WHEN REQUIRED INSURANCE IS UNAVAILABLE AT ANY PRICE – REALLOCATING CASUALTY RISK POST 9/11 AND KATRINA

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> "Insurance is an arrangement for transferring and distributing risk." "Arrangement" underscores that insurance is contractual in nature; one party (the insured) makes a payment (the premium) to another to induce that other party (the insurer) to assume the first party's risk. The insurer enters into substantially identical arrangements with large numbers of similarly situated individuals; by taking advantage of the law of large numbers and the reality of regression to the mean across large samples, the insurer provides security to insureds at the same time that it finds predictability in the large pools of risks that it assembles. The insured, in exchange for the periodic payment of a small sum, escapes the risk of a large, devastating loss.[1]

Casualty and insurance provisions in real estate contracts are often given short shrift by clients and their attorneys. Insurance industry terminology is commonly misused and/or misunderstood by one or both sides to a transaction, leading to provisions that simply don't match with reality. The impact of natural and unnatural catastrophes in the first decade of the Twenty-First Century demands that closer attention be paid to these provisions to ensure that clients understand the obligations that have been placed upon them, and that those obligations are possible for them to meet.

A short primer on property insurance forms and terms[2]

Although an insurance company or an agent or broker representing that insurance company may develop its own policy forms, generally referred to as "manuscript policies," the most commonly used forms in the property insurance industry are issued by Insurance Services Office, Inc. ("ISO").[3] Manuscript policies are most often used for large or portfolio policies and are usually broader than the ISO forms. Because many provisions establishing standards for property coverage use the ISO forms as a point of reference, a short guide to the ISO forms and their contours of coverage follows.

Basic Form (Fire and Extended Coverage)

The ISO form *CP 10 10* covers fourteen basic causes of loss:

1. Fire
2. Lightening
3. Explosion
4. Smoke
5. Windstorm
6. Hail
7. Riot
8. Civil Commotion
9. Aircraft
10. Vehicles
11. Vandalism
12. Sprinkler Leakage
13. Sinkhole Collapse
14. Volcanic Eruption

A policy covering the above-mentioned fourteen perils, whether on ISO Form *CP 10 10* or a manuscript policy, is commonly known as "Fire and Extended Coverage" or "Basic Form" Coverage.

Broad Form (Specified Perils)

The ISO form *CP 10 20* provides coverage for the perils insured under the basic form plus four other causes of loss: (1) falling objects; (2) weight of snow, ice, or sleet; (3) water damage (in the form of sudden leakage from appliances); and (4) collapse from specified causes.

Special Form (formerly known as "All Risks")

The most commonly used form is the ISO form *CP 10 30*. Rather than naming perils, the ISO form *CP 10 30* provides coverage for loss from all causes not specifically excluded. It is sometimes referred to as "Special Extended Coverage." It is no longer called "All Risks" because courts interpreted the name literally and disregarded the

specified exclusions. This form provides coverage for "direct damage from . . . unless otherwise excluded . . . ." The following perils are specifically excluded:

1. Ordinance or Law
2. Earth Movement
3. Governmental Action
4. Nuclear Hazard
5. Utility Services
6. War and Military Action
7. Water
8. Fungus, Wet Rot, Dry Rot, and Bacteria
9. Boiler and Machinery Failure
10. Wear and Tear or Lack of Maintenance
11. Continuous Seepage or Leakage Over a Period of 14 Days or More
12. Dishonest Acts
13. Pollutants
14. Faulty Design or Workmanship

Many of the foregoing exclusions can be covered by endorsements to the primary policy or under separate policies.

Note that the "water" exclusion addresses damage caused by: (1) flood, surface water, waves, tides; (2) mudslide or mudflow; (3) water that backs up or overflows from a sewer, drain, or sump; and (4) water underground pressing on, or flowing or seeping through foundations, walls, floors, or paved surfaces, basements, doors, windows, or other openings. Resulting damage from fire, explosion, or sprinkler leakage is covered if caused by water damage. Proximate cause triggers coverage.

<u>Catastrophic Perils, Earthquake, Flood, or Windstorm</u>

Although there are ISO forms available to endorse these coverages onto the property policy, these coverages are usually written under separate policies. Earthquake and/or Flood may be written separately or combined under a DIC (Difference in Conditions) policy, a "property umbrella" type of coverage. Windstorms are included in the basic policies, but are subject to higher deductibles and/or sublimits in vulnerable

areas. The manner in which the deductibles apply depends upon how the policy is written. One example:

A policy covers three buildings. Per the filed Statement of Values, the value of Building 1 is $500,000; Building 2 is $500,000; and Building 3 is $1,000,000. The Total Blanket Limit on the policy is $2,000,000. The windstorm deductible is two percent.

- The windstorm loss to Building 1 is $40,000.
  - $500,000 (value of Building 1) x 2% deductible = $10,000
  - $40,000 loss less $10,000 = $30,000
- The windstorm loss to Building 3 is $20,000.
  - $1,000,000 (value of Building 3) x 2% deductible = $20,000
  - $20,000 loss less $20,000 = $0.
- Of the $60,000 total windstorm loss, the carrier will pay $30,000.

Flood insurance is frequently written under the National Flood Insurance Program (NFIP), a federally funded program which makes flood insurance available at a reasonable cost for properties in flood zone areas. These properties must be located in communities which participate in flood prevention programs as required by the federal government. Five hundred thousand dollars of coverage is available for direct damage to buildings and contents only. There is no coverage under this program for business income.

Although it is rare to see a per location deductible, it is most common in wind/flood areas. Wind deductibles will be shown separately on a property policy. It is common for the wind deductible to be one to three percent of the property value – the higher the deductible, the lower the premium.

Commercial property insurance normally includes debris removal costs resulting from a covered loss, limited to twenty-five percent of the sum of the paid loss plus the deductible. An additional limit of $10,000 is available in the ISO form for debris removal if the amount payable under the policy to reconstruct or repair plus the amount payable under the policy for debris removal exceeds the entire policy limit or the cost of

debris removal exceeds twenty-five percent of the sum of the paid loss plus deductible. Higher limits are available using the Debris Removal Additional Limit of Insurance (ISO form *CP 04 05*).

Coverage Conditions or Limitations to Coverage

1. *Blanket Limit* **-** a single limit of insurance that applies over more than one location or more than one subject of insurance - such as building and personal property. A blanket limit provides better protection against underinsurance as the full limit can be applied to any one location.

2. *Stop Loss Limit* **-** defines the limit of insurance as the largest possible loss at any one location. (Assumes only one location will be damaged in a single loss. Earthquake insurance is usually written for a stop loss limit to insure, as closely as possible, the PML [probable maximum loss] of the insured property.)

3. *Replacement Cost* **-** pays the full value of replacing the damaged property up to and not exceeding the limit shown on the policy. Property must actually be repaired or replaced. However, all replacement policies contain "exceptions" describing items not included in replacement cost.

4. *Actual Cash Value (ACV)* **-** commonly defined as replacement cost less depreciation or, in some jurisdictions, fair market value. This is less expensive than replacement cost because with ACV policies, the insured is usually purchasing a lower amount of insurance than with a replacement cost policy.

5. *Coinsurance Clause* **-** provides penalty if the insured does not purchase a limit of insurance at least equal to the percentage stated on the declarations page - usually 80%, 90% or 100% of the value of the insured property.

6. *Agreed Value or Amount* **-** waives coinsurance penalty by stating that the insurance amount is agreed to be equal to the percentage of value required by the coinsurance provision. The same result may be obtained by providing for "no coinsurance clause."

7. *Waiver of Subrogation* **-** the insured party is obligated to have his insurer waive the insurer's rights of recovery against the other party for damage to insured's property.

Evidence of Insurance

A "Certificate of Insurance" is simply a document which evidences the existence of an insurance policy. It is not the policy itself. There are three different standard forms of certificates of insurance, each which contain slightly different information:

- ACORD 25-S (titled "Certificate of Insurance") is evidence of liability insurance, not property insurance. It does not give the recipient of the certificate any rights and does not obligate the insurer to notify the recipient upon cancellation or amendment of the policy.
- ACORD 27 (titled "Evidence of Property Insurance") is evidence of property insurance. It differs significantly from the ACORD 25-S because it confers upon the recipient all of the rights under the policy and it obligates the insurer to give the recipient notice of cancellation of the policy.
- ACORD 28 (titled "Evidence of Commercial Property Insurance") is a relatively new form, but is generally considered to be an improvement over ACORD 27 for the benefit of the recipient of the certificate.

Standard allocation of casualty risk in commercial real estate leasing and financing

Customarily, the owner of a multi-tenant commercial development maintains property insurance on at least the structural elements and common areas of the improvements in that development. For example, in a shopping center, the owner will insure the common areas (parking lot, landscaping, etc.), roof, walls, foundation, and possibly the demising walls. If a casualty destroys the center, the owner will typically be required to rebuild the shell of the building with the finish level originally provided to the tenants. Tenants are then required or expected to carry property insurance on the improvements to their premises and any personal property contained therein.

It is important to make sure that the lease obligations with respect to restoration are in synchronicity with the definition of the property that has been respectively insured by landlord and tenant. Commercial property policies generally cover "Buildings" and "Building Person Property." A "Building" is generally defined as a structure and includes: (1) completed additions; (2) fixtures; (3) permanently installed machinery and equipment; and (4) personal property owned by the named insured and used to maintain or service the Building. The term "Building" does not generally include: (1) land, water, growing crops or landscaping; (2) foundations of buildings, structures, machinery or boilers, if the foundations are below the lowest basement floor, or the surface of the ground, if there is no basement; (3) bridges, roadways, walks, patios, or other paved surfaces; (4) bulkheads, pilings, piers, wharves, or docks; (5) underground pipes, flues, or drains; (6) retaining walls not part of the building; and (7) cost of excavations, grading, backfilling, or filling. "Building Personal Property" refers to the personal property located within a building and out in the open within 100 feet of the building.

In the context of the landlord/tenant relationship, the risk of casualty to the building shell is allocated to the landlord. The landlord then purchases property insurance to cover or mitigate that risk and then typically charges the cost of that insurance back to the tenants through common area maintenance charges (CAM) or rent. Minor tenants normally do not have the bargaining power to require the landlord to obtain property insurance of a particular type or in a threshold amount. Major tenants often attempt to impose very specific requirements on landlords. A few examples:

<u>Example A</u>

> Lessor shall obtain and keep current with insurance companies rated by A.M. Best Company as A-VIII or better: fire insurance with extended coverages endorsement on all other buildings in the Center insuring such portion of the current full replacement value thereof as will prevent Lessor from becoming a co-insurer and including a waiver by the insurer of all rights of subrogation against Lessee.
>
> (from a 2004 grocery store lease in Indianapolis, Indiana)

<u>Example B</u>

> Landlord shall maintain a policy of fire and property insurance in the form of the Insurance Services Offices' ISO Property form 1030 – Causes of

> Loss Special Form or equivalent insuring against damage to Landlord's Parcel which shall be in the amount of the full replacement cost of the insured improvements, including demolition cost less a deductible of not less than Ten Thousand Dollars.
>
> (from a 2005 junior box lease in Seattle, Washington)

Example C

> Landlord shall maintain Special Form property insurance (sometimes referred to as "Special Extended Coverage" and formerly known as "all-risks") property insurance covering the Premises, the Building, and the remainder of the improvements in the Center against loss or damage resulting from fire and other insurable loss. Such insurance shall be on a 100% replacement cost basis, adjusted at least annually to account for increases in the replacement cost.
>
> (from a 2006 junior box lease in Naples, Florida)

Lenders also play an important role in dictating which type of property insurance will be carried on a commercial real estate asset. The required insurance provision in loan documents can vary quite a bit. The emergence of Commercial Mortgage Backed Securities ("CMBS" or "securitized loans") has led to some standardization of very broad language that attorneys need to review carefully.

It is vitally important that attorneys representing landlords, tenants, and lenders understand what insurance is required by a specific document and whether the insurance maintained by the client satisfies that requirement. For outside real estate counsel, this may be particularly difficult since they are unlikely to have reviewed their client's insurance policy.

Impact of recent natural and unnatural catastrophes on the availability of property insurance

An increase of "extreme weather events" linked to climate change has resulted in mounting weather-related catastrophe losses over recent years.[4] Catastrophic hurricanes caused inflation-adjusted insured property losses of $87.8 billion from 1949 to 1999.[5] In 2004 and 2005 alone, eight named hurricanes hit Florida, resulting in 2.8 million property

claims with an estimated gross probable loss of $35.9 billion.[6] In 2005, Hurricane Katrina resulted in insured losses of over $45 billion in the Gulf Coast.[7]

Although the Southeast has born the brunt of weather-related catastrophe in recent years, the rest of the country is not immune. New York City has created the Office of Long-Term Planning and Sustainability to, among other responsibilities, coordinate the development of a "climate adaptation strategy" to deal with the impact of rising oceans and unpredictable storms on the city.[8] One area of concern is the lower parts of Manhattan, as far north as the Village, whose elevations make them vulnerable to flooding. In addition, glass in the newest Manhattan buildings can only withstand winds of 110 miles per hour. A Category 3 hurricane generates sustained winds of 111 to 130 miles per hour. One recent study found that a repeat of the "Long Island Express," the Category 3 storm that hit New England in 1938, would cause $200 billion in damage today.[9]

In response to these conditions, homeowners and commercial owners have found it difficult to obtain property insurance at any price in coastal areas, have seen significant increases in premiums and deductibles, and/or have found that "windstorm" coverage is being excluded from property insurance coverage. Following Hurricane Katrina, a few insurance companies cancelled policies immediately in Florida, particularly in South Florida, while a number of others dropped policies at renewal time.[10] In response to new models which raise the threat of hurricanes for New England and the Mid-Atlantic, Allstate Insurance announced in the summer of 2006 that it will not take new homeowner policies in New Jersey, Connecticut, Delaware, or New York City.[11] Commercial property owners able to renew policies in Florida in 2006 reported premium increases ranging from 30% to 400%, with higher deductibles and, often, no windstorm coverage.[12] As 54% of all Americans live within fifty miles of the coastline, these problems show no sign of waning.[13]

Description of the problem

A number of problems for landowners have arisen as a result of the recent events described above. A few common scenarios:

Scenario 1

Owner's sole asset is a 100,000 square foot grocery-anchored shopping center in South Florida built in 1996. The 50,000 square foot anchor tenant lease contains the following insurance provision:

> Landlord shall, at all times during the Term and at no expense to Tenant, carry all-risk property damage insurance on all of the buildings and permanent improvements from time to time in the Shopping Center for the full replacement cost of such buildings and improvements.

Owner's property insurance policy was up for renewal on October 1, 2006. In June, he received notice that the policy would not be renewed. Owner scoured the market and found that he could obtain a policy on ISO Form *CP 10 30*, but that windstorm coverage would be specifically excluded. Although his old policy was at a cost of $2.00 per square foot (for a total of $200,000 per year), the new policy cost $3.00 per square foot ($300,000 per year). Windstorm coverage is separately available, but would cost an additional $1.00 per square foot ($100,000 per year).

Owner's unavoidable financial problem is that although anchor tenant requires Owner to maintain a certain level of coverage, it will not reimburse Owner for its pro rata share of that policy. In other words, Owner's non-recoverable expenses have just increased by $100,000 for the year (50% of the total increased cost of $200,000), a large sum for a single-asset property owner.

The second problem is whether Owner must obtain the additional, expensive windstorm coverage to comply with anchor tenant's lease. In 1996, when the lease was written, "all-risk" property damage insurance was available and would have included windstorm coverage. In 2007, the equivalent of "all-risk" insurance available in South Florida excludes windstorm coverage. The lease is silent with respect to whether the definition of "all-risk" was fixed in time in 1996 or is adjustable as insurance availability fluctuates. Since the anchor tenant does not reimburse Owner for its pro-rata share of insurance costs, Owner has a powerful economic incentive to decide not to take out windstorm coverage.

What is the result? If Owner chooses not to obtain windstorm coverage, the anchor tenant may find out if it pays attention to Owner's periodically proffered proof of

insurance. More likely, however, the disconnect will not be noticed by the tenant unless and until a windstorm event causes damage to the property and Owner's repair and restoration obligations in the lease are triggered. Then his financial problem grows significantly worse as he must fund the cost of restoration out of pocket. For a single-asset property owner, this confluence of events leads to a potentially bank-breaking uninsured risk.

The risk for Owner is compounded by the terms of his mortgage. In 2003, Owner placed permanent debt on the asset in the form of a ten-year securitized (CMBS) loan. The mortgage contains the following insurance provision:

> Borrower shall keep the Project insured against damage by fire and other hazards covered by a standard extended coverage and all-risk insurance policy for the full insurable value thereof on a replacement cost claim recovery basis (without reduction for depreciation or co-insurance) and shall maintain such other casualty insurance as reasonable required by Lender, including, but not limited to, boiler and machinery, flood, windstorm, earthquake/sinkhole, and/or building law or ordinance.

Owner received written notice in 2004 that he would be required to maintain windstorm and flood coverage in accordance with the terms of the loan agreement. Owner's loan is non-recourse except for the standard "bad boy" carve-outs, including "Borrower's failure to maintain insurance as required by this Agreement." The CMBS loan has been sold and is now in the hands of a servicer. The servicer has no authority to re-negotiate the insurance provisions of the loan agreement in light of the new realities of the insurance market.

What is the result? Again, the problem is unlikely to surface unless and until a windstorm casualty impacts the property. In that event, the Owner would be faced with the following facts:

- Owner is required by the loan agreement and possibly the anchor lease to maintain windstorm coverage.
- Owner has been unable to obtain windstorm coverage at a commercially reasonably cost.
- Owner must come out of pocket to pay for the restoration of the center.

- Even if Owner successfully meets his restoration obligations, he may be found to be in default of the anchor lease, which could result in the loss of his anchor tenant, and/or the loan agreement, which could lead to a default and foreclosure.

The foregoing Scenario 1 illustrates that property owners, particularly small property owners, need to understand the insurance obligations in their loans and leases. The issue facing Owner and his attorneys is whether, before the nightmare scenario of a windstorm casualty occurs, Owner can do anything to mitigate his risk.

One possibility is that the Owner informs the anchor tenant and lender that it is unable to secure windstorm coverage. Based on the lease language set forth above, Owner may have a good-faith argument that it has no obligation to obtain insurance beyond the "all risks" policy available in 2007. If windstorm is excluded generally from "all risks" policies, the lease creates no affirmative obligation to obtain it. If, however, a court holds that the Owner was required to secure windstorm coverage, regardless of the cost, it is most likely that an anchor tenant would have all remedies available at law or equity, including termination of the lease.

The loan agreement, and the notice that followed, however, are more clear – Owner has an obligation to obtain windstorm coverage. If Owner gives the loan servicer notice that it is unable to comply with the insurance requirements, Owner could satisfy lender's security by providing a personal guaranty by the parent of borrower, letter of credit, posting a bond, or establishing a reserve for the potential uninsured loss. This only works, of course, if the parent of borrower has sufficient assets for such measures.

The bottom line is that the unavailability of windstorm coverage in this Scenario represents a material reallocation of risk that could make it too problematic for Owner to continue to hold the asset. Owner's best strategy may be divestment.

Scenario 2

Buyer has contracted to purchase a small complex of office buildings a few hundred feet from the coast north of Ft. Lauderdale, Florida for $60 million and the closing is scheduled for July 4, 2006. Buyer has deposited $2 million in earnest money,

the due diligence period has expired, and Buyer's earnest money is now non-refundable. Two weeks before the closing, Buyer's insurance broker informs it that it can add the new office buildings to its portfolio insurance policy, but it will be unable to provide windstorm coverage. In fact, Buyer's insurance broker has been unable to find any insurance company willing to provide windstorm coverage for the buildings. Buyer discovers that Seller's insurance company was planning to drop the buildings at renewal time and will not extend coverage to Buyer.

Buyer is faced with a unenviable choice: (1) terminate the agreements and surrender the earnest money; or (2) acquire a $60 million asset in South Florida with no windstorm coverage. Although Buyer does not have many options, we can learn from this nightmare scenario and draft provisions to avoid this situation in future contracts. *See* page 20-21, infra, for further discussion.

<u>Scenario 3</u>

Owner owns a $800 million portfolio of commercial assets throughout the East and Southeastern United States, of which $150 million are within ten miles of the coast. When Owner's property insurance comes up for renewal, Owner is informed that it will only be able to obtain a sub-limit of $50 million for windstorm coverage. All of Owner's individual assets are worth less than $50 million, although Owner has clusters of assets which exceed $50 million in several geographic areas, including South Florida. The majority of Owner's anchor leases and loan agreements state that it is required to maintain "comprehensive all risk insurance in an amount equal to 100% of full replacement cost." Is Owner in compliance with these provisions?

Owner's sublimit will cover the complete destruction of at least one of its windstorm-prone assets, but until the catastrophe occurs, we have no way of knowing which, if any, assets will be damaged after the sublimit is exceeded. This may mean that Owner is in technical compliance with the lease and loan insurance provisions, but that provides no real security to the anchor tenants and lenders. There is still a real possibility that a windstorm loss at any particular property will be at least partly uninsured. Ultimately, this scenario poses a question that will have to be resolved through the courts.

Tenants

Although Scenarios 1-3 discuss the economic and legal risk to landowners as a result of the rising cost and potential unavailability of property insurance, tenants, particularly small tenants, face equally severe corollary issues. Tenants may discover that the insurance required by their landlords is unavailable at any price, or at a commercially unreasonable cost. If a landlord finds property insurance but experiences a one hundred percent increase in cost in a property with full recoverables, then the tenants really shoulder the economic burden. Large tenants may be able to absorb these increased costs, at least in the short term, more readily than the small tenants that are the heart of a commercial asset. If all landlords in the geographic area are in the same boat with respect to increased cost, then they may not be at a competitive disadvantage vis a vis one another, but if the tenants cannot find a more affordable space, they may be forced to relocate or close. Needless to say, none of these impacts help fuel economic development.

Potential solutions

Both small and large landlords face potential problems as a result of the issues described in Scenario 1 and Scenario 3 above. As the size and geographic diversity of the landlord's holdings grow, however, their risk lessens because they are more able to obtain affordable insurance. Several potential solutions exist and more will doubtless be invented by creative attorneys, public servants, and entrepreneurs.

Keep in mind that these issues do not affect only landowners – in addition to the issues of increased cost noted above, tenants and lenders face the real possibility that assets in which they have invested considerable funds will not be protected by insurance of a type and at a level for which they have bargained.

Reallocation of Risk

All of the players in a commercial asset (landlord, tenants, lender) owned by a small landowner face increased cost and/or risk as a result of the property insurance

crisis. One potential solution is to reallocate risk (which is then insured) from the owner to either the major tenant(s) or the lender.

The traditional model assumes that the property owner will obtain property insurance and perhaps charge back the cost of it to tenants. But it may make more economic sense in the small owner/large anchor tenant relationship for large tenants to take out portfolio policies to achieve the same economies of scale that large owners experience. This would represent a significant re-alignment of the traditional allocation of responsibilities between landlord and tenant. If the anchor obtains the property insurance, they will have the security that at least their store is insured. This obviously would work more easily in a retail scenario where the anchor's leased premises is physically separate from the remainder of the asset. It is already being used in many single-tenant assets. However, this is not a complete solution as it is difficult to imagine a scenario in which the anchor tenant would obtain insurance on the entire asset.

A large lender may be in a much better position to pass through portfolio insurance to its borrowers at competitive rates. It is unlikely that a national or even regional lender would employ too much capital in the same vulnerable areas, instead choosing to mitigate its risk by geographically diversifying its loan portfolio. This should in turn make it easier for the portfolio to be insured. Unlike the anchor tenant, the lender would be able to insure the entire asset, which would give all parties more comfort.

Government insurance

When insurance is unavailable or available only at unreasonable rates for particular perils, Congress and state governments have stepped in from time to time to mandate coverage by private insurers or to offer insurance themselves.

In 1968, Congress enacted the National Flood Insurance Act ("NFIA"), which provided subsidized insurance through private insurers and was managed by the Federal Emergency Management Agency (FEMA).[14] Policyholders pay premiums that represent about thirty-five percent to forty percent of the true actuarial risk.[15] Individual homeowners and commercial owners benefit because they can obtain insurance at reasonable rates that would not be available in the private market. However, the marginal true cost of providing the insurance coverage is borne by taxpayers.

In addition to the tragic human loss on 9/11, the attacks inflicted over $30 billion in insured losses and an additional $50 billion in uninsured losses.[16] Prior to 9/11, conventional wisdom held that the risk of terrorism was so slight that it was included in most "all risk" policies and reinsurers did not exclude it. Secretary Paul O'Neill accurately predicted the response by the industry: "Because insurance companies do not know the upper bounds of terrorism risk exposure, they will protect themselves by charging enormous premiums, dramatically curtailing coverage or – as we have already seen with terrorism risk exclusions – simply refusing to offer the coverage."[17] Congress reacted by passing the Terrorism Risk Insurance Act of 2002 ("TRIA") as a temporary price stabilization measure.[18] TRIA had a sunset date of December 31, 2005, but it was later extended until December 31, 2007.[19] Although structured differently than national flood insurance, TRIA effectively functions the same way over the long term because taxpayers ultimately bear substantial risk of loss, rather than individual private owners.

The federal government has not yet responded to the windstorm insurance crisis with an analogue of the NFIA or the TRIA. However, state governments across the Gulf Coast have implemented various emergency measures.

Louisiana's Insurance Commissioner adopted Emergency Rule Number 15 on October 20, 2005, which limited the ability of insurers to cancel or refuse to renew policies due to non-payments of premiums.[20] The rule was scheduled to expire on December 31, 2005, for victims living or working in the parishes affected by Hurricane Katrina, but was extended by Emergency Rule 23, promulgated on January 20, 2006. Emergency Rule 23 suspended insurers' rights to cancel or refuse to renew personal lines or commercial lines property insurance coverage on insured who filed claims as a result of Hurricane Katrina. Instead, coverage on property damaged by the hurricane could only be cancelled or not renewed sixty days after the property had been "substantially repaired." Not surprisingly, a number of issues have arisen as a result of Emergency Rule Numbers 15 and 23.

The Louisiana legislature has also considered measures like the "Reliable Homeowners Insurance Act," which would require insurers doing business in Louisiana

to continue to offer personal lines residential property insurance on a statewide basis and to limit the pace of an insurer's withdrawl from the market.

In May 2002 the Florida legislature created the Citizens Property Insurance Corp. ("CPIC") by merging the Florida Windstorm Underwriting Association and the Florida Residential Property and Casualty Joint Underwriting Association. CPIC was designed to be the insurer of last resort, but quickly became the largest insurance company in Florida. In January 2007, Florida allowed CPIC to expand into the commercial insurance business by lifting the $1 million limit and permitting CPIC to write windstorm policies across the state.[21] In October 2006, CPIC proposed significant hikes in premiums, including a statewide average rate increase of more than 600% for commercial wind insurance coverage. In parts of Sarasota County, the increases were proposed to be as much as 1263%.[22] Florida's legislature apparently put a kibosh on the proposed rate hikes and CPIC is currently offering reductions in premiums to its 1.3 million customers.[23]

Self insurance[24]

Self insurance is an option for large landowners, but will be of little help for smaller or single-asset owners. Self insurance is a risk management method whereby an eligible risk is retained, but a calculated amount of money is set aside to compensate for the potential future loss. The amount is calculated using actuarial and insurance information and the law of large numbers so that the amount set aside (similar to an insurance premium) is enough to cover the future uncertain loss. Self insurance is similar to insurance in concept, but involves either the payment of a self-insurance premium to a captive insurance company, cell captive or rent-a-captive insurer, or making an on-balance sheet provision and not paying a premium to an insurer at all.

Self insurance is possible for any insurable risk, meaning a risk that is predictable and measurable enough in the aggregate to be able to estimate the amount that needs to be set aside to pay for future uncertain probable losses. For a risk to be insurable, it must represent a future, uncertain event over which the insured has no control. Other characteristics which assist in making a risk self-insurable include the ability to price or rate the risk. If the insurable event is one in a large number of similar risks, the aggregate

risk can be estimated according to the law of large numbers and the probability of that event occurring in the future can be quantified. Normally, catastrophic risks are not self-insured as they are highly unpredictable and high in loss-value. Catastrophic risks are normally underwritten by the re-insurance or wholesale insurance market. Any risk where the potential loss is so large that no one could afford to pay the market premium required to provide cover would not be commercially insurable. An example is that earthquakes cannot be fully insured against because an earthquake can cause more damage than any insurer or the combined insurance market is willing to risk in total assets. However, captives and self-insurance programs are often designed to provide for a part of a risk that would be catastrophic to the business concerned, or catastrophic risks that are often commercially uninsurable.

Full or exclusive self-insurance is rare, as a combination of self-insurance and commercial insurance usually provides the best cover for the self-insured. Usually the predictable losses of the risk are retained and self-insured, forming a first or "working" layer of cover, and a stop-loss or stop-gap policy is purchased from the commercial insurance market. The commercial insurance market then pays for losses above the specified self-insurance limit per loss, thereby stopping the cost of losses to the self-insured above the retained values. Effectively the losses paid for by the insured before the stop-loss policy pays becomes the deductible layer. Depending on the level at which risks are stopped, commercial insurance cover should become less and less expensive the further away the commercial insurer moves from the working layer of paying claims each year.

The idea of self insurance is that by retaining, calculating risks, and paying the resulting claims or losses from captive or on-balance sheet financial provisions, the overall process is cheaper than buying commercial insurance from a commercial insurance company. Cost savings to the self-insured entity are usually realized through the elimination of the carrying-costs that commercial insurers are obliged to pass on to their insurance consumers.

Drafting for a new reality

Although windstorm coverage in the Southeast is the most immediate cause of concern, given the hurricane seasons experienced in recent years, other extreme weather conditions including hail and wildfire are potentially significant issues and careful drafters will keep a broad outlook when reviewing insurance provisions which will remain in force for the next decade or longer. According to ISO, the three states with the highest property insurance claims in 2006 were Indiana, Missouri, and Tennessee.[25] In addition, the windstorm issue is not limited to South Florida. Risk Management Solutions, a hurricane computer modeling company, is predicting that hurricanes will occur with much greater frequency and intensity over the next five years, and is advising insurance companies that they need to increase their annual loss estimates by twenty-five percent to thirty percent in New England and the Mid-Atlantic states.[26]

Leases[27]

Casualty and insurance provisions, particularly with respect to leases in storm-prone areas, have taken on a new importance as a result of the natural and unnatural catastrophes described in this paper. Careful attention to and drafting of these provisions offers counsel an excellent opportunity to add value for our clients. Although this paper has mainly focused on landlord insurance issues, tenants may also have difficulty obtaining insurance required by landlords in order to allow tenant to restore its leasehold improvements, fixtures, equipment, and inventory and re-open for business immediately after the landlord has completed its restoration of the building. Counsel representing both landlords and tenants need to understand the kind and quality of insurance reasonably obtainable by the other side, and need to help their respective clients understand and appreciate the risks, if any.

In addition to the insurance provisions, both sides need to pay careful attention to provisions that address:

- the rights of each party to terminate in the event of a casualty;
- the obligations of a landlord to rebuild and the time period in which landlord is required to rebuild;

- co-tenancy provisions following a casualty;
- abatement of rent during a casualty;
- tenant's obligation to restore and re-open;
- securing the tenant's premises following a casualty; and
- hurricane shutters or similar prevention measures.

The aftermath of Hurricane Katrina teaches us that landlord counsel should make its restoration obligations subject to the actions of governmental authorities, the availability of utilities, inability to obtain workers or materials, subsequent casualties, and other delays that are not in landlord's reasonable control. Some of these conditions may be part of force majeure, but it is in landlord's best interests to spell them out to prevent future misunderstandings. The lease should also clearly state what landlord is required to restore and what is tenant's responsibility. Clear language will make it easier to adjust insurance proceeds and to complete restoration.

Purchase Agreements

To prevent the Buyer's unfortunate choice described in Scenario 2 above, buyers' counsel should add an "escape clause" to purchase agreements to permit the termination of a contract and retention of the earnest money due to the unavailability of property insurance.

A few years ago, the Florida Association of Realtors and the Florida Bar added the following provision to their standard residential form: "If Buyer is unable to obtain Hazard, Wind, Flood, or Homeowners' insurance at a reasonable rate due to extreme weather conditions, Buyer may delay Closing for up to 5 days after such coverage becomes available." This language was crafted to address the problem of closings scheduled during hurricane season – if a storm was off shore, insurance companies were unwilling to write new policies.

In the commercial context, it would be advisable for buyers to attempt to broaden this language further to provide that if buyer were unable to obtain property insurance, including windstorm coverage, at a commercially reasonable price prior to closing, then

buyer could opt to postpone closing until a certain date (presumably after hurricane season) or could terminate the contract and receive its earnest money.

Loan Agreements

Lenders are extremely risk-adverse. They normally pay close attention to insurance and casualty provisions and take care to draft broadly to protect their security. For example:

> [Borrower] shall, at [Borrower's] expense, maintain in force and effect on the Mortgaged Property at all times while this Security Deed continues in effect . . . [i]nsurance against loss or damage to the Mortgaged Property by fire, lightning, windstorm, tornado, hail, terrorism, riot and civil commotion, vandalism, malicious mischief, burglary and theft and against loss and damage by such other, further and additional risks as may be now or hereafter embraced by an "all-risk" or "special causes of loss" type of insurance policy. The amount of such insurance shall be not less than one hundred percent (100%) of the full replacement cost (insurable value) of the Improvements (as established by an MAI appraisal), without reduction for depreciation.
>
> If the "all-risk" or "special causes of loss" policy required . . . above excludes coverage for wind damage, [Borrower] shall maintain separate coverage for such risk. Furthermore, if the Mortgaged Property is located in the State of Florida, or within twenty five (25) miles of the ocean coast of States of Texas, Louisiana, Mississippi, Alabama, Georgia, North Carolina, Hawaii or South Carolina, windstorm insurance must be maintained in an amount equal to the lesser of (i) the full replacement cost of the Mortgaged Property or (ii) the maximum limit of coverage available with respect to the Improvements and Equipment. If available, a minimum of twenty-four (24) months general business income coverage specifically relating to wind damage shall be required. The maximum deductible shall be $10,000.00.

(from a 2006 CMBS loan in Atlanta, Georgia)

It is a cardinal rule of contract drafting to avoid the word "shall" in covenants that can only be satisfied through third-parties, i.e. Borrower shall maintain insurance. If Borrower is unable to obtain the insurance, Borrower is in default, even though it had no control over the situation. One option to avoid the future default while protecting the lender's security is to draft the following kind of provision:

> Borrower shall maintain . . . comprehensive all risk insurance on the Improvements and the Personal Property, in each case (A) in an amount equal to 100% of the "Full Replacement Cost," for which purposes of this Security Instrument shall mean actual replacement value (exclusive of costs of excavations, foundations, underground utilities and footings) with a waiver of depreciation, provided, however, that Borrower shall only be required to obtain insurance against windstorm damage for that portion of the Full Replacement Cost as may be insured at commercially reasonable rates, as reasonably determined by Lender.
>
> (from a 2006 CMBS loan in Naples, Florida)

The catch is that although this provision appears in a non-recourse loan, it is accompanied by an Indemnity Agreement that provides that Borrower's guarantor indemnifies the Lender for any cost arising out of "the failure of the Improvements to be insured by Qualified Insurers against windstorm damage in an amount equal to 100% of their Full Replacement Cost, regardless of whether such insurance is required pursuant to the Security Instrument." In essence, Borrower is not required to maintain windstorm coverage at 100% of replacement cost, but if it fails to do so, its guarantor is on the hook to Lender in the event of a windstorm catastrophe for the uninsured margin. This solution does not reallocate risk – it places it squarely on the landowner – but it does avoid an unintentional and unavoidable breach of the loan document and makes it clear to both parties at the outset how they will deal with the new reality of windstorm insurance.

Conclusion

There are no easy answers to the problems discussed in this paper. We cannot control the forces of nature, nor the nature of forces who desire to harm us. However, the public sector and the private market will continue to struggle to allocate risk among the parties to commercial real estate transactions to provide security at a reasonable cost. In the meantime, attorneys have the opportunity to add real value for their clients by careful review and drafting of casualty and insurance provisions.

ENDNOTES

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