business and the insurance risks for the uses thereon. This should be re-assessed on a lease to tenants whose particular uses pose potential additional risks.

However, as the legal advisor on a lease, and after you have told your client to seek advice from its insurer on the policies and coverages recommended, you should be aware of the importance of the insurance clauses and be able to identify some basic issues for your client to consider with its insurance advisor.

III. WHICH PARTY INSURES FOR WHICH RISKS?

Self-Insurance

Where a party is satisfied that the risk of a loss is minimal and/or that the other party has sufficient "financial covenant" and funds to remedy the loss if it occurs, it may permit the other party to "self-insure" against certain specified types of losses.

Parties should be cautious to ensure that the right to self-insure is made personal to the other party (and not to any assignees or successors) and that such a right may be revoked where the other party's financial circumstances have changed.

Multiple Parties Insured Under One Policy

If self-insurance is not an option, then each party must each contract with its respective insurer or can be covered under the same policy in some cases.

The party that contracts with the insurer is known as the "**first named insured**". The first named insured is, amongst other things:

- "responsible for payment of the premiums,
- permitted to terminate or make changes to the policy,
- is notified by the insurers if the policy is cancelled or amended by the insurer, and
- is the payee in respect of any refunded premiums."[1]

[1] Dawn Michaeloff, *Insurance and Risk Management in Commercial Leasing* (The Cartwright Group Ltd., 2009) at p. 7.

In a commercial lease it is common for a party, often the landlord, to require that it be added to the tenant's policy (who is the first named insured) policy as either:

- an “additional named insured” or
- an “additional insured”.

“**Additional named insureds**” have the same above-noted rights as well the obligations of the first named insured whereas "**additional insureds**" do not.

That being said, an additional named insured's rights and obligations are typically curtailed by a "**sole agent clause**" in the policy. A sole agent clause restricts the above-noted rights and obligations to only the first named insured.

A major benefit to being named as an "**additional named insured**" is that the additional named insured's employees, executive officers, and directors are covered to the same extent as the first named insured (and its employees, executive officers and directors) under the insurance policy.

"Designating a landlord as an additional named insured extends the policy coverage to all of the landlord’s operations instead of those operations performed only on behalf of the tenant. Both an additional insured and an additional named insured are entitled to a right to defend in an action and, so long as the policy contains a sole agent clause, (also called the first named insured clause in the [Insurance Bureau of Canada's ("**IBC**")] benchmark CGL policy) the tenant is the only party responsible for paying premiums." [2]

[2] Barbara Zeller, Miller Thomson "Tread carefully through 'additional named insured' territory", February 2014

A major disadvantage is that a breach of a policy condition by an additional named insured may result in the policy being voided.

Further, being shown as an "additional named insured" does not obligate the insurer to provide the landlord with a notice of policy cancellation or amendment or protect the landlord from a breach of the policy resulting in a denial of proceeds or entitle the landlord to the insurance proceeds. The last point is addressed by the landlord being noted as a "loss payee" and ideally as the "first loss payee" (as there may be others such as lenders).

In contrast, an additional insured's employees, executive officers and directors do not have the same protections as the first named insured; but a breach of a policy condition will not result in the policy being voided.[3]

Importantly, as there is typically a sole agent clause in the policy, being an "additional named insured" does not automatically make that party a "loss payee". Instead, a party must specifically require that the other party include it as a loss payee under the policy.

Landlords will typically require tenants to include the landlord as a loss payee under the tenant's property policy so that the landlord will receive the insurance proceeds. This enables the landlord to ensure that the insurance proceeds are used appropriately (i.e. to repair/replace the damaged property).

Severability of Interests

As mentioned above, insurers may deny coverage where the insured party breaches a policy condition or where coverage is excluded through some action of the party. Where there

[3] Dawn Michaeloff, *supra* footnote 2 at pp. 10–11.

are multiple insureds under one policy, the insurer may deny all of the insureds where only one party breaches the policy.

In order to protect added insureds, the first named party is typically required to insert a "**severability of interests**" clause in their respective policies, which requires the insurer to treat each of the insureds as if they were insured under separate policies so that a default by one does not result in a default by the insureds.

IV. KEY INSURANCE TERMS IN COMMERCIAL LEASES

As mentioned above, three of the major types of insurance required in a commercial setting are:

- property insurance;
- indirect loss insurance, and
- liability insurance.

The amount and extent of insurance required and the risk allocation of such insurance will differ from lease to lease. However, in most leases, if not all, those three types of insurance will be required by one or both of the parties.

This section will outline common coverage for each type and will highlight gaps in coverage and how to bridge such gaps.

A. Property Insurance

Property insurance is required to fund the costs of repairing or replacing real and personal property that the insured owns or has a legal obligation to repair or replace, that is damaged or destroyed by a covered risk.

Property policies only cover direct losses arising from property of which the parties have an interest. "**Direct loss**" is loss that is caused directly from damage to the physical property, as opposed to indirect loss, which is discussed more fully below.

While almost all commercial leases will require that both the landlord and the tenant obtain property insurance for their own property, the parties can set out the limits and which type of property insurance each party must to obtain

. The two most common types of property insurance policies are "fire and extended coverage" and "all risk".

"**Fire and extended coverage**" policies cover loss from events specified in the policy; whereas "**all risk**" policies cover loss arising from all events, *except* those events that are specifically excluded. the latter is better for landlords and tenants.

A key feature of property insurance policies is that these policies are effective after all major construction activities have been completed. Of course, landlords and tenants will typically be required to maintain property insurance coverage during construction activities. As such, the parties will be required to obtain a "**builder's risk policy**", which insures against the same type of loss as general property insurance, but extends during periods of major construction, repairs and alterations.

"**All risk**" property insurance policies, which typically cover "additions, alterations or repairs", may not be sufficient to cover major construction periods. This is because major construction may be viewed by the insurer as a "material change in risk" under the policy. Typically, where material changes in risk are not disclosed to the insurer, the policy will be found void and the insurer will deny coverage.

Regardless of whether the construction activities are viewed as a material change in risk, parties should be required to obtain and maintain builder's risk insurance during major construction periods because the coverage is typically broader than in general property insurance policies. Most notably, unlike general property insurance, builder's risk insurance covers damage caused by the insured's subcontractors.

Boiler & Machinery Insurance

General property insurance does not insure against loss arising from damage from pressure vessels, machinery or electrical apparatus used to generate, transmit or utilize mechanical or electrical power and auxiliary piping.[4]

As such, most commercial leases will contain obligations that the landlord, tenant, or both, obtain and maintain boiler and machinery insurance with respect to those boilers and machinery which are theirs. As with property policies, coverage under boiler and machinery insurance extends to direct loss arising from damage of equipment that the insured owns or has a legal obligation to repair or replace.

This type of equipment is commonly considered to be owned by the landlord as it is a "leasehold improvement". As such, landlords are typically required to arrange for this coverage.

[4] Dawn Michaeloff, *supra* footnote 2 at p. 29.

Where the equipment solely serves a tenant's premises and the tenant has a legal obligation under the lease to repair or replace the equipment, the tenant should be required to insert a "broad form" extension to its boiler and machinery policy so that coverage will extend to the equipment, that the tenant controls but does not own.[5]

B. ***Indirect Loss Insurance***

As property policies only deal with "direct" loss, parties are typically required to obtain and maintain additional insurance for indirect losses. The major indirect losses that arise in the commercial context are:

- business interruptions;
- extra expenses; and
- consequential losses.

Tenants and landlords should be required to obtain and maintain business interruption insurance, which covers loss arising from the landlord's reduction in income (this form of business interruption insurance is called "**rental income insurance**") and the tenant's reduction in earnings as a result of damage to insured property.

A "**contingent business interruption endorsement**" should also be required, which covers losses arising from damage which occurred outside of the insured property, such as access to the insured property being blocked as a result of a fire in a neighbouring property. The parties can further determine whether basic coverage[6] (while the property is untenable) or extended

---

[5] *Ibid* at pp. 29–30.

[6] Basic coverage (called "gross earning insurance" for tenants and "rental value insurance" for landlords) is typically used where earnings can quickly be restored to their former state.

coverage[7] (for an additional period of time after the damaged property is repaired or replaced) is required.

"**Extra expense insurance**" is typically obtained and maintained by tenants to insure the costs of temporarily relocating while the insured property is untenable. The costs of leasing temporary space are outside of the tenant's normal operating expenses and would not be covered under its business interruption policies.

Finally, "**consequential loss insurance**" can be obtained by either party to insure against loss arising from specified events and not otherwise covered. For example, accounts receivable insurance can cover losses arising from damage of the accounts receivable documents, or an endorsement to boiler and machinery insurance can be added to insure against loss of spoiled produce.[8]

C. Liability Insurance

In virtually all commercial leases, both parties should be required to obtain liability insurance which covers loss arising from "third party" claims. In the insurance context, a "third party" is anyone not insured under the policy and could include the landlord or the tenant.

Importantly, liability insurance policies require that the insured notify the insurer whenever there has been an accident that may give rise to a claim.

As with all policy conditions, if the insured breaches the condition, the insurer may deny coverage.

---

[7] Extended coverage (called "profits insurance" for tenants and "use and occupancy insurance" for landlords) is typically used where it will take an extended period of time after restoration to bring revenue back to normal.
[8] Dawn Michaeloff, *supra* footnote 2 at p. 35.

For large corporations, the insured should be required to insert a "notice and knowledge clause" in the policy so that the insured is only required to notify the insurer when the accident is made known to an executive officer of the corporation.

Landlords and tenants are both typically covered under separate liability policies. However, landlords will also typically require a tenant to add the landlord as an insured under the tenant's liability policy.

Additionally, landlords will typically require that the tenant's liability insurance be the primary insurance in respect of a loss so that the tenant's liability insurer will respond to an insured loss first.

Importantly, where multiple parties are insured under the same policy, the insured should be required to insert a "**cross-liability**" clause into the policy which requires the insurer to protect each insured separately as if a separate policy had been issued to each insured party. Without a cross-liability clause, the insurer may refuse to defend the insured where a cross-claim is made by the other insured.

SUBROGATION IN LIGHT OF ROYAL HOST

The right of "**subrogation**" permits the insurer to step into the shoes of the insured and gives the insurer the right to sue on behalf of the insured. An example of this occurs where the tenant has caused damage to the landlord's property and the landlord's insurer pays the damage proceeds to the landlord and then "steps into the shoes" of the landlord as the injured party and sues the tenant for recovery of the proceeds the insurer paid to the landlord.

In order to avoid such a result, the tenant will often require a "waiver of subrogation" to be added into the lease with respect to the landlord's insurance obligation with the intent of having the landlord require its insurer to waive its right to subrogate. My experience is that insurers typically agree to this. However, even if a lease is silent on the "waiver of subrogation", the Supreme Court of Canada in the 3 cases noted below, has held that a tenant **may** still be protected from subrogated claims by a landlord's insurer where the tenant contributes to the landlord's cost of insurance – as is the case in all fully net leases.

An insurer's right to subrogate where the landlord covenants to insure the premises and the tenant pays for a portion of that insurance has been considered by the Supreme Court of Canada in three seminal and interrelated cases in the 1970s[9] (the "**Trilogy**"). The decisions in the Trilogy cases culminated in two oft-cited principles:

> "The first is that a landlord's covenant in a lease to insure the premises is a contractual benefit for the tenant, and the tenant would receive no benefit if the landlord could sue the tenant for the damages due to its negligence. The rationale for the principle is that since the landlord is free to insure the premises, the inclusion of a covenant to insure must be for the benefit of the tenant. If the landlord's insurer were allowed to bring subrogated claims against the tenant, the covenant 'expressly running to the benefit of the tenant… would have no subject matter': *T. Eaton Co.,* at p. 754.
>
> The second principle is that where the tenant pays for the insurance coverage, it should get the benefit of the insurance coverage. The logic is that the tenant having paid for the insurance should get the benefit of the insurance. As Laskin C. J. put it in *Pyrotech Products Ltd.,* at p. 41, the tenant 'has paid for an expected benefit, as between itself and its landlord which any standard fire policy would reflect in providing indemnity to the landlord."[10]

---

[9] *Cummer-Yonge Investments Ltd. v. Agnew-Surpass Shoe Stores Ltd.* (1975), [1976] 2 S.C.R. 221 (S.C.C.); *Pyrotech Products Ltd. v. Ross Southward Tire Ltd.* (1975), [1976] 2 S.C.R. 35 (S.C.C.); and *Smith v. T. Eaton Co.* (1977), [1978] 2 S.C.R. 749 (S.C.C).

[10] *Royal Host GP Inc. v. 1842259 Ontario Ltd.*, 2018 ONCA 467 at paras 5–6 [***Royal Host***].

Recently, in *Royal Host GP Inc. v. 1842259 Ontario Ltd.*, 2018 ONCA 467, the Ontario Court of Appeal clarified that the principles from the Trilogy cases are not rules that are applicable in every case.

In *Royal Host,* the landlord operated a hotel in which a tenant leased a portion in which it operated a restaurant. A fire broke out in the tenant's kitchen which caused extensive damage to the landlord's building. The landlord was indemnified by its insurer, which then brought a subrogated claim against the tenant. The tenant took the position that even if the fire was caused by its negligence, the terms of the lease prevented the insurer from bringing the action. The relevant term of the lease was as follows:

> The Landlord shall take out and maintain, to the full replacement value, fire and other hazard insurance, as the Landlord in its sole discretion may deem advisable, on the Building, excluding any property thereon with respect to which the Tenant or other tenants are obliged to insure, and its own general liability insurance, including general liability insurance in respect of the Common Areas in an amount no less than $10,000,000.00 in respect of any injury to or death or one or more persons and loss or damage to the property of others, the costs of which shall be included in Common Expenses.
>
> Notwithstanding the Landlord's covenant contained in this Section 7.02, and notwithstanding any contribution by the Tenant to the cost of any policies of insurance carried by the Landlord, the Tenant expressly acknowledges and agrees that
>
> (i) the Tenant is not relieved of any liability arising from or contributed to by its acts, fault, negligence or omissions, and
> (ii) no insurance interest is conferred upon the Tenant, under any policies of insurance carried by the Landlord, and
> (iii) the Tenant has no right to receive any proceeds of any policies of insurance carried by the Landlord.

Relying on the Trilogy, the motion judge stated that "as a general rule, courts have limited the subrogation rights of an insurer when a landlord covenants to pay for the insurance and agrees to look to its own insurer for any loss." The motion judge dismissed the action

because it determined that the language in s. 7.02 of the lease, referring to the tenant's negligence, did not create a right of subrogation for the landlord's insurer.

The Court of Appeal reversed the motion judge's decision, based on the motion judge's error in regarding the principles from the Trilogy as "a rule of general application".

Instead, the Court of Appeal reasoned, the Trilogy "*determined that it is the terms of the lease that establish the rights and obligations between the landlord and tenant, and not the insurance policy.*"[11] The Court of Appeal determined that the clear language of the lease focused directly on each of the general principles set out by the Trilogy, and that "notwithstanding" those principles, the stipulations that followed applied despite the existence of those principles.[12]

The decision in *Royal Host* makes it clear that a subrogated claim can still be available even where a landlord agrees to insure a premises and the tenant pays for a portion of that insurance. *Royal Host* is yet another reminder to commercial parties that insurance terms in a lease must be carefully drafted to adequately protect those parties' commercial interests.

robapp\5137962.2

[11] *Royal Host*, *supra* footnote 19 at para 15.
[12] *Ibid*, at paras 18–20.