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**Windstorms,
Tornadoes,
and Floods,**

Oh My!

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Property Insurance Basics That Every Lawyer Should Know

By Marie Antoinette Moore

Maybe climate change has increased the number of natural disasters across the United States, or maybe the 24-hour news cycle has simply made us all more aware of these calamities. In either case, every part of the country seems to have the potential for some weather-related casualty—whether from hurricanes, tornadoes, high winds, flooding, or fires—and property owners affected by these casualties need to have the right to receive money from their insurance companies to rebuild and restart their businesses. Lawyers must be able to advise their clients and draft their documents to deal effectively with the property damage coverage that needs to be maintained to permit this rebuilding and recovery.

The Base Forms Covering Physical Damage

Property owners obtain “property insurance” (no, it’s not called “casualty insurance” and hasn’t been for a while) to provide compensation for the cost of loss of or damage to their properties. An insurance policy can

be written on a company form policy or can be a “manuscript” policy, which is a custom policy prepared for a particular insured party.

The Insurance Services Office, Inc. (ISO), promulgates forms for its underwriter clients with customary form coverages (as distinguished from what can be provided by a manuscript policy). The first two sets of letters and numbers in an ISO form’s designation (for example, the “00 10” in #CP 00 10 06 07) identify the type of form and are, for the most part, used consistently for the same type of form over many years. The last two sets of numbers (for example, the “06 07” in #CP 00 10 06 07) identify the year and month in which the form was promulgated. Lawyers should be wary of these forms—they do change from time to time.

ISO Form #CP 00 10 06 07, the Building and Personal Property Coverage Form, describes what is and is not insured, but an additional form is needed to set out the “Covered Causes of Loss.” Generally, there are three types of commercial property “Causes of Loss” policy types:

leakage, sinkhole collapse, volcanic action, and some damage caused by windstorm or hail (generally ISO Form #CP 10 10 06 07).

- *Broad Form* provides Basic Form coverage as well as coverage for additional listed perils, such as falling objects, weight of snow, ice or sleet, and some water damage caused by the accidental leakage of water or steam caused by the breaking apart or cracking of a plumbing, heating, or air conditioning or other system or appliance located at the insured property (unless caused by discharge or leakage from a sprinkler system, a sump pump, a roof, flood, or other excluded causes) (generally, ISO Form #CP 10 20 06 07).
- *Special Form* covers all “Risks of Direct Physical Loss” (the former name of this type of policy was “All Risk”) except those perils that are specifically excluded (generally ISO Form #CP 10 30 06 07).

All of these forms expressly exclude various causes of loss, including earth movement, flood, the backing up of water from a sewer, drain, or sump, governmental action, enforcement of ordinance or law, nuclear hazard, the failure of utility services, war and military action, and mold (unless the mold results from fire).

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- *Basic Form* covers common listed risks, such as fire, lightning, explosion, smoke, vehicle, or aircraft (other than the insured’s vehicles) coming in contact with the covered property, riot or civil commotion, vandalism, sprinkler

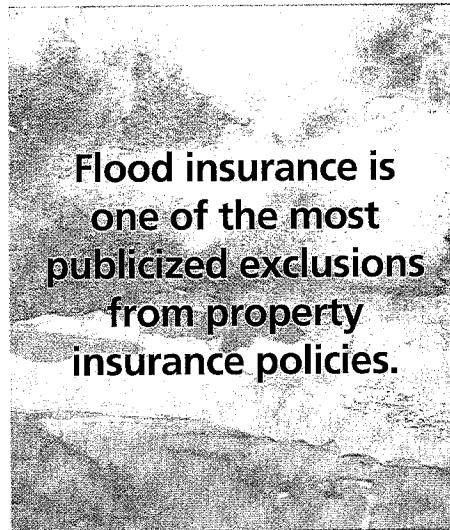
The extent to which a policy covers windstorm loss or has a higher deductible for windstorm or hurricane losses depends on the wording of the policy and whether the property is in a coastal area. See Tex. Dep't of Ins., *Commercial Property Insurance*, www.tdi.texas.gov/pubs/consumer/cb012.html (last visited June 21, 2012). In the case of each of these policy forms, expanded windstorm or hurricane coverage may need to be added as an included risk. Id. Property owners in coastal areas should be sure that their property policy covers all types of windstorm and hurricane damage and should confirm that their deductible is not higher for this risk. If this coverage is too expensive, then the owner needs to understand the rebuilding costs that it may have to fund from its own pocket.

Flood insurance is one of the most publicized exclusions from property insurance policies. At this time, flood insurance can be obtained for both residential and commercial properties through policies issued by private commercial insurers that are sponsored by the National Flood Insurance Program (NFIP), a FEMA program. Current NFIP flood insurance policies have a \$500,000 limit for commercial buildings and \$500,000 limits on their contents. A property owner can obtain additional flood coverage from some private insurers for a price.

If flood insurance can be obtained, it should be obtained. The premiums are governmentally regulated and as a consequence, reasonable. Just because a property owner's bank does not require flood coverage does not mean that the coverage is not needed. Lawyers should be careful to advise clients that a flood insurance policy will not cover the contents of a home or commercial building unless the insured expressly selects this contents coverage. Many homeowners in flooded areas find out to their surprise that their televisions and sofas are not covered by their flood policies, even though their home is covered. NFIP flood insurance will not cover loss of a business's income.

The NFIP flood insurance program

is subject to re-authorization from time to time. Recently each reauthorization has been for less than a year, but on July 6, 2012, the President signed the Biggert-Waters Flood Insurance Reform Act of 2012, which extended the National Flood Insurance Program's authority through September 30, 2017. See Federal Emergency Management Agency, Section on the National Flood Insurance Program, *National Flood Insurance Pro-*



gram: *Reauthorization Guidance* (July 16, 2012), available at www.fema.gov/national-flood-insurance-program/national-flood-insurance-program-reauthorization-guidance. At this time, it is hard to predict the changes that will be effected by this act. What is clear is that when representing buyers in areas where flood insurance is important, lawyers should stay abreast of the current status of the NFIP flood insurance program. They should also ascertain whether there is a storm in the Gulf or other condition at the time of the closing that will prevent the buyer from obtaining the flood coverage it needs. In fact, lawyers for these buyers should include in their purchase agreements a provision stating that if NFIP flood coverage is not available on the required closing date by reason of weather conditions, the closing date will be extended until it is available.

Earthquake coverage is also needed in many regions, but it can also be expensive.

Clearly, the most comprehensive form of property insurance outside of a well-crafted manuscript policy is the general Building and Personal Property policy form (ISO CP 00 10) with the Special Form Causes of Loss (ISO CP 10 30) and with added coverage for otherwise excluded risks (such as windstorm, if it is a policy exclusion, flood, and earthquake) if this coverage is needed in the area where the property is located.

Property insurance does not generally cover the surface of the ground if there is no basement or if there is a basement, the foundations below the lowest basement floor. It also excludes a number of other types of property such as vehicles, electronic data, information contained in valuable papers and records, and satellite dishes and antennas. The property owner needs special coverage for these otherwise-excluded types of valuable property.

The Amount of Coverage for Physical Damage

The policy's declarations page sets out the dollar limits of coverage. These dollar limits are the most that an insurer will pay in any single occurrence. Unless a building is old and its replacement cost exceeds what the owner will wish to spend on replacing it, the owner generally asks for property insurance covering the "full replacement cost" of the property. Even if the owner is not inclined to maintain this coverage, most banks require that their borrowers maintain replacement cost coverage (subject to various consumer credit rules). If the policy covers the replacement cost of the improvements and the owner elects to restore the property after a loss, the policy will require the insurer to pay the cost to replace the lost or damaged property with other comparable property, *with no deduction for depreciation*.

An alternative to replacement cost coverage is coverage for the "actual cash value" of the insured property. A California statute illustrates the difference between replacement cost and actual cash value, at least for purposes of California law, in a policy

in which the value of the covered property is not specified (an "open policy"):

- (a) Under an open policy, the measure of indemnity in fire insurance is the expense to the insured of replacing the thing lost or injured in its condition at the time of the injury, the expense being computed as of the time of the commencement of the fire.
- (b) Under an open policy that requires payment of actual cash value, the measure of the actual cash value recovery, in whole or partial settlement of the claim, shall be determined as follows:
 - (1) In case of total loss to the structure, the policy limit or the fair market value of the structure, whichever is less.
 - (2) In case of a partial loss to the structure, or loss to its contents, the amount it would cost the insured to repair, rebuild, or replace the thing lost or injured *less a fair and reasonable deduction for physical depreciation* based upon its condition at the time of the injury or the policy limit, whichever is less. In case of a partial loss to the structure, a deduction for physical depreciation shall apply only to components of a structure that are normally subject to repair and replacement during the useful life of that structure.

Cal. Ins. Code § 2051 (a)–(b)(2) (emphasis added).

As a rule, replacement cost policies are more expensive than actual cash value coverage because the policy limits of replacement cost coverage will reflect the cost to replace the damaged property with new property, even if, after replacement, the property will be worth less than the amount spent to restore it.

Even if the owner obtains a

replacement cost policy, the insurance company still can be required to pay only the "actual cash value" if the property is not actually restored. See Cal. Ins. Code § 2051.5. In addition, replacement cost policies have agreed insurance limits, and if these agreed limits are too low, co-insurance may limit recovery.

Co-Insurance

ISO form property policies generally contain "co-insurance" provisions, and these provisions can be a real problem for the insured. Under a co-insurance provision, if specified policy limits are much less than the insured replacement cost or actual cash value, then the insured's recovery will be reduced by application of the co-insurance calculator.

The policy's declarations page should show the co-insurance percentage, which is frequently 80% to 100%. The application of this percentage is somewhat complex. As an example, if the replacement cost of the property at the time of the loss is \$1 million, the co-insurance percentage is 80%, the policy limits are \$500,000, the loss is \$300,000, and the deductible is \$50,000, then the insurer will (1) multiply the co-insurance percentage by the replacement cost of the covered property at the time of the loss ($\$1,000,000 \times .80 = \$800,000$), (2) divide the policy limits (\$500,000) by the product obtained in (1) ($\$500,000 \div \$800,000 = .625$), (3) multiply the amount of the loss before the application of the deductible (\$300,000) by the figure calculated in (2) ($\$300,000 \times .625 = \$187,500$), (4) subtract the deductible from the figure in (3) ($\$187,500 - \$50,000 = \$137,500$), and (5) pay the result (\$137,500) or the limit of the insurance, whichever is less. The remainder of the loss will not be covered.

To avoid this harsh result, the insurance limits must be higher than the co-insurance percentage multiplied by the anticipated total actual cash value or the replacement cost of the insured property. A property owner should be careful to maintain the full insurance amount needed to avoid application of co-insurance.

There is another way to avoid the application of co-insurance, though only commercial owners generally make the effort (or have a broker that is knowledgeable enough to make the effort). A property insurance policy can be written with an "agreed amount" stipulation. If there is an agreed amount, the insurer agrees that the insured property is worth a stipulated amount and that co-insurance provisions will not apply to limit the insured's coverage. Of course, the owner needs to engage engineers and other professionals to be sure that the agreed amount will be sufficient for rebuilding, but at least the owner will have some certainty in its risk management plans.

Loss of Business/ Loss of Rents Coverage

The Basic, Broad, and Special Form policies, by themselves, will reimburse the property owner only for the repair or replacement cost of the physical property. This is fine for a homeowner, but what about a landlord's loss of rents, a business's loss of income, or a retailer's loss of business? How will the business owner pay its continuing expenses while it cannot operate at its usual location? These owners need to obtain coverage for Business Income, with or without Extra Expenses, to have basic coverage for the loss of business arising from damage to its insured business location.





A basic Business Income (Without Extra Expense) policy is illustrated by ISO Form #CP 00 32 06 07, and a basic Business Income (With Extra Expense) form, by ISO Form #CP 00 30 06 07. Of course, an owner and an insured also can craft a manuscript version of a loss of Business Income policy.

A basic Business Income policy will cover the business's net profit or loss (before income taxes) that would have been incurred had the "covered cause of loss" set out in the Basic, Broad, Special, or other form of the property loss policy not occurred. Courts have explained that in a retail business, these policies cover the gross sales or other gross receipts less the operating expenses of the business. See, e.g., *Morton M. Goldberg Auction Galleries, Inc. v. Canco, Inc.*, 650 So. 2d 801 (La. Ct. App. 1995). Lost profits must be proved by the insured operator as part of the claims process. See, e.g., *In re Cosmetics Plus Group, Ltd.*, 379 B.R. 464 (S.D. N.Y. 2007); *Polytech, Inc. v. Affiliated FM Ins. Co.*, 21 F.3d 271 (8th Cir. 1994); *Yount v. Lafayette Ins. Co.*, 4 So. 3d 162 (La. Ct. App. 2009). Business interruption is only a temporary cessation or impairment of the operations of an established business, and the insured can recover only for the period during which it can prove that its damages were directly attributable to the insured risk. See, e.g., *Napolitano v. F.S.P. Inc.*, 797 So. 2d 111 (La. Ct. App. 2001).

If the business was not operating at a profit before the casualty, then, under some decisions, no business income insurance proceeds will be payable for the period after the casualty—business income coverage is not a guaranty of recovery. See *Dictiom-atic, Inc. v. U.S. Fid. & Guar. Co.*, 127 F. Supp. 2d 1239 (S.D. Fla. 1999); compare *B.F. Carvin Constr. Co. v. CNA Ins. Co.*, No. 06-7155, 2008 WL 5784516 at *3 (E.D. La. June 14, 2008) (holding that because the insured construction business had more profits after Hurricane Katrina than before the hurricane, the business had not demonstrated the actual loss required to recover under its Business Income insurance policy). But see *Chalmette Retail Ctr., L.L.C. v. Lafayette Ins. Co.*, 974 So. 2d 822 (La. Ct. App. 2008) (refusing to deduct income from a post-storm lease of a parking lot to FEMA from the loss of rental income proceeds because it found that the policy did not cover the parking lot, only the building).

Most basic Business Income policies include coverage for "continuing normal operating expenses, including payroll." See ISO #CP 00 32. A business can and probably should also obtain coverage for "Extra Expenses." How are normal operating expenses different from Extra Expenses? Extra Expenses are those expenses that the business did not incur in the ordinary course of its operation before the casualty, but that it does incur during the casualty restoration period to minimize or avoid incurring additional business losses. For example, if a business opens at a temporary location, its Extra Expenses will include the costs of setting up and operating in this location. See ISO #CP 00 50 06 07. Not surprisingly, Business Income policies provide that the covered loss will be reduced to the extent that the insured could have resumed its operations, and the recovery will be based on the length of time it would have taken for the insured to have resumed its operations as quickly as possible. They also require that the insured take reasonable steps to minimize its losses. ISO #CP 00 32. Some of the costs of these reasonable

actions may be covered by a normal Business Income policy, but, to avoid arguments, a business owner should also obtain Extra Expenses coverage. Compare ISO #CP 00 32 to ISO #CP 00 50.

Landlords generally obtain their loss of rents (loss of Rental Value) coverage as part of a broader policy of Business Income coverage. See ISO #CP 00 32. In a form like ISO #CP 00 32, loss of Rental Value will constitute part of the covered business income only if the landlord selects—and the policy declaration page shows the selection of—the Rental Value coverage option.

A loss of Rental Value policy is intended to provide coverage for the loss of rental value (less operating costs) of the portion of the insured property that is rented to third parties or held out for rental to third parties if the loss is caused by a covered risk, but only during the period of rental loss that is attributable to this covered risk. See *DePhelps v. Safeco Ins. Co. of Am.*, 65 P.3d 1234, 1239 (Wash. Ct. App. 2003). It does not cover loss of rental value caused by bad economic conditions arising from a disaster in the area—only rental loss caused by damage to the specified insured property caused by the covered risk. ISO #CP 00 32.

An insured needs to be sure that its policy gives it an adequate coverage period for loss of business, operating expenses, and loss of rents. Most policies optimistically call this period the "period of restoration," probably based on the assumption that funds will be available immediately for repairs. ISO #CP 00 32. This period starts when the physical loss occurs (or a specific time after that date—72 hours for Civil Authority coverage in ISO #CP 00 32 06 07). It ends on the earlier of the date on which business is resumed or the date by which the property should have been repaired or rebuilt if the work was performed as quickly as possible. See ISO #CP 00 32. See also *Breton, LLC v. Graphic Arts Mut. Ins. Co.*, No. 09-CV-60, 2010 WL 678128 at *3 (E.D. Va. Feb. 24, 2010). A business owner would be wise to obtain an endorsement or other

policy provision covering delay.

Loss of rents insurance is limited in duration (frequently 12 months) or amount (frequently fixed by coverage limits), or both. Landlords need to be comfortable with the limitations in their policies. In net leases in which the tenant will perform the work of rebuilding, the landlord should try to avoid giving the tenant a free rent period that is longer than the period or amount covered by the landlord's loss of rents insurance.

Of course, a business can be shut down simply because its electronic data have been lost. A standard Business Income policy may provide coverage if the loss of data arose from actual damage to the insured property caused by a "covered cause of loss," but the limits of this coverage are low. See ISO #CP 00 32. If the business owner wants real coverage, it must carry a special policy or endorsement.

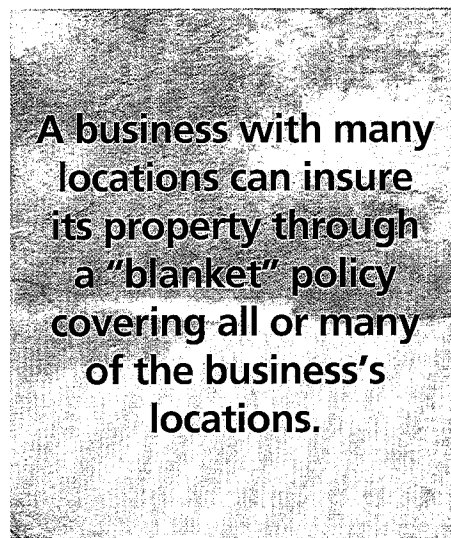
Co-insurance also may limit a property owner's Business Income recovery. As in the case of coverage for physical loss to its property, a property owner should either maintain coverage limits that are a reasonable approximation of its actual anticipated business losses or have the insurance company stipulate to an agreed amount with no co-insurance.

Deductible Amounts, Self-Insurance, and Blanket Coverage

A business with many locations can insure its property through a "blanket" policy covering all or many of the business's locations. Blanket policies are based on the assumption that a fire or other casualty will not damage more than one of the covered properties during the same period. For this reason, an insurer will issue a blanket policy covering more than one location at a lower cost per property. Most often, in a blanket policy, the business owner and the insurer create a Schedule of Values listing each of the properties. The Schedule of Values is attached to the policy and agreed to by both parties. The business owner should anticipate

increases in value during the policy period and the effects of inflation in fixing these values and in the overall limits. Co-insurance should not be a part of policies that include a Schedule of Values. The insurer can require recent appraisals to determine the limits, but the business owner should have its insurer stipulate that the values on the Schedule of Values are "agreed amounts" that avoid the application of co-insurance.

A business owner will have to pay



its deductible amount from its own pocket. A high deductible generally reduces the cost of the policy. For this reason, many national businesses have very high deductibles.

Deductible amounts are a form of self-insurance. The higher the deductible, the more the business owner is self-insured. Businesses also can self-insure through an overall plan that includes retentions and is administered by a third-party insurer or broker. High deductibles and high self-insurance limits mean that for a particular small location, the business owner will have to replace lost or damaged property using its own assets, without third-party insurance backup.

Many businesses can easily evaluate and are in a position to accept the risks posed by blanket insurance, high deductibles, and self-insurance for their own properties. But these may not be acceptable risks for the business owner's landlord. If

the tenant has agreed to maintain the property insurance on a landlord-owned building in a net lease situation, the landlord must be very careful to assure that it does not have to rely on the tenant's assets rather than conventional third-party insurance for the funds needed to replace its building. In addition, the landlord cannot rely on a certificate of insurance to prove that its tenant is maintaining the required insurance—the landlord needs to look at the entire policy for real assurance. W. Rodney Clement Jr., *Is a Certificate of Insurance a Worthless Document?*, Prob. & Prop. 46 (May/June 2010). To avoid grappling with blanket policies, high deductibles, self-insurance, and proof of insurance, a landlord is best served by maintaining its own property damage and loss of rental value insurance and either building its cost into the rent or requiring the tenant to reimburse it for these coverages.

Waivers of Subrogation

An insurer that has paid an insured for property damage or loss of business is subrogated to the rights of its insured. This means that it is permitted to step into the shoes of its insured and proceed to recover the amount that it has paid from the person that caused the loss. For example, if a tenant throws a lighted match into a waste basket and the landlord's building burns as a consequence, the insurer will first pay the landlord, then proceed against the tenant for the amount paid. Under the same principle, when an insurer pays a tenant for its equipment, fixtures, or inventory damaged by negligence of another party—for example, the landlord's defective electrical system—the insurer has the right to proceed against the person that caused the accident or casualty (in this example, the landlord) to recover the amount it paid its insured. See, e.g., *Reade v. Reva Holding Corp.*, 818 N.Y.S.2d 9 (N.Y. App. Div. 2006).

In a business relationship, the fairness of making a negligent party pay for losses caused by its own negligence is generally less important than the parties' desire to allocate

in a cost-effective way the risks of doing business and the costs of the insurance providing protection for these risks. For these reasons, in their leases and other contracts, parties often include a mutual waiver of subrogation. If the insurer's rights of subrogation have been waived for a party, it cannot then sue that party if it caused the damage—just as it cannot sue its own insured.

Of course, a waiver of subrogation may not have the desired effect in all situations. An insured has the ability to waive its insurer's rights of subrogation only to the extent that its policy permits it to do so. Although many property damage policies permit a tenant to waive its insurer's rights of subrogation against its landlord, some do not, and an express waiver by the insurer (generally in an endorsement) may be needed. In addition, particularly when a tenant or other party has a high deductible or is otherwise self-insured for its property and business loss, the

landlord needs to couple the waiver of subrogation requirement with a waiver of claims by the tenant or other party for all property damage and business loss that could have been insured had conventional third-party insurance been maintained. Unfortunately, this waiver will not be enforceable to the extent that a state prohibits a party from waiving claims caused by the other party's negligence. See Marie A. Moore, *Indemnification Provisions in Leases: What We Ask for and What Really Matters*, Prob. & Prop. 33 (Sept./Oct. 2008). In other rare cases, a state's public policy might also void an otherwise valid insurer's waiver of subrogation for an insured claim. See *Fed. Ins. Co. v. Richard I. Rubin & Co.*, No. 92-4177, 1993 WL 489771 (E.D. Pa. Nov. 15, 1993) (waiver of subrogation was not effective in a situation in which the building owner violated statutes or regulations designed to protect human life, even if only property damage resulted from the violation).

Fortunately, in most cases, courts

will give effect to a third-party insurer's waiver of subrogation for which its insured paid and to which the insurer agreed. See *Hudson v. Forest Oil Corp.*, 372 F.3d 742, 747-48 (5th Cir. 2004).

Conclusion

Lawyers need to know these basic property insurance principles when they advise clients on coverages and when they draft leases and other contracts that require their clients or other parties to maintain some or all of the property coverage. Hurricane Katrina and other major disasters revealed the problems that result when the owner has not maintained the coverages the owner really needs, but an owner can have the same problems after a more common sort of casualty. To avoid these issues, owners and their lawyers need to read the insurance company forms and pick the right ones, even though they hope that these forms will never be tested by a real casualty. ■

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