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"Independent Insurance & Risk Management Consultants"

Landlords, Risk and Insurance—
Buyer Beware

By Albert L. Sica *April 2011*

In a challenging real estate environment, surprises are the last thing you need. Risk management and proper insurance purchasing is critical to help landlords avoid surprises and minimize their risk of loss. Your insurance policies are the final step in determining how you might be affected by an incident and what financial impact the event will have on your building or business. Unfortunately, most people think "I buy insurance, so I must be covered, right?"

If you're like most landlords, this may be how you deal with your insurance.

> *My policies are renewing, my broker tells me he will shop them, he gets a couple of quotes and explains the price, and maybe we discuss the deductible. He states he went to "many insurers" and these were the best (maybe only) quotes.*

In this market, you likely renewed flat (no premium increase) or received a slight (3-5 percent) reduction. Or, you may have some reason to "shop" your broker.

> *You take your policies, white out the premiums and give them to the nice fellow who has been calling you throughout the year. He might come back with a better quote and tell you about a couple of coverages he had "thrown in." You pay a down payment and bind coverage. Somewhere in the process (if you're lucky) there is lunch, dinner or golf.*

The above scenario describes the entire risk management program for many of today's insureds. This is not the process that should take place to cover everything you have worked for and to protect you against any suits brought against you.

What should you do? Buyers beware! Educate yourself. Let's start with the risks you face as a building owner and what you can do about them.

Basic risk	Insurance Applicable
Building is damaged or destroyed	Property insurance — carry replacement cost with agreed value coverage
Rental Income is disrupted by an event	Loss of Rents insurance — annual rent roll
The need to rebuild your location to current building codes after a loss	Add a "Law or Ordinance" extension to your property policy with sufficient limits
Persons are injured on or around your premises	Liability insurance — should include general liability insurance and an umbrella policy
Employee steals money or property	Crime insurance — Employee Dishonesty

Many times a business owner can purchase multiple coverages in a "package" policy. A typical package policy includes Property, Business Income, General Liability, perhaps Crime and Auto coverage. Depending on the size of the business, these policies may be referred to as a BOP (Business Owners Policy).

In the real estate industry, it is common to have a separate legal entity for each location. Brokers often tell their insureds they need a policy for each location, but that is simply not true. There is no "ownership" requirement, so two different locations with different legal entities with similar exposures (both rental buildings) can share one policy that notes both locations. There are pros and cons to covering multiple locations on one policy. Most disadvantages can be overcome to allow you to take advantage of administrative and financial efficiency.

<u>Property insurance</u> covers your building and personal property. Most property losses stem from common "perils"— fire, storm damage, vandalism, ice, wind, etc.

Property coverage should be written on an "all risk" basis, providing "replacement cost" coverage without deduction for depreciation. If there is a coinsurance percentage noted in the policy, ask your broker for "agreed value" coverage to suspend the coinsurance language (and any potential penalty). On older buildings it is important to obtain an endorsement for "demolition or increased cost of construction due to law or ordinance." This added coverage pays for the cost to install sprinklers, ADA compliance features or other building cost upgrades that you must incur to comply with current building codes. Without this extension, there may not be any meaningful coverage for these added costs, leaving you to bear the costs out of pocket.

<u>Flood and water damage insurance</u> is a frequently overlooked property coverage. Flood risks are typically excluded under an "all-risk" property policy, yet many landlords are unaware of this important limitation. Coverage for water damage, including back-up of sewers or drains, is typically included but subject to a low sub-limit ($25,000). This sub-limit is inadequate for most building owners and can usually be increased for a very modest additional premium (sometimes at no extra charge!). Your broker or agent can help you determine your Flood Zone. If you need federal Flood coverage, your broker or agent can assist you in applying to the National Flood Insurance Program. Note that coverage is very limited under the plan. You can only buy $500,000 in commercial property limits ($250,000 for residential) and coverage is provided on an actual cash value basis. Replacement cost coverage is not provided.

<u>General Liability and Excess (Umbrella) Liability insurance</u> protects the business owner when some third party (guest, tenant, contractor, etc.) has a loss on the premises and alleges the owner was at fault. This insurance is written with the understanding that "It's covered unless it's excluded," so you should carefully check any attached exclusions or policy conditions. Be careful about endorsements such as "designated premises" or "contractor insurance warranties" as they can be embedded in a contractors policy and take away valuable coverage.

Tenants are frequently the biggest source of general liability claims. Occurrences such as slip and falls, libel or slander by one of your employees against a tenant, or violence alleging the landlord did not provide adequate security plague today's residential landlord.

Choose liability limits carefully. Most commercial policies have a $1M occurrence limit with a $2M aggregate (all claims that occur in one policy year). It is possible to ask for a "per location aggregate" which would give you an aggregate for ***each*** location you cover under the policy. Property owners should have ***at least*** a

$5M Umbrella policy and in most cases much more. There are many real estate insurance programs today that offer limits of $25M or $50M for very competitive rates.

Property owners should consider the following "incidental" coverages.

- Workers' Compensation – Be cautious about the payroll amounts you declare. Report overtime as straight time and ensure the classification codes assigned by insurers are correct. There is room for error without your verification. Rates vary greatly by class code. If your workers are misclassified, you may be overpaying for workers' compensation coverage. Also, ask about your Experience Modification Factor. In New Jersey, we have an intrastate modification and anything over 1.0 indicates your claims history is above average compared to your peers. This will result in a surcharge on your policy.
- Automobile Coverage – You may have autos you cover under the business, but every business owner has an exposure for "hired and non-owned" automobile coverage. That's when your clerk goes to the bank for you, runs over someone and you get named in the suit. After all, if she wasn't going to the bank ***for you***, the accident wouldn't have happened. Automobile Liability including non-owned and hired coverage should be scheduled under your Umbrella. This provides you with higher limits than the typical $1M found under a standard commercial auto policy.
- Crime Coverage - This is another of those often-overlooked coverages for one main reason: "It can't happen to me." One third of all corporate bankruptcies are directly caused by employee theft. Seventy-five percent of all employees steal from work and most do repeatedly, according to the US Chamber of Commerce. Crime is often excluded from other policies. Buy a crime policy with sufficient limits ($250K minimum for Employee Dishonesty), because crime losses often occur over many years. Once a theft loss is discovered, business owners often learn it has been occurring over the last 10 or more years.

There are several other coverages you can purchase to cover risks that occur to property owners. Employment and tenant discrimination risks are high on the list, as are other "employment practices liability (EPL)" risks such as wrongful termination and sexual harassment. Often an EPL insurance policy can be purchased with a "third party coverage" extension that includes tenant discrimination. Many times EPL coverage is relatively inexpensive. If written properly, EPL coverage can provide valuable protection for a business owner.

Be careful how you handle and protect personal information. Real estate owners are not subject to "Red Flag Rules" designed to help prevent identity theft. However, the way your company handles and secures a tenant's or prospective tenant's personal information could mean a significant monetary award if that information is misused by an employee of your firm.

Now that you have assembled a solid insurance program, work hard ***not*** to use it. After all, if you do file claims, the insurer will want more in premiums or, worse, may nonrenew your coverage. There are several easy ways to protect your organization from claims. One of the most effective methods is to require all repairmen and contractors who work on your property to hold you harmless and indemnify you, and furnish you with proper certificates of insurance. Anyone who completes work for you should demonstrate adequate liability coverage and workers' compensation insurance and name your company as additional insured on their liability policies. Generally, $1M of general liability insurance coverage is the minimum you should require. Depending on the scope and size of the job, the contractor should provide evidence of higher limits. Higher risk work, such as structural, demolition, scaffolding, roofing and elevator work, should require limits of $2M – $10M.

While considering your exposures, don't overlook the problems you may face with your tenants. Claims from dog bites can be severe, especially when children are involved. Frequently incidents occur between two tenants, but in the absence of "deep pockets," the Landlord/Owner becomes the target. One of the most effective risk management techniques is avoidance; consider that with pets. Many landlords restrict certain "dangerous" dog breeds, since many insurance companies subscribe to this approach in tenant and homeowner policies.

As part of your risk management program, include a clause in your rental agreement requiring all tenants to provide proof of renters' insurance coverage prior to them occupying the premises. Most renters' insurance policies provide coverage against fire and personal property theft, and personal liability coverage for injuries and damages caused by tenant neglect. This will help "insulate" your coverage and prevent paying claims that are covered by a renter's policy.

Finally, be cautious about where you buy your insurance. Those who sell insurance are either "agents" or "brokers." It is important that you understand the difference. The insurance industry appoints "agents" who function on behalf of the insurance company and have "agency." When you pay the agent it is like paying the company. When you get a proposal or binder from the agent it's like getting the proposal or binder from the company. On the other hand, in most cases brokers have no "agency" and therefore they do not speak for or act on behalf of the company.

We suggest verifying that any documents (proposals, binders, etc.) are accompanied by the insurer's actual quote. When possible, pay your Insurers directly. Insist that your broker/agent disclose their relationship with the insurer. You can always call the carrier and verify they have the same view of that relationship. Your contract is with the company; they are pledging their capital to protect you. Get to know them; meet their representatives. You are, after all, partners. It is much harder to non-renew a business that is a recognized and valued account.

Taking the time to understand your risks and how you might transfer those risks (to an insurer or to others through agreements) is an important process for business owners to understand. Don't avoid it. Learn about it, ask questions and make sure the answers make sense to you and that you agree with what is written in your policy. If they don't make sense, ask again. Make sure your insurance representative has a thorough understanding of your business and your risk exposures.

About The ALS Group

Albert L. Sica is the managing principal of The ALS Group, an independent insurance and risk management advisory firm located in Edison, NJ. The ALS Group has provided fee based advice to Real Estate and Developers for over 15 years. We do not sell insurance or offer any brokerage services. Visit www.als-uic.com or e-mail Al at asica@als-uic.com, or call (732)395-4251 for more information.