

Pass Through Your Building's Insurance Deductibles – But Set Limits

■ Issue to Negotiate

Every insurance policy you buy for your building – such as boiler and machinery insurance or liability insurance- is likely to have a deductible. When damage covered by the policy occurs, can you pass through the amount of the deductible to your tenants as an operating expense?

■ Tenant's View

A savvy tenant will want you to exclude your insurance deductibles from its operating expense pass-through if the item being replaced or repaired is a capital improvement. The tenant will argue that capital improvements aren't properly included in operating expenses, so the deductible amount shouldn't be included either. Also, a tenant may argue that letting you pass through the insurance deductible removes your incentive to buy insurance with a low deductible. You'll instead pick the insurance package with a high deductible and low premiums.

That high-deductible, low-premium strategy helps you keep the average monthly operating expense number low and make your building or center look more attractive. But if the insurance policy is ever triggered – say, by a fire – the tenant will be left footing the bill. If a tenant must suddenly pay its share of a very high deductible that's passed through, it might suffer severe financial damage.

■ Compromise: Agree to Cap with Ability to Pass Through Excess in Later Years

There's a way you can ease a tenant's fear of being unexpectedly hit with a big expense,

while you get the right to pass through the deductible to that and your other tenants, says Santa Monica, Calif., attorney Susan Fowler McNally. Agree to limit the amount of the insurance deductible that you can pass through in a year, but make the tenant pay the portion of the deductible that exceeds the limit in later years. This way, you're not responsible for eating the excess, and the tenant can pay the excess over time rather than all at once.

Specifically, the compromise requires that:

- You can carry insurance coverage for all-risk, structural, fire, boiler and machinery, liability, earthquake (where necessary), terrorism (where necessary), and replacing tenant improvements (at a set amount per usable square foot);
- Your insurance coverage and deductibles don't differ greatly from insurance coverage and deductibles of owners of comparable first-class buildings in the area;
- Insurance deductibles passed-through don't exceed a set dollar amount (or "cap") in any calendar year;
- You amortize, over the "useful life" (which you'll determine) of the improvements that are being repaired or replaced with the insurance proceeds, the portion of the deductible that exceeds the cap; and
- Tenant's payments of the amortized cost of the excess portion include interest (based on a rate similar to those used by owners of comparable first-class buildings in the area).

Example: You buy boiler and machinery insurance with a deductible of \$750 for your building. But you and the tenant agree to cap the amount of the deductible that can be passed through in any calendar year at \$500. When a fire destroys your building's boiler, you file an insurance claim for a new boiler (a capital improvement). You pay the \$750 deductible, but you can pass through only \$500 in that year. If you determine that the new boiler has a useful life of 15 years and that owners of comparable buildings charge 8 percent interest, you'll amortize the \$250 excess over 15 years at 8 percent so that over the next 15 years, the tenant will pay \$18 per year $([250 \div 15] + [(250 \div 15) \times .08])$.

PRACTICAL POINTER: Requiring your insurance coverage, deductibles, and interest rate to be similar to those that owners of comparable first-class buildings in the area get gives the tenant some assurance that your insurance costs, deductibles, and interest charges won't be out of the ordinary, explains McNally.

■ Add Language to Lease

To set up this compromise, add the following language to your lease's insurance clause:

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Model Lease Language

- a. Landlord shall carry insurance coverage for all-risk, structural, fire, boiler and machinery, liability, earthquake, terrorism, and for replacement of tenant improvements (to a maximum of \$[insert dollar amount, e.g., \$35.00] per usable square foot); provided, however, that such coverage and the deductibles corresponding thereto shall not materially differ from those elected by landlords of comparable first-class office buildings in the vicinity of the Building.
- b. In no event shall Landlord pass through to Tenant as an Operating Expense any insurance deductibles

in excess of \$[insert dollar amount, e.g., \$250,000] in any calendar year; provided, however, that the portion of the subject deductibles in excess of \$[insert dollar amount, e.g., \$250,000] (if any) for any single calendar year shall be amortized over the useful life (as reasonable determined by Landlord) of the improvements being repaired or replaced with the proceeds of Landlord's insurance coverage, together with a commercially reasonable interest factor, consistent with that used by other landlords of comparable first-class buildings in the vicinity of the Building in making such calculations.

PRACTICAL POINTER: If you have a blanket policy covering many different buildings, the tenant will want you to agree that the deductible you're passing through relates solely to the building where its space is located, notes McNally.

Insider Source

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