Tenants Works and Building Insurance

Background

Generally where a building has multiple tenants the building will be insured by the landlord. Often a tenant will, when negotiating the covenants concerning insurance of the building in a lease, seek a waiver of subrogation rights unless the insurance is in the joint[1] names of the landlord and the tenant.

It is a general principle that if an insurer pays out under a policy it can step into the shoes of the insured (in this case the landlord) in relation to any claim the insured may have against a third party. Where premises are destroyed or damaged by an act or omission of the tenant in circumstances where the landlord would have a claim against the tenant then the insurer can bring a claim against the tenant in the name of the landlord. A waiver of the insurer's rights of subrogation confirms that the insurance company will not pursue a tenant where the tenant caused damage which led to the landlord's claim under the insurance policy, and so agreeing such a provision is important as far as the tenant is concerned.

The Issue

When fitting out premises a tenant needs to consider not only risks/insurance in respect of the fitting out works themselves (such works insurance is beyond the scope of this Note) but also the risks/insurance of the building.

Historically a tenant would normally approach the landlord at an early stage to add the contractor (and the tenant) as a joint insured to the insurance policy for the building or at the very least obtain a waiver of the insurer's subrogation rights in respect of the contractor (and the tenant) for any damage done to the existing structure of the building due to the tenant's works. Landlords would generally make such addition or procure such a waiver without any objection. In some cases policies would contain an option for the landlord to obtain waiver of subrogation rights on request at no extra cost. If an additional premium were payable this would normally be passed on to the tenant by landlord. If the insurance premium subsequently increased as a result of a claim under the policy due to damage caused by the tenant's works, again the cost would be passed on to the tenant.

In more recent years the practice has grown up whereby most landlords/developers refuse to add the tenant and contractor (or just the contractor) to the insurance policy for the building or to procure a waiver of subrogation rights against the tenant and contractor (or just the contractor) (usually as a result of wishing to maintain their risk position/protecting their investment, or as a result of advice from insurers).

When a tenant is negotiating a new lease this potential issue can be hammered out at an early stage. The tenant will be able to decide the most appropriate course of action depending on whether or not the landlord is willing to add the tenant and its contractor to the insurance policy for the building or to obtain a waiver of subrogation rights. However the problem is exacerbated where the tenant is already in occupation of its premises under the terms of an agreed lease which does not address this issue, and subsequently wants to engage a contractor to carry out works to the premises which requires a licence for alterations. In this case if the landlord refuses to add the contractor to the insurance policy for the building or to procure a waiver of subrogation rights for the contractor then this gives rise to a couple of issues which a tenant will need to consider when deciding how to deal with the risks that arise. As insurers are now advising tenants that they are unlikely to get the benefit of the landlord's policy for their contractors (and so should not agree construction contracts on this basis) these issues will need to be considered at an early stage.

It should also be remembered that in their licences and leases landlords can request wide-ranging indemnities for damage to property from their tenants. These will also need to be

[1] Generally this Note refers to "joint" insurance, as shorthand. Typically, the relevant policy would be issued on a "composite" or "co-insurance" basis, where the interests of each insured are separate and distinct and the rights of one insured will not be affected by any action/inaction of another.

factored into the tenant's thinking, as if these indemnities are conceded they can cause a concern both the contractors (to whom the tenant may seek to pass these indemnities on) and the parties' insurers.

First, the tenant will need to consider whether under its building contract with its contractor the building is treated in the same way as any other third party property[2].

That is not the case under the standard JCT suite of contracts (JCT being the standard form of contract generally used in the UK for this sort of project). Generally under a JCT contract the risk of loss or damage to the building caused by "Specified Perils" (primarily fire and flood) is subject to a separate risk and insurance regime. Under standard position in the majority of JCT contracts the risk of damage to existing structures by Specified Perils is to be insured by the Employer (tenant) in the joint names of the Employer and the Contractor.

Even if the building is treated the same way as other third party property, the tenant's contract with its contractor will generally only impose liability for damage to third party property where such damage has been caused by the negligence of the contractor or of those for whom the contractor is responsible. In that event the tenant will need to consider the extent of its own liability for non-negligently caused damage. If the tenant may have some liability (because eg it is not a joint insured under the landlord's policy, or there is no waiver of subrogation rights against it, in respect of this risk) then it will need to consider how to protect itself against that risk. Absent appropriate protection, a tenant faced with a large claim may become insolvent as a result.

Second, if the building is treated in the same way as any other third party property the contractor will (as noted above) generally take the risk of and need to obtain sufficient cover for the cost of reinstatement of the whole building should the building be destroyed by, for example, negligently caused fire or flood damage. The contractor will need to take care in this respect: typically a public liability policy will exclude from the definition of third party property any property within the contractor's custody or control, so if the contractor has assumed this risk it will need to make sure this exclusion does not apply to the building.

That issue aside, the cost of the premium for this cover may be disproportionate when compared to the value of the works being carried out. The amount of public liability cover a contractor will carry varies wildly depending on its size – it can range from £5m - £10m for small independent contractors to £100m+ for large national contractors. The contractor may find itself carrying out works valued at £500,000 to a floor of a building with a reinstatement value of hundreds of millions. The cost of additional public liability cover to this reinstatement value could be at least £100,000. This cost is clearly disproportionate to the value of the works. In these circumstances a contractor will no doubt look to the tenant to cover the cost of this additional cover. Depending on the tenant's negotiating position it may seek to pass the cost onto the landlord.

In these circumstances a contractor who goes ahead and carries out the works without obtaining adequate third party cover is at risk of insolvency in the face of a major claim against it.

Whilst this Note focusses on the position of the tenant and its contractor, the issues of how far any joint insurance or waiver of subrogation rights extends to sub-contractors and suppliers of all tiers will also need to be addressed when considering possible solutions.

Finding a solution

There is a range of possibilities for dealing with this issue. However it is important that parties are aware that there is an issue in the first place and that it is considered and addressed at an early stage.

[2] i.e. property other than the Works. Such property is generally expected to be covered (against negligent caused damage at least) by the Contractor's third party liability policy

The options are:

(a) The tenant obtains the agreement of the landlord to add the tenant and the contractor to the insurance policy for the building and pays the cost of any additional premium. This would need to be covered in the agreement for lease/licence for alterations; generally at most it would only require a minor amendment to the relevant insurance provisions in a JCT contract. However, as noted above, this option is now rarely available.

(b) The tenant obtains a waiver of the landlord's insurers' rights of subrogation against the tenant and its contractor and pays the cost of any additional premium. Again, modest amendments to the relevant insurance provisions in a JCT contract would be required. Similarly, however, this option is rarely available.

(c) Absent (a) or (b) above, the tenant's aim will be to ensure that its risks and liabilities in respect of damage to the building are mirrored by the contractor's risks and liabilities under the building contract. This could be achieved by ensuring that its risks and liabilities are limited to the risk of negligently caused damage; if that is accepted the insurance provisions in the building contract could be amended to rely solely on the contractor's indemnity for negligently caused damage to property. Alternatively, if the tenant's risks and liabilities extend to non-negligently caused damage as well as negligently caused damage, it could seek to pass this risk on to the contractor and ask the contractor to arrange for its own public liability insurance to be extended to provide cover for both negligent and non-negligent damage to the building caused by the carrying out of the tenant's works. It can be difficult for a contractor to arrange such an extension. If it is the agreed solution, however, the building contract would need to be amended to reflect this and the issue of who should bear the cost of any extension required to the contractor's policy to effect this cover would also need to be agreed.

(d) A "layered" approach is adopted whereby:-

i. The risk of damage to the building is borne by the contractor up to a certain level (usually commensurate with the level of public liability cover the contractor holds) and the contractor ensures its public liability cover extends to this risk;

ii. Sometimes, the next layer of risk (i.e. above that borne by the contractor but below the level at which the landlord's policy kicks in) is borne by the tenant who will then ensure its public liability cover extends to this risk;

iii. Above that level the landlord agrees to cover the risk (either under the existing policy or under a separate policy) to provide indemnity to the tenant and the contractor.

Again, the issue of who should bear the cost of any extensions required to the relevant policies to effect this cover would also need to be agreed.

As noted above, options (a) and (b) can be reflected in a JCT building contract by adopting the traditional JCT approach with minimal amendments. However, the traditional JCT approach does not work for options (c) and (d). Options (c) and (d) can be catered for within the JCT 2016 suite of contracts by adopting the "C.1 Replacement Schedule". The "C.1 Replacement Schedule" is a new option within JCT Insurance Option C in the JCT 2016 suite of contracts. If selected, it enables the parties to address the question of risk of and insurance of damage caused to the existing building by Specified Perils in a bespoke schedule. If option (c) or (d) is selected, therefore, that could be included in a bespoke schedule (covering both allocation of risk and what insurance is to be taken out by whom) which would then be included within the building contract as a "C.1 Replacement Schedule". That said, it will still be important to take specialist advice to ensure that the Schedule is completed correctly and incorporated into the contract properly – and to ensure that there are no further amendments required in light of the particular insurance arrangements being put in place for the project in question.

As noted above, this issue needs to be addressed and solved to all parties' satisfaction as early

as possible. Agents need to be aware of this issue when drafting heads of terms. Lawyers acting for tenants need to negotiate and include appropriate drafting not only in agreements for lease and leases but also in any licences for alterations. Tenants and their Project Managers and Contractors (and their lawyers) need to be aware of the issues and ensure they are discussed and addressed at an early stage in the negotiation of the building contract and that the provisions of the standard form building contract being used are completed and amended as necessary to reflect the allocation of risk agreed.