The "Three-Legged Stool": The Interplay of Property Insurance, Mutual Waivers and Waivers of Subrogation in Commercial Leases

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There are few subjects in a commercial lease more intricately intertwined--and more misunderstood--than the trio of topics for this article. Because they are so interrelated in a well-drafted lease, they have been referred to as a "three-legged stool"[1]--all three legs are required for the stool to stand up. After a review of the issues, this article will conclude with a well-integrated, sample lease section addressing all three subjects.

The mutual goals of economic efficiency and cost-effectiveness dictate that landlords and tenants each assume responsibility for the risk of loss, and insuring against it, relative to their respective property. (Excluded from this discussion, of course, is the single-tenant building lease in which the tenant both obtains and pays for the insurance on both the landlord's building and the tenant's contents as part of a single insurance policy.) When this concept is elaborated into lease clauses dealing with property insurance, mutual waivers, and subrogation issues, the elements of the "three-legged stool" emerge:

1. Landlord and tenant each insure their own property against damage or loss by fire or other casualty, typically for the full replacement value.

2. Landlord and tenant each release the other for damage to their respective property caused by the other to the extent of the amount of property insurance required to be carried on that property under the lease (regardless of any negligence or even willful damage, and regardless of any self-insurance).

3. The mutual waiver by landlord and tenant extends to those who under common law or by statute would "step into the shoes" of the damaged party by reason of subrogation - typically the property insurers. In the commercial lease context, this takes the form of the parties each agreeing to obtain from its property insurer a waiver of the insurer's right of subrogation against the other, and if required under the policy, an approval of the mutual waiver in the

preceding paragraph.[2]

One of the great challenges in negotiating the commercial real estate lease is to maintain internal consistency within the various provisions of the lease. This challenge manifests itself on several levels relative to property insurance, mutual waivers and waiver of subrogation: the lease negotiator must assure, first, that these three provisions are consistent with each other (are the three stool legs the same length?), and, second, that these three provisions are consistent with numerous other lease terms, such as liability for damages from various events (for example, a roof leak or a broken pipe), responsibility to perform various repairs, risk of loss, and surrender of the premises at the end of the lease.

A logical, but rarely utilized, way to increase the chances of keeping the property insurance, mutual waivers and waiver of subrogation sections of a lease consistent is simply to collect them in the same place in the lease, thereby subtly reinforcing their interrelation. In the typical lease, these three topics are dealt with in separate sections, usually scattered through the pages of the lease, enhancing the risk of an "out of sight, out of mind" error by the negotiators. By contrast, in the sample lease language attached at the end of this article (see Appendix A), they have been brought together in a logical order, which should facilitate assuring that all three legs of the stool still reach the floor once the lease negotiations have been concluded.

A LOOK AT THE ESSENTIAL LEASE PROVISIONS

Property Insurance. In a well-drafted commercial lease, the landlord insures the building components "at its own expense,"[3] while the tenant insures its property at its own expense. In allocating what is to be insured by each party, attention should be paid to whether, elsewhere in the lease, tenant-installed improvements and fixtures become the landlord's property upon their installation or at some later time (such as lease expiration), or instead remain the property of the tenant and may be removed by the tenant, in the absence of default, at the time of lease expiration. So long as the tenant-installed improvements and fixtures remain the tenant's property, they should be insured by the tenant, but if the lease contains language making them the landlord's property, either immediately upon installation in the premises or at some intermediate time, then their insurance is properly the landlord's responsibility as soon as they become the landlord's property. Both the landlord and the tenant will be best served if their respective property insurance policies protect against all the perils included in a "Causes of Loss - Special Form" policy, and are in the amount of the full replacement cost, without deduction for depreciation, of the property insured.

Mutual Waiver and Release. The mutual waiver and release should be expansive, and extend to the usual laundry list of related parties (e.g., officers, directors, partners, members, managers, employees, agents, concessionaires, licensees and invitees, hereinafter the "Related Parties") to either a landlord or tenant. The waiver and release are limited, however, to loss or damage caused by risks covered by insurance; the right of recover for loss or damage from uninsured risks should not be released. The waiver and release paragraph is integrally related to the insurance coverage paragraph, because if the landlord's insurance will cover the landlord's loss or damage, even if

caused by the tenant's negligent actions, then it would be inappropriate for the landlord to hold the tenant liable for the loss or damage, since it would result in a double recovery by the landlord. The same, of course, applies to loss or damage to tenant's property, caused by the landlord's negligence, but covered by tenant's insurance. Counsel should resist the temptation of giving in to opposing counsel's "parade of horribles," citing the most extreme and improbable cases of gross negligence or willful misconduct that ought to be carved out of the mutual waiver and release paragraph; if the loss or damage from the event is covered by insurance, it is proper for it to be waived and released.[4] A loss not covered by insurance, however, would not be released.

Mutual Waiver of Subrogation. This lease clause may just be the one most likely to make a young real estate lawyer's eyes glaze over - especially when the other party's attorney starts renegotiating it, necessitating a thoughtful analysis and defense of the provision's intricate ties to the property insurance and mutual waiver and release sections. Conceptually, the mutual waiver of subrogation is a logical extension of the mutual waiver and release provision, as it extends the agreements made in the mutual waiver and release clause to apply to the parties' respective insurers who, by common law or by statute, "step into the shoes" of the injured party by applying the principle of subrogation. While the mutual waiver clause is designed to prevent a double recovery, this provision is instead designed to prevent the subversion of the lease's requirement that each party insure its own property against loss or damage, and that its own insurer assume the risk of loss.

Thus, a mutual waiver of subrogation provision will require each lease party to cause its own property insurance policy to include, either as an integral clause in the policy or in an endorsement, a waiver by the insurer of its right of subrogation, and all rights it may have by an assignment from its insured, against the other lease party and all its Related Parties. The Related Parties, incidentally, should be the same ones released in the mutual waiver paragraph, except that the landlord also may appropriately require any subtenant to secure a waiver of subrogation from its insurer.[5] As some property insurance policies require the insurer to agree to the mutual waiver of subrogation, the lease should include the requirement to obtain such approval, if dictated by the terms of either party's policy.

OTHER LEASE PROVISIONS WHICH NEED TO BE CONFORMED

Repairs by Landlord or Tenant. This is where consistency often breaks down, as many lease negotiators punitively seek to foist the responsibility for repairing casualties caused by the other party (or its Related Parties) onto that party. Sometimes this is done explicitly, and other times implicitly by disclaimer (e.g., if tenant caused the damage to the roof, then landlord is not responsible for repairing the damage, inferring without expressly stating that if the landlord is not responsible, then the repair must be the tenant's duty), but regardless of whether it is explicit or implicit, if there is insurance coverage, then tying the repair duty to the causation of the loss or damage is inconsistent with the principles of mutual waiver and release and mutual waiver of subrogation. The farthest the parties should stretch the idea of a punitive allocation of the repair duty is to assign the repair duty to the causative party if and only if the casualty was not covered by the insurance carried by the party responsible for covering the damaged property. This is consistent with mutual waiver and release and mutual waiver of subrogation, because those

concepts contemplate that the loss or damage was covered by insurance.

Similarly, provisions dealing with repairs made necessary by an Act of God or a mortal third party should only make a lease party (and which party it is should be consistent with the insurance and general repair obligations) liable for paying the portion of the repair cost, if any, which exceeds the proceeds received from insurance. Thus, if a fire is caused by a lightning strike or an electrical panel short, or a car crashes through a plate glass window, then the proceeds from the landlord's insurance (to the extent landlord's financing does not require that insurance be applied to pay down its loan) should pay to repair the building, while the proceeds from the tenant's insurance should be applied to the replacement of the tenant's trade fixtures, furnishings, equipment and inventory. The obligation to apply insurance proceeds to the repair or replacement of tenant improvements and fixtures, like the original obligation to insure them, should be allocated according to whether, under the terms of the lease, they had become the landlord's property by the time of the casualty.

Risk of Loss. Many leases contain a paragraph detailing what property within the premises the tenant is considered to own, and then continue to address tenant's sole risk of loss as to its own property in the event of a casualty. Some poorly drafted versions of this paragraph, however, conclude by carving out cases "where the loss is caused by the gross negligence or willful misconduct of the landlord." Such a proviso, making the landlord responsible for damage to the tenant's property, while doubtlessly tempting to tenant's counsel, is nevertheless at odds with the concept of mutual waiver and release detailed above, and should be excised from a lease which embraces the principles of the "three-legged stool."

Surrender of the Premises at Lease Expiration. Sometimes a landlord-friendly lease will require the tenant to surrender the premises simply "in good condition and repair." To be consistent with the insurance obligations and mutual waiver provisions discussed above, the provision should exclude the effects of ordinary wear and tear, casualty and condemnation, and situations to which the mutual waiver and release apply.

IMPLIED WAIVER OF SUBROGATION

We now turn from that well-crafted lease you have just drafted to the poorly drafted lease your just burned-out tenant client has just brought you to review for the first time. What do you do if your tenant's employee caused the fire, there is no mutual waiver of subrogation clause, and the landlord's insurer has paid the landlord's claim and is now seeking subrogation from your client, the tenant? You argue that the waiver of subrogation is implied from other terms in the tenant's lease. According to *Friedman on Leases*,[6] courts have embraced three distinct approaches to the implied waiver of subrogation:

1. those cases - a growing majority - that are very receptive to inference of an implied waiver of subrogation, and set it as the general approach, except when special circumstances suggest

otherwise;

2. those cases that refuse to find implied waivers in the "typical" case and will grant it only in the exceptional circumstance; and
3. those cases that adopt what might be called a "middle" position - generally open to the idea of implied waiver but insisting that the question must be resolved case-by-case on the particular equities of each situation.

The first approach, described by Friedman as "[t]he modern trend, which is rapidly being adopted as the more sound policy approach," treats tenants as equitably implied co-insureds solely for the purpose of inferring waiver of subrogation, regardless of whether the tenant is named as a co-insured under the landlord's property insurance policy. Implying the tenant is a co-insured under the landlord's policy defeats subrogation because there can be no right of subrogation by an insurer against its insured or co-insured. First enunciated in *Sutton v. Jondahl*, the *Sutton* doctrine provides that if the intent of the parties as to the allocation of the cost of insurance premiums is not explicitly stated in the lease, then the landlord's insurance is presumed to be for the mutual benefit of both landlord and tenant, and the tenant will be treated as a co-insured.[7] Eighteen states have adopted this approach in residential leases (*Sutton* was a residential lease case), and thirteen of those states have extended the approach to commercial leases. (Alas for your burned-out tenant, however, Virginia is not among these states.) Among the facts which support these states in implying a waiver of subrogation (in some cases, only one such fact has sufficed) are:

- The landlord carried fire insurance for the entire premises, creating a presumption that negligently-caused fire damage is the main reason to obtain such coverage. Moreover, negligence is a standard factor in determining fire insurance premiums, and the premiums are taken into account in setting the tenant's rent.
- There is a public policy against waste, but allowing subrogation compels the tenant to obtain duplicative insurance coverage to protect itself against a subrogation claim. Also, more waste results if the insurer were allowed to collect twice - once by receiving its premiums and again by recovering its payouts by a subrogation claim against the negligent tenant.
- Language in the lease which exempts the tenant from responsibility for fire damage in some cases (e.g., excluding damage by fire from the surrender clause, landlord assumption of the responsibility to repair fire damage, options to terminate or continue a lease after a fire (especially if the landlord is responsible for repairs), and rent abatement during the repair period) is often cited to support an implied waiver of subrogation.

By contrast, six states, relying on the common law rule that a tenant should be responsible for its own negligence, require waiver of subrogation to be expressed "in unequivocal terms."[8] Their position was colorfully summed up by Judge Fast of the New Jersey Superior Court, when he opined:

> I find no binding case law or reason in common sense that would hold that where the

> landlord would have a claim against a tenant, the existence of insurance obtained by the landlord, paid for by landlord from landlord's own unrestricted funds, and for the benefit of the landlord should exculpate the tenant from the consequence of negligent conduct absent an express agreement to that effect. I find that proposition to fly in the face of common sense and the public policy of holding one responsible for the consequences of one's own negligence."[9]

Finally, thirteen states, including Virginia, Maryland and North Carolina, apply Friedman's so-called "middle approach," looking to the reasonable expectations of the parties as shown by their intent in the lease and the facts and surrounding circumstances. The Supreme Court of Virginia embraced this approach when it decided *Monterey Corporation v. Hart*, 216 Va. 843, 224 S.E.2d 142 (1976). In *Monterey*, Roanoke's Patrick Henry Hotel suffered $50,000 of damage in a fire negligently caused by Margaret Hart Barnes (since deceased), who, with her husband, had been renting an apartment in the hotel. The printed form lease provided by the landlord (and hence to be construed against it) made several references to the consequences of fire, including (1) excluding "damages by accidental fire" from tenants' obligation to surrender the premises in the condition leased to them, (2) the tenants' rent abatement during restoration or, if more than thirty days were required to restore the premises, the tenants' right to terminate the lease, all without imposing any obligation on the tenants to perform the restoration, and (3) obliging the tenants to not take any action that would cause landlord's fire insurance premiums to be increased.[10] At the end of a thoughtful review of the case law on both sides, the Supreme Court of Virginia cited *Rock Springs Realty, Inc. v. Waid*, 392 S.W.2d 270, 277-78 (Mo. 1965):

> Where it is clear that the parties contemplate insurance to be paid for by the lessor it is logical to conclude that they intend the lessee to pay for the insurance through rent payment. It would be an undue hardship to require a tenant to insure against his own negligence where he is paying for the fire insurance which covers the premises in favor of the lessor. The lessee should not be treated as a negligent third party subject to subrogation rights, but should have the benefit of the insurance policy. Such a policy [which] contemplates a potentially negligent occupant and a right of subrogation would be a windfall to the insurer.[11]

After considering the totality of the facts and circumstances in ascertaining the intent of the parties in entering into the lease, the *Monterey* Court then concluded:

> It is unreasonable to believe that the average layman contracting as a lessee of an apartment in a large multi-million dollar hotel would understand that a lease similar to the one signed by appellee's decedent would exempt him only for loss by fire not caused by his negligence. Logically, the lease agreement here should be interpreted to mean that appellee's decedent was exempted from liability for all fires normally insured against by the usual fire insurance policy.
>
> It is our conclusion that the effect of the provisions of the lease was to absolve a tenant of any liability for damage to the building caused by a fire other than one attributable to the tenant's intentional and unlawful act.[12]

Recently, U.S. District Court Judge Conrad succinctly summarized Virginia's adoption of this

"middle way" in *Cincinnati Insurance Company v. Tienda La Mexicana, Inc.*, 2009 WL 4363450 (W.D. Va. 2009), where he characterized the holding in *Monterey* as follows:

> Instead of establishing the implied co-insured doctrine as it is applied in other jurisdictions, the Court in *Monterey* held that, under Virginia law, an express provision in a lease freeing a tenant from his common law liability for fire loss due to his own negligence will control. In the absence of an express provision relieving a tenant of liability, a court must look at the lease as a whole to determine the intent and reasonable expectations of the parties.[13]

Judge Conrad proceeded to refer to the tenant's raising two lease provisions which other jurisdictions have found sufficient to imply the waiver of subrogation: "first, that the 'Landlord shall adequately insure the building and all public or common areas for fire' and second, that 'if said buildings [destroyed by fire] can with reasonable diligence be repaired within 60 days, said buildings shall be, *by Landlord*, repaired'" (*emphasis in original*). Instead, the court described the import of the two lease terms as "ambiguous at best," and ascribed much greater weight to the more explicit lease clause on insurance, which provided that "Tenant will be responsible for any damages to the premises by the following but not limited to: himself, customers, and/or delivery personnel." The court concluded that such language reaffirmed the original common law rule of tenant liability, and refused to relieve the tenant of responsibility to repair the fire damage under any theory of an implied co-insured or other basis for an implied waiver of subrogation.[14]

A similar conclusion had been reached three years earlier by the U.S. Fourth Circuit Court of Appeals in *Allstate Insurance Company v. Fritz*, 452 F.3d 316 (2006), which dealt with an apartment building fire negligently caused by the guest of two James Madison University student tenants. Where the lease expressly made the tenants liable for all costs of repairs resulting from the negligent actions or omissions of tenant or tenant's guests, the Court (reversing the District Court's opinion, which supported a waiver of subrogation) acknowledged the rule in *Monterey*, but pointedly noted that in this case, the lease clearly stated the parties' intent to place the liability on the tenants, and refused to disregard what it considered to be an unambiguous agreement by the landlord and tenants.[15] Thus, the message is clear that while Virginia courts are willing to imply a co-insured status and waive the right of subrogation, they will not ignore the express intention or reasonable expectations of the parties in order to do so.

SAMPLE LEASE PROVISIONS

So, where does this leave the beleaguered real estate lawyer, faced with having to draft property insurance, mutual waiver and waiver of subrogation lease clauses which will both efficiently allocate risks and responsibilities and also be upheld in court? First, the lease should embrace the concepts of the "three-legged stool" with which this article opened. Second, all the other lease clauses which might give rise to inconsistent results should be carefully reviewed to make certain they are not at odds with the core terms of the "three-legged stool." While supplying samples of all of the relevant lease clauses rendered consistent with these three concepts goes beyond the scope of this article, I am pleased to conclude with sample commercial real estate lease clauses for achieving the desired consistency among the lease clauses for property insurance, mutual waiver and mutual waiver of subrogation. Found in Appendix A, these sample clauses are not

intended to be heavily slanted to either the landlord's or the tenant's benefit, but they do assume the existence elsewhere in the lease of the typical lease clause that any leasehold improvements and fixtures installed by the tenant immediately become affixed to the fee and hence, the property of the landlord. As noted above, I believe it will promote the drafter's ability to resist the introduction on inconsistent modifications to these three provisions if they are presented as integrated clauses, all in a single section of the lease, as shown in Appendix A. Drafters, of course, will need to modify these sample clauses appropriately for use in a residential lease or a lease of space in a multi-tenant commercial building.

APPENDIX A

SAMPLE LEASE CLAUSES FOR PROPERTY INSURANCE, MUTUAL WAIVER AND MUTUAL WAIVER OF SUBROGATION

SECTION 10. PROPERTY INSURANCE; MUTUAL WAIVER; WAIVER OF SUBROGATION.

a. Landlord shall obtain and keep in force during the term of this lease a policy or policies of insurance covering loss or damage to the premises (but excluding items listed in Section 10.b, below), providing protection against all perils included in a Causes of Loss - Special Form policy (or its successor form), in the amount of their full replacement cost (i.e., the cost to replace without deduction for depreciation). Tenant shall pay during the term hereof, in addition to rent, the amount of the premiums for the insurance required under this subsection within thirty (30) days after receipt of a bill therefor from Landlord.

b. Tenant shall obtain and keep in force during the term of this lease a policy or policies of insurance covering loss or damage to Tenant's own property, inventory, trade fixtures and furniture, and personal property of others, providing protection against all perils included in a Causes of Loss - Special Form policy (or its successor form) in the amount of their full replacement cost (i.e., the cost to replace without deduction for depreciation). Landlord is not responsible for Tenant's property, inventory, trade fixtures and furniture, and personal property of others within the Tenant's care, custody or control.

c. Notwithstanding any other provision of this Lease to the contrary, neither party to this lease or its officers, directors, partners, members, managers, employees, agents, concessionaires, licensees and invitees shall be liable to the other for loss or damage caused by any risk covered by insurance required to be carried under this lease, and each party to this lease hereby waives any rights of recovery against the other and its officers, directors, partners, members, managers, employees, agents, concessionaires, licensees and invitees for injury or loss on account of such covered risks.

d. All policies of property insurance required to be carried by either party under this Section 10 shall include a clause or endorsement whereby such party's insurer waives all right of subrogation, and all rights based upon an assignment from its insured, against the other

party, its officers, directors, partners, members, managers, employees, agents, concessionaires, licensees and invitees, and in the case of Tenant, its subtenants and their officers, directors, partners, members, managers, employees, agents, concessionaires, licensees and invitees, in connection with any loss or damage thereby insured against; provided that the foregoing reference shall not be deemed a consent by Landlord to any sublease of the premises. If any policy of insurance requires the agreement of a party's insurer as a condition to the effectiveness of this mutual waiver of subrogation, such party agrees to make a commercially reasonable effort to obtain such agreement.

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[1] Myles Hannan, *Using Property Insurance, Mutual Waiver, and Waiver of Subrogation Clauses in Commercial Leases (with Model Clauses)*, THE PRACTICAL REAL ESTATE LAWYER, Mar. 2001, at 23.

[2] *Id.* at 24.

[3] Tenant's counsel will no doubt dispute that landlords ever do anything truly at their own expense; they just use the tenant's rent to pay for it. This, in fact, has given rise in some states to a theory of implied waiver of subrogation, the leading case for which is *Sutton v. Jondahl*, 532 P.2d 478 (Okla. Ct. App. 1975), where the court relied, inter alia, on the fact that the tenant pays for the landlord's insurance premium as part of the tenant's rent. Please take note that theories of implied waiver of subrogation are not accepted in all states. See the discussion, *infra*, of implied waiver of subrogation for more on this line of cases.

[4] Self-insurance, incidentally, does not change the analysis, although opposing counsel may wish to set out minimum self-insurance requirements in the lease, or at least require periodic reporting by the self-insured party as to (1) the reserves it has set aside for its self-insurance plan and (2) what claims have been made by others against those reserves, to assure the other party that the self-insurance remains sufficient to cover its responsibilities with respect to a loss or damage.

[5] If the subtenant is included in the tenant's waiver of subrogation, landlord's counsel should consider including a disclaimer, clarifying that the reference to "subtenant" does not mean the landlord is consenting to any subleases.

[6] 1 MILTON R. FRIEDMAN, FRIEDMAN ON LEASES ? 9:11, at 9-91 to 9-112 (5th ed. 2010). The author leans heavily on, and refers the reader seeking greater detail to, FRIEDMAN ON LEASES, the gold standard among authorities on commercial leasing law, for this discussion of implied waiver of subrogation.

[7] *Sutton v. Jondahl*, 532 P.2d 478 (Okla. Ct. App. 1975).

[8] FRIEDMAN ON LEASES, *supra* note 6, ? 9:11.2, at 9-102.

[9] *Zoppi v. Traurig*, 251 N.J. SUPER. 283, 288, 598 A.2d 19, 21 (1990).

[10] *Monterey Corp. v. Hart*, 216 Va. 843, 845-46, 224 S.E.2d 142, 144 (1976).

[11] *Id.* at 849-50, 224 S.E.2d at 146-47.

[12] *Id.* at 851, 224 S.E.2d at 147.

[13] *Cincinnati Insurance Co. v. Tienda La Mexicana, Inc*., 2009 WL 4363450, at *3 (W.D. Va. 2009).

[14] *Id.* at *4.

[15] *Allstate Insurance Co. v. Fritz*, 452 F.3d 316, 322-23 (2006).

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