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Insurance Coverage for Damage to Tenant Improvements

The Critical Interplay Between Lease Language and Insurance Policy Terms

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Multiple factors are often involved in the analysis and determination of ownership interests and insurance obligations for tenant improvements and betterments, furniture, fixtures and equipment, and other "personal property" within leased premises. In the event of a loss—be it property damage or total destruction—landlords, tenants and their respective property insurers must consider both the tenant's and the landlord's obligations under any lease in effect at the time of a loss, and the coverage provided by the landlord's insurance policy and tenant's insurance policy. In the event of conflicting or unclear language in these contracts—which is not an unusual scenario—there is often a dispute as to which party is economically responsible for damaged or destroyed property. Additionally, how the relevant lease terms and insurance policies are interpreted and applied can often vary by jurisdiction. It is therefore vital to identify the contractual duties of the landlord, the tenant(s), and the insurers to avoid losses or payments that exceed one's actual obligations.

The Language in the Lease

The language in a lease—which defines the terms of the relationship between a landlord and tenant—may specify ownership interests with respect to improvements and betterments. This classification in turn could impact consideration of which insurance policy or policies provide coverage for damage to or destruction of such property.

For example, a lease may provide that once affixed to the premises—whether by the landlord or tenant—all improvements and betterments: (1) become the sole property of the landlord; (2) are not the property of the tenant; and (3) cannot be removed or altered by the tenant without the landlord's express consent. Alternatively, a lease may state that furniture, fixtures and equipment are the property of the tenant or that ownership of certain fixtures, improvements and betterments varies based on whether they were installed by the landlord or by the tenant, or the precise nature of the item.

In the event of a loss, it can be difficult to determine which items of property were: (1) part of the building's core and shell; (2) part of the improvements and betterments owned by the landlord under the terms of the lease; or (3) part of the property owned by the tenant under the terms of the lease. The language in the lease may also specify whether the landlord is contractually required to bear financial responsibility for the replacement of damaged or destroyed property.

Additionally, the lease may apportion responsibility of insuring the improvements and betterments. A lease may require the tenant to insure all improvements and

betterments and personal property owned by the tenant, that the tenant insure furniture, equipment and other personal property, *or* that the tenant insure only those improvements and betterments or other personal property installed by the tenant. The lease may also specify which property the landlord agrees to insure.

In short, the language in a lease must be closely examined to determine: (1) the ownership interest in a given item of "personal property" within the leased premises; (2) any landlord responsibility to replace damaged or destroyed property within the leased premises; and (3) obligations to insure a given item of property. Ideally, the lease language will address these issues consistently, so that ownership and insuring responsibilities mirror each other. Unfortunately, that is often not the case, thereby further complicating efforts to understand the parties' respective rights and obligations.

The Insurance Policies

In addition to the tenant lease—a contract that defines the rights and responsibilities of the landlord and tenant—another set of contracts comes into play in the event of a loss: the landlord's property insurance policy and the tenant's property insurance policy. There are two ways in which the language of these policies can become problematic. First, the language of these policies regarding property coverage within the leased premises may be inconsistent from one policy to the other. Second, the policy or policies may conflict with the rights and obligations as defined in the lease. Such inconsistencies and ambiguities within and between the various contracts at play can create considerable uncertainty regarding economic responsibility for the damage or destruction of property within leased premises.

In a tenant's insurance policy, the definition of "personal property"—and any specific provisions that relate to coverage for tenant improvements and betterments, furniture, fixtures and equipment—will typically address the scope of coverage for tenant improvements. For example, a tenant's policy may explicitly provide that personal property includes improvements and betterments installed in any premises owned, leased or occupied by the insured. Absent any such explicit provision, however, a general definition of personal property may refer to property owned by or in the possession of the insured.

If a tenant's lease states that all improvements and betterments belong solely to the landlord, the tenant may be unable to demonstrate ownership interest in such property and the insurer may thus determine that the property is therefore not covered. However, the tenant may argue that its possession of the property creates an insurable "use interest" in the property, and therefore, the property is insured despite the lack of an ownership interest. Legal authority in some jurisdictions may support that argument. For example, under New York law, an insurable interest in property typically includes "any lawful and substantial economic interest in the safety or preservation of property from loss, destruction, or pecuniary damage." *Sigola Mfg., Inc. v. Dairyland Ins. Co.*, 124 A.D.2d 654, 654 (N.Y. App. Div. 1986). Where a tenant agreed in its lease to insure the premises, this argument is even stronger under New York law. *See id.*

In a landlord's insurance policy, the definition of "personal property" may also explicitly include tenant improvements and betterments within premises owned by the landlord and leased to others. Alternatively, a landlord's policy may explicitly provide that the only improvements and betterments that are insured are those located within property occupied by the landlord. In the latter case, the insurer may argue that even if a lease between the landlord and the tenant provides that the landlord owns the improvements and betterments, those items are not covered property because such property is located in premises not occupied by the insured landlord.

It is absolutely essential to understand how each policy defines "personal property" and whether such definitions conflict in order to determine whether an insurer bears financial responsibility for replacing or repairing damaged property (or for the actual cash value of such property). This analysis can become more complex when one or more policies at issue contain an "Other Insurance" provision that makes coverage contingent on the availability of other insurance—an issue discussed below.

The Interplay Between Multiple Insurance Policies

Property policies commonly contain an "other insurance" provision. The language of such provisions tends to vary, but they typically require that in the event of a loss, any other applicable insurance policy must respond first. Theoretically, a policy containing such a clause would only respond to the extent that the "other insurance" was insufficient to cover the entire loss. Not surprisingly, a landlord's policy and a tenant's policy may both contain "other insurance" provisions. The legal authority in each jurisdiction will have a significant impact on the determination of how these competing "other insurance" clauses should be resolved. For example, in Texas, when the "other insurance" provisions conflict, both the tenant's insurer and the landlord's insurer must share the cost of replacing or repairing the property. *Travelers Lloyds Ins. Co. v. Pacific Employers Ins. Co.*, 602 F.3d 677 (5th Cir. 2010).

Alternatively, both the landlord's policy and the tenant's policy could explicitly provide coverage for certain property within the leased premises. In that instance, the insurers should consider the possibility of sharing the cost of replacing or repairing the property at issue, either because of the competing "other insurance" provisions or simply as a sensible and efficient approach to resolving all claims. Otherwise, there may be multiple recoveries for the same property, with one insurer paying the landlord the full replacement cost for the property and the other insurer paying an actual cash value claim to the tenant for that same property.

To further complicate matters, landlords often provide cash up front at the start of a lease term for the tenant to use to pay for the fit out of the premises. That sum is typically added to the monthly lease amount, spread out over the duration of the lease. As a result, where property is damaged near the end of a lease term, the landlord may have already been repaid for the original cost to install the improvements, and subsequently be paid a second time by the insurer for the cost to replace the

improvements, with of course, the tenant receiving a separate payment from its insurer for that same property.

Parties should be cognizant of any applicable case law related to these issues to determine whether the applicable jurisdiction permits multiple or overlapping recoveries. For example, in New York, there is case law supporting the argument that an insurer's contractual payment obligations to the insured cannot be offset by a recovery provided for by another policy. *Foley v. Mfrs. & Builders' Fire Ins. Co. of N.Y.*, 46 N.E. 318 (N.Y. App. Div. 1897); *Alexandra Rest., Inc. v. N.H. Ins. Co. of Manchester*, 272 A.D. 346 (N.Y. App. Div. 1947).

Conclusion

In the event of a catastrophic loss involving property within leased premises, tenants, landlords, and their respective insurers should carefully review the applicable language in all leases and policies involved, and consider the possibility of conflicting terms. Particularly where disputes arise, the parties should consider any jurisdiction-specific case law that may establish and/or clarify their rights and duties. Ultimately, a comprehensive understanding of the contract language involved and how that language meshes or conflicts—will be essential in determining where each party's obligations begin and end.

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