

ALLOCATING EXTRAORDINARY RISK IN LEASES:

Indemnity/Insurance/Releases and Exculpations/Condemnation
(Including a Review of the Risk Management Provisions of the
Texas Real Estate Forms Manual's Office Lease)

Presented by:

WILLIAM H. LOCKE, JR.
Graves, Dougherty, Hearon & Moody
blocke@gdhm.com

401 Congress Avenue
Suite 2200
Austin, Texas 78701-3587
512-480-5736

State Bar of Texas
27th ANNUAL ADVANCED REAL ESTATE LAW COURSE
June, 2006

San Antonio, Texas

CHAPTER 45

BIOGRAPHICAL INFORMATION

William H. Locke, Jr.

Graves, Dougherty, Hearon & Moody,
A Professional Corporation
401 Congress Ave., Suite 2200
Austin, Texas 78701
512/480-5736
FAX: 512/478-1976
blocke@gdhm.com

EDUCATION:

B.A., The University of Texas
J.D. with Honors, The University of Texas

PROFESSIONAL ACTIVITIES:

Board Certified in Real Estate Law: Commercial, Residential and Farm and Ranch
Life Fellow, Texas Bar Foundation
Fellow of College of Law of State Bar of Texas (20+ Year Maintaining Member)
Past Director, Texas College of Real Estate Attorneys
Past President, Corpus Christi Bar Association
Past Chairman, Zoning and Planning Commission of City of Corpus Christi

LAW RELATED PUBLICATIONS AND HONORS:

Co-author of State Bar of Texas publication Texas Foreclosure Manual 2nd Ed. 2006.
Author, State Bar of Texas, Advanced Real Estate Law Course on "*Ins and Outs of Deed of Trust Foreclosures - Practical Tips for the Practitioner*" (2005).
Author, State Bar of Texas, Advanced Real Estate Law Course on "*Field Guide for Due Diligence on Income Producing Properties*" (2000) and "*Papering The Deal: From Land Acquisition to Development*" (2004).
Author, State Bar of Texas, Advanced Real Estate Drafting Course on "*Documentation for the To-Be-Built Office Condominium*" (2005).
Author, State Bar of Texas, Annual Advanced Real Estate Drafting Course and the Annual Advanced Real Estate Law Course on "*Risk Management*"; "*Shifting of Extraordinary Risk: Contractual Provisions for Indemnity, Additional Insureds, Waiver of Subrogation and Exculpation*"
Author, AIA Summer School on "*Risk Allocation in the AIA General Conditions - An Examination of the AIA A201 in Light of Texas Law*" (2005).
Author, Texas Society of CPAs on "*Real Estate Law for CPAs*" (2005).
Author, Advanced Real Estate Law Course: Leases In-Depth of Southern Methodist University on "*Civil Forfeiture Actions*;" and at the Annual Mortgage Lending Institute on "*Seizure of Lender's Collateral Under Drug Enforcement Laws.*"
The Best Lawyers in America (Real Estate) (2000 - 2006).
Who's Who in America (1995 - 2006) and Who's Who in American Law (1985 - 2006).
Texas Monthly, Super Lawyer - Real Estate (2001-2006).

ACCOMPLISHMENTS: Established the Palmer Drug Abuse Program in Corpus Christi in 1979 and in Austin in 2000 as programs helping teens and young adults recover from alcohol and drug abuse; Conceived of and participated in obtaining designations of the Corpus Christi Aquarium as the Official Aquarium of the State of Texas and the Mexic-Arte Museum of Austin, Texas as the Official Mexican and Mexican American Fine Art Museum of Texas; and conceiving and participating in the implementation as chairman of the Corpus Christi Zoning and Planning Commission of the neighborhood zoning plan process for the city of Corpus Christi.

Table of Contents

THE BASIC PRINCIPLES		Page
I.	INTRODUCTION	1
II.	INDEMNITY	2
	A. Terminology	2
	B. Requirements for Enforceability	2
	1. Fair Notice	2
	2. Express Negligence.....	2
	3. Overcoming the Worker's Compensation Bar.	3
	4. Comparative Indemnity.....	3
	5. Strict Liability.	3
III.	INSURANCE.....	3
	A. Contractually Assumed Liability Insurance: Coverage for the Protecting Party.....	3
	1. Exception to an Exclusion.	3
	2. Named Insured Not Insured for all Contractually Assumed Liabilities - No Coverage for Indemnified Person's Sole Negligence.	4
	B. Additional Insurance: Coverage for the Protected Party.....	4
	1. Purpose.	4
	2. Automatic Coverage or by Endorsement.....	5
	3. Endorsements: ISO or Manuscripted Forms.	5
	4. Covered Matters.	5
	a. Ongoing Operations.....	5
	b. Completed Operations.....	6
	c. Premises.....	6
	5. Covered Liabilities.	8
	a. Negligence.....	8
	(1) Additional Insured's Vicarious Liability for Named Insured's Negligence.....	8
	(2) Additional Insured's Own Negligence.....	8
	b. Interpretation of Additional Insurance Covenants	8
	(1) Express Negligence Test Not Applicable to	

	Insurance Covenant.....	8
	(2) 2004 Revision to ISO Forms.....	9
	c. Manuscript Additional Insured Endorsement to Limit Coverage to Indemnified Liabilities.....	9
6.	Liability for Failure to List Other Party as Additional Insured.....	9
7.	Caveat.....	10
C.	Protected Party's "Other Insurance".....	10
	1. Generally All Policies Are "Primary" and "Contributory" Unless Amended.....	10
	2. Endorsing Named Insured's Policy to be Primary Not the Solution.....	11
	a. Primary vs. Sole Contributing.....	11
	b. Endorsing the Additional Insured's Policy to Be Excess Coverage.....	11
IV.	RELEASES AND EXCULPATIONS.....	11
V.	CONDEMNATION.....	12
A.	Allocation in the Event Lease is Silent.....	12
	1. Value of Tenant's Interest.....	12
	a. Loss of Tenant's "Leasehold Advantage".....	12
	b. No Award Allocated to Tenant for Its Lost Business or Personal Property.....	12
	c. Moving Expenses Compensable.....	12
	d. Tenant's Improvements and Fixtures Compensable.....	13
	2. Interplay with Other Lease Clauses.....	13
	a. Permitted Use Clauses.....	13
	b. Renewal Clauses.....	13
	3. Effect on Tenant's Obligation to Pay Rent.....	13
	a. Rent Abated on Total Condemnation.....	13
	b. Rent Not Proportionally Abated if a Portion of Leased Premises Taken.....	13
B.	Contractual Apportionment of Award.....	14
	1. Value of Tenant's Use is Less than Highest and Best Use at Time of Taking.....	14
	2. Value of Tenant's Improvements Not Fully Amortized at Time of Taking.....	14
C.	Contractual Allocation of Award to Landlord.....	14
	1. "Termination-on-Condemnation" Clauses.....	15
	a. Automatic, Optional and Mixed.....	15
	(1) Automatic termination clauses.....	15
	(2) Optional termination clause.....	15

	(3) Mixed termination clause.....	16
	b. Coupling with a clause for rent abatement or partial rent adjustment or partial rent abatement.....	17
	c. Coupled with a Disclaimer of Claim or Assignment of Claim Clause.....	17
	d. "Ownership of Improvements at End of Lease Term" Clauses.....	18
2.	Types of Allocation Clauses.....	18
	a. Allocation of Set Amount to Tenant or Establishing a Method of Valuation of Tenant's Interest in Tenant's Improvements.....	18
	b. Assign Rights to Improvement Value to Landlord.....	18
	c. Permit Removal of Improvements at End of Lease Term due to Condemnation.....	18
	d. State Landlord Owns Leasehold Improvements at End of Lease Term.....	18
	e. Better to Recognize Tenant's Right to Improvement Value as Opposed to Being Silent.....	18
3.	Protecting Tenant's Lender.....	19
I.	HYPOTHETICAL.....	20
II.	FORMS.....	23
	A1. Texas Real Estate Forms Manual Ch. 11 Leases - Manual's Commentary on Risk Allocations.....	24
	A2. Forms Manual Form 11-3 Office Lease.....	26
	A3. Forms Manual Form 11-35 Tenant Improvements Rider to Lease or Work Letter.....	31
	A4. Forms Manual Form 11-34 Insurance Addendum to Lease.....	32
	A5. Supplement to Insurance Addendum to Lease.....	35, 42
	B. Office Lease - Tenant's Certificates of Liability and Property Insurance.....	46, 49
	C. Office Lease - Landlord's Certificates of Liability and Property Insurance....	53, 55
	D. Tenant's Contractor's Certificates of Liability and Property Insurance.....	59
	E. Endorsement to Tenant's Insurance Policy Making Landlord Additional Insured: CGL Endorsement - CG 20 11 01 96 Additional Insured- Managers or Lessors of Premises.....	67
	F. Endorsement to Landlord's Insurance Making Tenant Additional Insured: CGL Endorsement - CG 20 26 07 04 Additional Insured-Designated Person or Organization.....	73
	G. Endorsement to Contractor's Insurance Policy Making Tenant and Landlord Additional Insureds: CGL Endorsement - CG 20 10 07 04	

Additional Insured – Owners, Lessees or Contractors – Scheduled
Person or Organization..... 77

H. CGL Waiver of Subrogation Endorsement - CG 24 04 10 92
Waiver of Transfer of Rights or Recovery Against Others To Us..... 79

I. Endorsement to Tenant’s Business Auto Policy Making Landlord
Additional Insured: TE 99 01B (BAP Texas) Additional Insured 80

J. Endorsement to Tenant’s Business Auto Policy Waiving Insurer’s
Subrogation Rights As to Claims Against Landlord: TE 20 46A (BAP
Texas) Changes In Transfer Of Rights Of Recovery Against Others To Us
(Waiver Of Subrogation) 82

K. Endorsement to Tenant’s Workers Compensation Policy Waiving
Insurer’s Subrogation Rights As to Claims Against Landlord: WC 42 03
04 A Workers Compensation And Employers Liability Insurance Policy..... 84

DETAILED ANALYSES OF THE BASIC PRINCIPLES

FOOTNOTES (Separate Table of Contents) 90

I. INTRODUCTION

Risk allocation provisions are contained in all contracts. They are used in an attempt to assure the intended economic objectives of the “deal.” The most common methods by which risk is shifted in a contract are by the use of representations and warranties, insurance covenants, express assumption of liabilities, indemnity, exculpation, release and limitation of liability provisions.

Every provision of a contract is either restating the rule that would be supplied by the court in the absence of the provision or is expressly shifting a risk from one party to the other.

This Article concerns lease provisions dealing with the shifting of certain “extraordinary” risks from one party to the other including indemnities, exculpations and releases and supporting liability insurance. This Article does not address casualty loss of property or property insurance, which topic is being addressed by an Article at this seminar.

“**Indemnity**”^[2] is, “I agree to be liable for your wrongs.” Indemnity is a shifting of the risk of a loss from a liable person to another. However, many times scrivener use an indemnity provision when they do not know whether the Indemnified Person is a potentially liable person. Sometimes, an indemnity provision is no more than a restatement of existing duties, “I will indemnify you for my wrongs;” “You will indemnify me for your wrongs.”

“**Exculpation**”^[76] is, “I am not liable to you for my wrongs.” An exculpatory provision is designed to exclude, as between the parties to a contract, certain designated duties, liabilities or costs due to the occurrence or non-occurrence of events.

“**Release**”^[76] is, “You are not liable to me for your wrongs.” A release is an agreement in which one party agrees to hold the other without responsibility for damage or other liability arising out of the transaction involved.

Each contracting party’s risk-related goals are (1) to accept no more risk than it can reasonably bear or insure, and (2) to transfer the balance of the risk to the other party. The following factors are involved in the ultimate determination as to how much risk a party receives or transfers: (A) which party is in the best position to control the extent of the occurrence of the risk?; (B) does one party have specialized knowledge of the type of risks most likely to occur and how to prevent or identify them?; (C) custom and practice in the particular industry (for example,

sellers to buyers; landlords to tenants; owners to contractors; contractors to subcontractors); (D) the bargaining strength of the respective parties; and (E) statutory and common law public policies.

This Article examines how liability insurance can be used to protect an indemnifying party through coverage for its contractually assumed liabilities and to protect an indemnified party by being an additional insured on the indemnifying party’s liability insurance. Generally, the indemnifying party is required by the indemnified party to carry commercial general liability (“**CGL**”) insurance naming the indemnified party as an additional insured on the indemnifying party’s CGL policy. In such case, the indemnifying party is the “**named insured**” and the indemnified party is the “**additional insured**.” In this article the indemnifying party and the named insured are sometimes referred to in this article as the “**protecting party**” and the indemnified party and the additional insured are sometimes referred to as the “**protected party**.” Insurance is also a form of indemnity. However, Texas courts on public policy grounds construe the same “arising out of” indemnity triggering language used in both types of indemnity strictly against coverage of an indemnified party’s negligence by a contract and broadly in favor of coverage of an additional insured’s negligence in additional insured endorsements issued pursuant to the same contract.^[26 - 29] Indemnity agreements are strictly construed in favor of the indemnifying party.^[14]

The most common method of risk management is through contractual provisions for insurance. The success of an entity’s approach to contractual risk transfer can be considered successful if it meets the following criteria.

- Risks retained are appropriate and affordable.
- Risk as an element of the overall transaction and negotiation is incorporated at the onset.
- Indemnity, insurance, and other pertinent conditions are not so onerous that contract negotiations drag on unnecessarily delaying the transaction or necessitating the use of second-rate service providers to accomplish the contract’s purpose.
- Contractual conditions allocating risk are not so onerous that a court disallows their operation at a future point in time.

- Insurance requirements are clear, using recognized terms that can be interpreted both at the time the contract is negotiated and in possible future disputes.
- Insurance and other support for the indemnity is in place when a loss occurs.
- A thorough insurance monitoring process keeps the transferee in compliance with the insurance requirements.
- The performance of the contract is monitored and regularly evaluated.

Criteria quoted from CONTRACTUAL RISK TRANSFER Strategies for Contract Indemnity and Insurance Provisions (International Risk Management Institute, Inc. 2005).

This Article contains a discussion of certain risk management provisions in the lease forms contained in the *Texas Real Estate Forms Manual* of the State Bar of Texas. Accompanying each of these forms is a commentary noting the bias (the protected party) and a discussion of the risk allocations and the methods by which the risk is allocated. Also, included are the insurance endorsement forms commonly referenced in the risk management provisions and a commentary as to risk coverage and exclusions to coverage addressed by these insurance endorsements. Each of these forms has been annotated with footnotes identifying relevant case law and containing additional commentary explaining the risks being addressed by each form and certain gaps in coverage not addressed or possibly inadvertently being misaddressed.

II. INDEMNITY

A. Terminology

“**Indemnity**”^[2] is, “*I agree to be liable for your wrongs.*” Indemnity is a shifting of the risk of a loss from a liable person to another. It is like insurance between the parties. Sometimes, an indemnity provision is no more than a restatement of existing duties, “*I will indemnify you for my wrongs;*” “*You will indemnify me for your wrongs.*”

B. Requirements for Enforceability

The Texas Supreme Court has imposed certain contract drafting requirements in order for a negligent party to shift its liability to another person.

1. Fair Notice.

The concept of fair notice was introduced into Texas indemnity law in 1963 by the Texas Supreme Court in *Spence & Howe Const. Co. v. Gulf Oil Corp.*, 365 S.W.2d 631 (Tex. 1963). The fair notice requirement focuses on the appearance and placement of the provision as opposed to its “content.” The supreme court in *Spence* reasoned that

[t]he obvious purpose of this rule is to prevent injustice. A contracting party should be upon **fair notice** that under his agreement and through no fault of his own, a large and ruinous award of damages may be assessed against him solely by reason of negligence attributable to the opposite contracting party. *Id.* at 634.

2. Express Negligence.

In 1987 the Texas Supreme Court expressing frustration with the writing style and craft of Texas lawyers in *Ethyl Corp. v. Daniel Const. Co.*, 725 S.W.2d 705, 707 (Tex. 1987) adopted the “express negligence” requirement.^[6] In *Ethyl*, the court observed

As we have moved closer to the express negligence doctrine, the scriveners of indemnity agreements have devised novel ways of writing provisions which fail to expressly state the true intent of those provisions. The intent of the scriveners is to indemnify the indemnitee for its negligence, yet be just ambiguous enough to conceal that true intent from the indemnitor. The result has been a plethora of lawsuits to construe those ambiguous contracts. We hold the better policy is to cut through the ambiguity of those provisions and adopt the express negligence doctrine. The express negligence test replaced the “clear and unequivocal” test....

The express negligence requirement is a rule of contract interpretation and therefore is to be determined by the court as a matter of law. *Fisk Electric Co. v. Constructors & Associates, Inc.*, 888 S.W.2d 813, 814 (Tex. 1994). The indemnity must expressly state that it indemnifies the indemnified person for liabilities caused in whole or in part by its negligence and not leave it to inference. For instance, “x will indemnify y for all loss arising out of the acts or omissions of y except for loss caused by

the gross negligence or willful misconduct of y” will not be enforced to indemnify y for loss caused by its negligence.

3. Overcoming the Worker’s Compensation Bar.

Unless there is an enforceable written indemnity covering an employer’s negligence, a landlord, tenant, and contractor can find itself liable to an employer’s injured employee, not only for its own portion of the negligently caused injury but also for the proportionate part attributable to the employer’s negligence without the ability to claim back against the employer for contribution. The Workers’ Compensation Act bars contribution actions by third parties unless the employer has executed before the injury a written indemnity agreement for injuries to its employees arising out of the employer’s negligence. Texas Workers’ Compensation Act, TEX. LABOR. CODE ANN. § 417.004 (Vernon 1996).

[20 - 22]

4. Comparative Indemnity.

The Texas Supreme Court in *Ethyl* found that the following indemnity provision did not protect an “indemnified” party either for its negligence or the indemnifying party negligence for injuries caused to the indemnifying party’s employee:

Contractor (Daniel) shall indemnify and hold Owner (Ethyl) harmless against any loss or damage to persons or property as a result of operations growing out of the performance of this contract and caused by the negligence or carelessness of Contractor, Contractor’s employees, subcontractors and agents or licensees.

Id. at 708. [12] The court termed this claim as one for “**comparative indemnity**.” The court held that the indemnity provision did not meet the express negligence test in this respect. The court stated

Indemnitees seeking indemnity for the consequences of their own negligence which proximately causes injury jointly and concurrently with the indemnitor’s negligence must also meet the express negligence test. ... Parties may contract for comparative indemnity so long as they comply with the express negligence doctrine set out herein.

5. Strict Liability.

In 1994 the Texas Supreme Court in *Houston Lighting & Power Co. v. Atchison, Topeka, & Santa Fe Railway Co.*, 890 S.W.2d 455 (Tex. 1994) expanded the express negligence doctrine to require indemnity agreements intending to cover a protected party’s strict liability to expressly state that it covers such strict liability. [17 - 19]

III. INSURANCE

There are two insurance methods to effectuate protection: (1) directly, either by purchasing a CGL policy naming the protected party as the named insured or by the protecting party causing its insurer to list the protected party as an additional insured on the protecting party’s CGL policy; and (2) indirectly, by the protecting party insuring its contractually assumed liability (its indemnity).

A. Contractually Assumed Liability Insurance: Coverage for the Protecting Party

1. Exception to an Exclusion.

Most but not all CGL policies cover the protecting party for liability for “Bodily Injury” and “Property Damage” arising under an “insured contract” (sometimes referred to as “**contractually assumed liability insurance**”). Coverage is accomplished through the addition to the CGL Policy of an **exception to an exclusion** from coverage. Standard form CGL policies (ISO CG 00 01) provide as to “Coverage A” the following exceptions to the exclusion from coverage of contractually assumed liability. [43]

Coverage A under standard form CGL policies is for loss arising out of “Bodily Injury” or “Property Damage.” “Bodily Injury” is in such policies defined as “bodily injury, sickness or disease sustained by a person, including death resulting from any of these at any time.” “Property Damage” in such policies is defined as “physical injury to tangible property, including all resulting loss of use of that property ... or loss of use of tangible property that is not physically injured.” The exception to exclusion from Coverage A reads

This insurance does not apply to “Bodily Injury” or “Property Damage” for which the insured is obligated to pay damages by reason of the **assumption liability in a contract** or agreement. This exclusion does not apply to liability for damages:

1. **assumed in a contract or agreement that is an “Insured Contract”,** provided the “Bodily Injury” or “Property Damage” occurs subsequent to the execution of the contract or agreement; or
2. that the insured would have in the absence of the contract or agreement. (Emphasis added)

An “**Insured Contract**” is defined in the standard ISO CGL policy form as including

that part of any other contract or agreement pertaining to your business (including an indemnification of a municipality in connection with work for a municipality) under which you **assume the tort liability** of another party to pay for “Bodily Injury” or “Property Damage” to a third person or organization [2004 endorsement CG 24 26 , *provided the ‘bodily injury’ or ‘property damage’ is caused, in whole or in part, by you or by those acting on your behalf*]. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement. (Emphasis added)

Note that ISO has published the italicized language for inclusion in CGL policies by an endorsement CG 24 26. [43] This introduces into the “insured contract” definition a “contributory negligence” condition equivalent to the one contained in the 2005 revisions to ISO’s additional insured endorsements discussed below in Section III **B5b(2)**. Inclusion of this type language into a CGL policy effectively eliminates coverage for the named insured’s indemnification of a third party for its sole negligence. Care therefore must be taken by named insureds in coordinating and negotiating the terms of their CGL policies and indemnity agreements. It is possible for a named insured to be “uncovered” in such circumstances for an indemnity of another party’s sole negligence. If this is coupled with an exclusion from additional insured coverage for an additional insured’s sole

negligence, the named insured may find itself acting as the insurer or in breach of its covenants to protect the additional insured/indemnified party!

2. Named Insured Not Insured for all Contractually Assumed Liabilities - No Coverage for Indemnified Person’s Sole Negligence.

Until 2004, the standard CGL policy form published by ISO insured its named insured for its contractually assumption of liability for its indemnitee’s sole negligence. [39] ISO issued in 2004 an endorsement, CG 24 26 07 04, which modifies the definition of “insured contract” to eliminate coverage for the sole negligence of an indemnitee. Thus, an indemnifying person should review its CGL policy to determine whether it will extend to protect it should it decide to indemnify the other party to its contract for the other party’s sole negligence. See Forms E-G to this Article.

B. **Additional Insurance: Coverage for the Protected Party**

1. Purpose.

Another commonly employed risk transfer technique is to require the protecting party to arrange for its insurance to cover the protected party as an additional insured. [44-56] An additional insured endorsement is equivalent to an insurance policy written for the additional insured. The strongest rationale for this request is the perceived fairness of making the protecting party’s insurance carrier responsible for the increased exposure to loss created for the additional insured due to the protecting party’s operations, work or control of the premises. Issuance of additional insured endorsements is routine and inexpensive as compared to a separate policy being issued to cover the exposure of the party to be protected. The risk of loss has been factored into the named insured’s premium.

An additional insured designation seeks to achieve the following results: It provides a limited form of primary coverage for the additional insured. It may remove the possibility of subrogation against the additional insured for covered liabilities. It provides the additional insured with direct policy rights within the primary insured’s policy, including separate defense cost coverage for claims involving the additional insured. It provides a “safety net” should the indemnity provision be unenforceable or otherwise be deficient. Additional insured endorsements generally do not carve out from the

coverage afforded the additional insured loss due to “**Personal and Advertising Injury**.” In these circumstances, protection for the protected party’s Personal and Advertising Injury is covered whereas without specific endorsement to the named insured’s CGL Coverage B, the named insured’s indemnity for such liabilities is not reinsured and the named insured not carving out this type of liability is uninsured as to its contractually assumed liability. Additionally, additional insured status may automatically entitle the additional insured to the named insured’s excess liability or umbrella coverage because such policies frequently cover all insureds (including the additional insureds) under the primary liability policy.

There are important considerations for a protected party to remember when evaluating whether to forgo a contractual indemnity by the protecting party and to rely solely on being an additional insured on the protecting party’s CGL policy. The policy may be canceled with or without the protected party’s knowledge; the insurer may become insolvent; and the additional insured’s coverage under the protecting party’s CGL policy is subject to the policy’s limits and exclusions from coverage.

2. Automatic Coverage or by Endorsement.

Coverage may be accomplished (1) by endorsement of the protecting party’s CGL insurance or (2) through blanket additional insured provisions in the protecting party’s CGL policy, which provide automatic additional insured status for persons that a named insured is obligated by contract to provide such coverage.

3. Endorsements: ISO or Manuscripted Forms.

Additional insured endorsements can be divided into two categories: endorsement forms promulgated by the Insurance Services Office, Inc. (“**ISO**”) and all other endorsement forms (referred to in the insurance industry as “**manuscripted**” forms).^[39] There are four nationwide insurance advisory organizations that develop standard insurance forms. ISO is the largest national insurance advisory organization. Its forms are considered to be the industry’s “standard” forms. 1 CONTRACTUAL RISK TRANSFER Strategies for Contract Indemnity and Insurance Provisions §XIII, p. XIII.B.2 (International Risk Management Institute, Inc. 2003).

ISO forms are identified by a two-letter prefix identifying the type of coverage, four digits identifying the form category and individual form number, and four digits identifying the edition date by month and year. For example, the CG 20 10 07 04 additional insured endorsement form is made up of “**CG**” to indicate that this is a CGL form; “**20**” indicates the category of CGL endorsement that this form belongs to, an additional insured endorsement; “**10**” is the number assigned to this particular CGL additional insured endorsement; and “**07 04**” indicates that this form is the July 2004 edition of the CG 20 10.^[39]

ISO has promulgated 33 forms of additional insured endorsements, each tailored to a different risk transfer, including CG 20 10 07 04–Additional Insured–Owners, Lessees or Contractors–Schedule Person or Organization and CG 20 26 07 04–Additional Insured–Designated Person or Organization.^[39]

4. Covered Matters.

Additional insured endorsements furnish coverage to an additional insured for liabilities “**arising out of**” the named insured’s “**work**”, “**operations**”, or “**premises**” or some variation of these themes.

a. Ongoing Operations

ISO form CG 20 10 is ISO’s standard endorsement for use in adding a project owner as an insured to a general contractor’s CGL policy or a general contractor to a subcontractor’s CGL policy (See **Form G** CG 20 10 07 04 Additional Insured – Owners, Lessees or Contractors – Scheduled Person or Organization). CG 20 10 provides coverage for the additional insured’s liabilities arising out of the “**ongoing operations**” of the named insured. CG 20 10 has undergone changes from coverage for liabilities “*arising out of the work*” of the named insured in the November 1985 version (CG 20 10 11 85), to “*arising out of the ongoing operations*” of the named insured in the October 1993 version (CG 20 10 10 93), the March 1997 version (CG 20 10 03 97), and the October 2001 version (CG 20 10 10 01). ISO made this change to clarify that this particular form of additional insured endorsement is intended to cover liabilities arising out of the “ongoing operations” of the named insured as opposed to liabilities arising out of operations that have been completed. The October 2001 revision added an express exclusion from coverage for liabilities “*occurring after ... all work ... has been completed*” to further emphasize the “ongoing” operations requirement. The 2004

revision to CG 20 10 to eliminate coverage for the additional insured's sole negligence is discussed at III B5b(2) of this Article.

b. Completed Operations

The ISO CG 20 10 11 85 additional insured endorsement ("arising out of your work") was construed in *Pardee Constr. Co. v. Insurance Co. of the West*, 92 Cal. Rptr.2d 443 (Cal. App. 2000) to cover an additional insured contractor's liabilities arising out of the completed operations of its named insured subcontractor. In *Pardee* the CGL policy and additional insured endorsement were issued 4 years after completion of the subcontractor's work on the project in question and were held to cover injuries arising out of the earlier work of the subcontractor. The wording of the additional insured endorsement must be examined to determine if complete operations coverage is included (e.g., by not limiting coverage to "ongoing" operations or by not expressly excluding coverage for completed operations). If completed operations coverage is desired and coverage is not afforded by the proffered endorsement form, coverage may be effected either by manuscripting the endorsement to extend to completed operations or by adding the coverage by a completed operations endorsement. ISO CG 20 37 Additional Insured – Owners, Lessees or Contractors – Completed Operations is designed to cover completed operations liabilities, first by stating that it covers liabilities "arising out of your (the named insured's) work" and stating that the liabilities covered are those liabilities arising out of the work that are "included in the products-completed operations hazard."

c. Premises

There are two ISO endorsements used primarily to add as an additional insured the owner of premises or land leased to the named insured, CG 20 11 01 96 Additional Insured – Managers or Lessors of Premises and CG 20 24 11 85 Additional Insured – Owners or Other Interests from Land Has Been Leased. Similarly, see **Form E** for CG 20 11 01 96 Additional Insured – Managers or Lessors of Premises, which ISO additional insured endorsement adds designated persons as additional insureds as to designated "**premises**" and covers the Additional insured's liability:

arising out of the ownership, maintenance or use of that part of the premises leased to you (the named insured) and **shown in the Schedule** subject to the following additional exclusions: ... Any "occurrence" which takes place after you cease to be a tenant in that premises. (and) Structural alterations, new construction or demolition operations performed by or on behalf of the (additional insured)....

An almost identical ISO endorsement is CG 20 24 11 85 Additional Insured – Owners or Other Interests from Land Has Been Leased. The sole and obvious difference being "land" versus "premises." The most common factually litigated scenario regarding these endorsements involves injuries occurring "**outside**" the "**part**" of the premises "shown in the schedule" leased to the tenant. This issue can also take on the nuance of whether coverage is effected if the schedule designates more or less than the "part of the premises" leased to the named insured.

Cases Finding No Coverage.

For example, in *General Accident, Fire and Life Assurance Corp. v. Travelers Ins. Co.*, 556 N.Y.2d 76 (1990), the court held that the AI endorsement did not cover a claim brought by the named insured's injured employee when the injury occurred outside the leased "premises." The court denied coverage even though tenant named insured's CGL policy was endorsed to name its landlord as an additional insured and designated the landlord's entire property as the "premises." The court reviewed the lease and found that it defined the term "premises" as a specific area and the "premises" was not where the injury occurred. New York follows a rule that these type endorsement designate the location ("the premises") where the injury must occur, and do not provide coverage when the injury occurs outside of the designated area even though the "occurrence" might be viewed as having "sprung" from the use of the landlord's facility. See *Greater N. Y. Mut. Ins. Co. v. Mut. Marine Office, Inc.* 3 A.D.3d 44, 769 N.Y.S.2d 234, 237 (2003), N. Y. App. Div. Lexis 13316 (2003)—injury occurred to a HVAC repairman who was injured while walking on roof of landlord's multi-tenant retail center to get to HVAC unit that tenant was obligated to maintain pursuant to lease of a retail space in the center. The additional insured endorsement form was an ISO CG 20 11 Additional Insured – Managers and Lessors of Premises (**Form E**). The injury neither occurred in the retail space leased to tenant or on the roof

directly above the space. See also *Rensselaer Polytechnic Inst. v. Zurich Am. Ins. Co.*, 176 A.D.2d 1156, 1157, 575 N.Y.S.2d 598 (N.Y. 3rd Dept. 1991)—stating that court was not persuaded that a duty to indemnify existed by the argument that although the accident did not occur within the leased premises, it did arise out of use of the leased premises; *Commerce & Indus. Ins. Co. v. Admon Realty, Inc.*, 168 A.D.2d 321, 323, 562 N.Y.S.2d 655 (1st Dept. 1990)—finding no duty to indemnify where the cause of the damage occurred outside the leased premises; *Northbrook Ins. Co. v. American Stats Ins. Co.*, 495 N.W.2d 450 (Minn. 1993)—additional insured endorsement held not to cover injuries occurring in alley behind named insured's bakery in a shopping center (in this case an employee of the bakery was injured when he slipped on ice while loading a truck parked in the alley behind the shopping center); *USF&G v. Drazic*, 877 S.W.2d 140 (Mo. 1994)—additional insured not covered for injuries to named insured tenant's employee who slipped and was injured on an icy parking lot.

Cases Finding Coverage.

An earlier New York case, *J. P. Realty Trust v. Public Serv.*, 476 N.Y.S.2d 325 (1984), found coverage for the additional insured for an injury occurring to the named insured's employee injured while using a freight elevator. The additional insured endorsement designated landlord's entire building as "that part leased to the insured;" however, the lease designated only two floors of the building as leased to the tenant as the "premises." The lease provided tenant use of the freight elevator. This court looked to the intent of the parties and construed the additional insured endorsement broadly in favor of coverage. Similarly, the court in *Harrah's Atlantic Inc. v. Harleysville Ins. Co.*, 288 N. J. Super. 152, 671 A.2d 1122 (1996) found coverage for the additional insured landlord for an injury occurring outside the premises leased to tenant (employee of NI tenant injured crossing street separating landlord's parking garage and landlord's building which housed tenant's retail space). The court noted

However, the requirement that there be a causal link or connection between the accident and the leased premises does not mean that there must be any degree of physical proximity between the leased premises and the scene of the accident. The two concepts are quite different. Thus, we would expect the outcome in the *Franklin* case to have been the same had

the tenant's business guest fell on the building's exterior steps even if they were some distance from the luncheonette. This so because the negotiating for such an endorsement in a lease the landlord is simply attempting to ensure against the risk of liability generated by the business about to be conducted by the tenant, and place the cost of insuring that risk on the tenant.

Franklin Mut. Ins. v. Security Indem. Ins., 275 N. J. Super. 335, 340, 646 A.2d 443, *cert denied* 139 N. J. 185, 652 A.2d 173 (1994). Also see *ZKZ Associates LP v. CNA Ins. Co.*, 224 A.D.2d 174, 637 N.Y.S.2d 117 (N.Y. 1st Dept. 1996)—court required the insurer of the tenant of a garage to defend the owner of the garage in a personal injury suit even though the accident occurred on the sidewalk in front of the tenant's property. The additional insured endorsement was issued on an inapplicable form as it provided additional insured coverage as to injuries arising out of premises "leased to" the named insured. There were no leased premises as the named insured was a garage operator. The court noted that named insured's CGL policy provided coverage to the named insured for garage operations including "the ownership, maintenance or use of locations for garage business and that portion of the roads or other accesses that adjoin these locations ...[; and] all operations necessary or incidental to a garage business." The court reasoned that "without traversing the sidewalk for access to and from the garage, there could be no use at all of the garage as a parking facility." *Id.* at 176. In *University of California Press v. G. A. Insurance Co. of New York*, 1995 U.S. Dist. Lexis 21442, 1995 WL 591307 (E.D.N.Y. 1995), the property damage and actual injury occurred within the leased premises. Books stored within the leased premises were damaged by leaking water from a sprinkler system malfunction one floor above the leased premises. The court found the language of the insurance agreement to be ambiguous and unclear as to whether

the term "arising out of" referred to where the breach took place, where the accident occurred or where the damage occurred.

Unable to reconcile that ambiguity, the court followed a basic principle of contract law and construed the ambiguity against the insurer as the policy's drafter. Thus, because the damage occurred within the leased premises, the court found in favor of coverage. The court in *Hormel Foods Corp. v. Northbrook Property & Casualty*

Insurance Co., 938 F.Supp. 555 (D. Minn. 1996), *aff'd*, No. 97-1197, 1997 U.S. App. Lexis 34146 (8th Cir. 1997) upheld coverage for an additional insured landlord which leased a hog-processing facility to the employer (Quality Pork Products, "QPP") of a person who was killed using a machine designed and manufactured by Hormel, installed on the premises, and leased to QPP by Hormel. The Northbrook insurance policy AI endorsement covered losses "arising out of the ownership, maintenance or use, of the leased premiss." The court held that the machine was so intertwined with the facility's operations as to make injuries flowing from it attributable to the "ownership, maintenance, or use" of the facility. The machine was bolted to the floor walls and was "unambiguously part of the premises." How far some courts will extend additional insured coverage is illustrated by *SFH, Inc. v. Millard Refrigerated Services, Inc.*, 339 F.3d 738 (8th Cir. 2003). The warehouse lease required the lessee to carry CGL insurance and the lessor and its manager as additional insureds. Coverage was affected through a blanket additional insured endorsement covering all additional insured's required by named insured's contracts to be covered. The additional insured language was identical to the ISO CG 20 11 coverage as to "liability arising out of the ownership, maintenance or use of that part of the premises leased to you." The lessee's property was destroyed by a fire at the warehouse. It was determined that the one of the manager's employees had disabled the sprinkler system. The court found in favor of coverage, stating

Construing the "arising out of" language broadly, we conclude that [the warehouse manager's] liability arose out of its maintenance of the leased premises. the fire started within the portion of the warehouse leased by [the lessee] and injured [the lessee's] property located in the leased premises. [The lessee's] loss was caused, or significantly increased, by the conduct of the [manager's] employee who shut off the water to the building's sprinkler system.

5. Covered Liabilities.

a. Negligence

(1) Additional Insured's Vicarious Liability for Named Insured's Negligence

Additional insured status affords the additional insured protection against vicarious liability arising

out of the named insured's acts or omission. [44] An additional's insured's vicarious liability for the acts or omissions of a named insured is an exceptional situation, for example, an owner's liability for its contractor's acts or omissions in the case of non-delegable duties and other exceptions to the independent contractor rule. 44 TEX. JUR. 3D, *Independent Contractors* (1996); and RESTATEMENT (SECOND) OF TORTS Introductory Comment to §§ 416-429 (1966). It has been urged that limiting additional insured coverage to the additional insured's vicarious liability is illusory and against public policy. See the dissent in *National Union Fire Ins. Co. of Pittsburgh, Pa. v. Glenview Park Dist.*, 158 Ill.2d 116, 632 N.E.2d 1039 (Ill. 1994). As noted below, Texas courts have followed the majority rule that additional insured coverage is not limited to coverage of the additional insured's vicarious liability for the named insured's negligence, or even to cases where the named insured is concurrently negligent with the additional insured.

(2) Additional Insured's Own Negligence.

Depending on the language of the protecting party's insurance, the protected party may be covered for its own negligence, whether or not the protecting party is negligent. As such, it supplements the protection afforded by the protecting party's indemnity. [44]

b. Interpretation of Additional Insurance Covenants

(1) Express Negligence Test Not Applicable to Insurance Covenant

In *Getty Oil Co. v. Insurance Co. of North America, NL Industries, Inc., Youell and Companies*, 845 S.W.2d 794 (Tex. 1992), *cert. den'd*, 510 U.S. 820, 114 S. Ct. 76, 126 L. Ed. 2d 45 (1993), the Texas Supreme Court declined to extend the express negligence doctrine to invalidate contractual provisions requiring the protected party (Getty) to be listed as an additional insured on the protecting party's (NL Industries') liability policies. [45] In *Getty* the injuries arose out of Getty's sole negligence; the indemnity provision excluded indemnity for Getty's negligence; the insurance covenant was silent as to whether the insurance was or was not to cover injuries due to Getty's negligence; the insurance covenant in the contract provided for NL Industries to maintain commercial general liability insurance and for such insurance was to "extend to and protect Getty." The court found that there was not a basis for preventing litigation as to whether Getty

was an additional insured under NL Industries' policies (e.g., through an automatic blanket insured provision).

(2) 2004 Revision to ISO Forms

Recently, ISO issued revisions to its AI Endorsements, including the CG 20 26, CG 20 10 and CG 20 37 (attached hereto as **Forms F and G**) to eliminate coverage for an Additional insured's sole negligence. For example, the CG 20 10 form will exclude coverage for liabilities attributable to the additional insured's sole negligence as follows:

Section II – Who Is An Insured is amended to include as an additional insured the person(s) or organizations shown in the Schedule, but only with respect to liability for “bodily injury”, “property damage” or “personal and advertising injury” caused, in whole or in part, by:

1. Your (the named insured's) acts or omissions; or
2. The acts or omissions of those acting on your behalf;

in the performance of your ongoing operations for the additional insured(s) at the locations(s) designated above.

The 2004 revision seeks to limit the trigger for additional insured coverage to occurrences caused by the sole or partial negligence of the named insured.

c. Manuscript Additional Insured Endorsement to Limit Coverage to Indemnified Liabilities

One approach parties have used is have the protecting party's insurer issue a manuscripted additional insured endorsement that is limited to insurable indemnified liabilities. In *Certainfeed Corp. v. Employers Ins. of Wausau*, 939 F. Supp. 826 (D. Kan. 1996). In *Certainfeed* the additional insured endorsement issued by Wausau was a blanket automatic insured provision in the CGL policy it issued to its named insured contractor. This provision provided as follows:

Section Two—Who Is an Insured:

5. Any person or organization ... for which you have agreed by written contract to procure ... liability insurance, but only for liability arising out of operations performed by you or on your behalf, provided that: ... (b) The insurance afforded to any person ... as an insured under this Paragraph 5 shall include only the insurance that is required to be provided by the terms of such agreement to procure insurance, and then only to the extent that such insurance is included within the scope of this policy.

The insurance provision of the construction contract, required the protecting party (the named insured contractor providing construction services to the plant owner) to provide insurance coverage for all “liability assumed” by the protecting party. The construction contract contained an indemnity agreement whereby the protecting party indemnified the protected party (the additional insured plant owner) for its negligence except if due to its sole negligence. The court construed the blanket addition insured provision as covering the additional insured's liability for injuries jointly caused by the protected party and by another contractor (a construction manager) to an employee of the named insured. The court thus held that the scope of the additional insured coverage was the same as the scope of the insurance that the named insured was to procure to protect the named insured on its indemnity.

6. Liability for Failure to List Other Party as Additional Insured.

A party that breaches its contractual obligation to list the other party as an additional insured is liable for all damages that would have fallen within the protection of the additional insured endorsement.^[50] The court in *Coastal Transport Co. v. Crown Central Petroleum Corp.*, 20 S.W.3d. 119 (Tex. App.-Houston [14th Dist.] 2000, writ denied) found that Coastal failed to list Crown as an additional insured on Coastal's Trucker's Policy and was liable to Crown for the \$4,816,549.28 judgment obtained by an employee of Coastal that was injured on Crown's premises. The insurance covenant did not refer to an additional insured designation but required Coastal to obtain

insurance “protecting” Crown. The insurance covenant in Coastal Transport reads as follows:

Carrier agrees to purchase at Carrier’s cost ... Comprehensive General Liability Insurance including care, custody and control coverage and liability assumed with \$1,000,000 limit per occurrence for bodily injury and property damage combined. Such insurance shall ... fully extend to, defend and protect Crown.

7. Caveat.

Unfortunately, although additional insured covenants are the most common risk management technique, they are also the most commonly misunderstood, even by professionals in the field—risk managers, insurance agents, lawyers and courts that are called on to interpret them. The most common error is for the party’s insurance covenant to fail to specify the terms of coverage and exclusions from coverage to be contained in the additional insured endorsement. See Commentary following **Form A2** discussing the Forms Manuals Office Lease. For example, a landlord may specify in its lease that the tenant and the tenant’s contractors will cause each of their CGL insurers to list the landlord and its management company and contractors as additional insureds on the tenant’s and the tenant’s contractors’ CGL policies. A tenant may specify in its contract with its tenant-finish out contractor that the contractor shall cause its CGL insurer to list the tenant, its landlord, and the landlord’s lender, management company and contractors as additional insureds on the tenant-finish out contractor’s CGL policy. The tenant’s contractor may specify in its subcontract that the subcontractors list the contractor as an additional insured on the subcontractors’ CGL policies. In each of these cases, the person desiring protection as an additional insured has left it up to the other party’s insurance carrier to define the scope of the coverage to be provided. This is equivalent to letting the fox determine how, when, and if to protect the chicken! This mistake has been made because there is no commonly accepted definition of what it is to be an “additional insured.” When a party fails to specify more than it be listed generically as an “additional insured,” it has opened the door to the other party’s insurer picking a form that effectively eliminates coverage for the additional insured. ^[44-56]

C. Protected Party’s “Other Insurance”

1. Generally All Policies Are “Primary” and “Contributory” Unless Amended.

The use of additional insured status as a risk transfer device is aimed at procuring insurance protection under the protecting party’s policy rather than the protected party having to rely upon its own policy. By definition, a party that carries its own liability insurance and is also an additional insured under another’s liability policy has multiple coverages which fall under the general heading of “**other insurance**” available to “contribute” towards satisfaction of the liability insured by both the protecting party’s policy and the protected party’s policy. ^[51]

A protected party ought to structure the joint insurance program with the protecting party so as to cause its own CGL policy not to be primary and contributory with the additional insurance coverage provided by the protecting party’s CGL policy.

Assuming both the protecting party’s CGL policy and the protected party’s CGL policy are standard form policies, then both parties’ policies by their standard terms, if not modified, declare themselves to be “**primary**” insurance and require any “other” insurance to which the additional insured has access to contribute proportionately to cover the liability. This risk of overlapping coverage may be addressed in advance of the loss either by amendment to the protected party’s policy or to the protecting party’s policy, or both.

The following are the “other insurance” provisions in the industry standard ISO CGL policy. These provisions are likely contained in both the protecting party’s CGL policy and the protected party’s CGL policy.

ISO CGL Policy:

4. Other Insurance.

If other valid and collectible insurance is available to the insured for a loss we cover under Coverages A or B of this Coverage Part, our obligations are limited as follows:

a. Primary Insurance

This insurance is primary except when b. below applies. If this insurance is primary, our obligations are not affected unless any of the other insurance is also primary. Then we will share with all that other insurance by the method described in c. below....

b. Excess Insurance.

This insurance is excess over: ...

- (2) Any other primary insurance available to you covering liability for damages arising out of the premises or operations, or the products and completed operations, for which you have been added as an additional insured by attachment of any endorsement; ...

c. Method of Sharing.

If all the other insurance permits contribution by equal shares, we will follow this method also. Under this approach each insurer contributes equal amounts until it has paid its applicable limit of insurance or none of the loss remains, whichever comes first.

If any of the other insurance does not permit contribution by equal shares, we will contribute by limits. Under this method, each insurer's share is based on the ratio of its applicable limit of insurance to the total applicable limits of insurance of all insurers.

2. **Endorsing Named Insured's Policy to be Primary Not the Solution.**

a. **Primary vs. Sole Contributing**

Endorsing the protecting party's policy to provide that it is primary does not solve the problem. In fact, most CGL policies already provide that they are primary in virtually all cases in which the additional insured would bring a claim on that CGL policy. Endorsing the protecting party's policy to be primary does not address the other insurance clause contained in the named insured's policy, which unamended provides for proportionate payment based on the limits of the additional insured's primary policy ("**contributory**"). This may be addressed by endorsing the named insured's policy to be the sole contributing policy, (i.e, not requiring contribution from the additional insured's policy).^[51]

b. **Endorsing the Additional Insured's Policy to Be Excess Coverage**

The protected party should verify that its own policy provides that it is excess coverage to the insurance available to it as an additional insured under the protecting party's CGL policy and that in such case it is not primary and contributing as "other insurance".^[51]

IV. **RELEASES AND EXCULPATIONS**

In 1993 the Texas Supreme Court in *Dresser Industries, Inc. v. Page Petroleum, Inc.*, 853 S.W.2d 505 (Tex. 1993) extended the fair notice principle and the express negligence doctrine to releases. This principle is likely to be extended to waivers,

exculpations and disclaimers seeking to exclude liability for one's own negligence, being merely a release worded in a different format. [76-82]

Many standard form waivers of subrogation are in the form of a release or waiver of either a landlord's or tenant's liability for its negligently caused injuries. These provisions are releases or waivers of claims and indirectly operate as a waiver of the party's insurance carrier's right of subrogation. If a waiver of subrogation is thus couched in terms of a waiver or release by one party of another party's liability for its negligence, then such provision is unenforceable unless it is written in a fashion that meets the express negligence test. [60-63]

V. CONDEMNATION

The risk that all or a portion of the leased premises or of the facilities supporting the leased premises, such as parking and means of access to parking, is a risk similar to acts of God ("special causes of loss") in that the parties did not cause the event to occur. Unlike that risk, however, the consequence is permanent. In both situations, the parties may have expended significant monies in making the leased premises ready for the lessee's occupancy that are not amortized as of the moment of taking and the lessee may incur significant consequential damages (such as moving costs, loss of good will, and lost profits due to business interruption). The parties can insure against the losses arising out of special causes of loss. The only means to address the losses arising out of condemnation is to contractually allocate in advance in the lease the condemnation award between the landlord and tenant. [83-100]

A. Allocation in the Event Lease is Silent

Texas follows the "**undivided fee**" or so-called "**unit rule**" in valuing property taken in condemnation. The condemned property is first valued as a whole, without consideration for how many parties own an interest in the property or the extent of their interest. The court determines the fair market value of the property. If the lease is silent as to how the award is allocated between landlord and tenant, the judge or jury first determines the market value of the entire property as though it belonged to one person, then the fact finder apportions market value as between lessee and owner of fee, with the value of the tenant's interest being first determined and awarded to the tenant and then the balance is awarded to the landlord. *Urban Renewal Agency v. Trammell*, 407 S.W.2d 772, 774 (Tex. 1966). The residual value

after deduction of the value of the tenant's interest is the landlord's "**leased fee**" value.

1. Value of Tenant's Interest.

a. Loss of Tenant's "Leasehold Advantage"

In the absence of a provision in the lease to the contrary, tenants are entitled to a portion of the condemnation award equal to their lost "**leasehold advantage**", if any. The value of a tenant's leasehold interest is either positive or negative. If there is a positive value it is referred to as a "leasehold advantage." The value of a tenant's leasehold interest is calculated as the present market value of the use and occupancy of the leasehold for the remainder of the lease term, plus the market value of the right to renew if such right exists, less the agreed rent the tenant must pay for the use and occupancy of the property, such values to be determined by the usual "willing seller-buyer rule."

For example, if the tenant pays \$1000/month rent, but the premises could be leased for \$1200/month, there is a \$200/month leasehold advantage being lost by tenant on condemnation of its leased premises for which it is to be compensated out of the condemnation award.

b. No Award Allocated to Tenant for Its Lost Business or Personal Property

Texas common law presumes that a tenant's business is not taken in condemnation. The tenant is free to relocate. Thus, no award is given to the tenant due to the impact of the condemnation on the going concern value of the business so interrupted, its trade name, lost profits, or impact on its personal property. *Luby v. City of Dallas*, 396 S.W.2d 192, 199 (Tex. Civ. App.—Dallas 1965, writ ref'd n.r.e.); *Herndon v. Housing Authority of City of Dallas*, 261 S.W.2d 221, 223 (Tex. Civ. App.—Dallas 19, writ ref'd).

c. Moving Expenses Compensable

A separate award is made to the tenant for reasonable moving expenses to move its personal property up to 50 miles, but not to exceed the value of the personal property itself. TEX. PROP. CODE § 21.043.

d. **Tenant's Improvements and Fixtures Compensable**

The value of the improvements, including fixtures taken or damaged, by condemnation is part of the undivided fee being condemned and is not separately valued in condemnation. Because fixtures are, by definition, part of realty, the condemning authority must pay compensation for the taking of, or damage or destruction to, fixtures caused by a condemnation.

In a lease silent as to allocation of a condemnation award, tenant paid for leasehold improvements, which as a practical matter can not be removed at the end of the lease term, are to be valued as part of the tenant's compensable interest.

In a case perhaps limited to its unique facts, the United States Supreme Court has found that a tenant's compensable interest for its leasehold improvements was to be measured by what a willing buyer would have paid for the improvements, which had a useful life exceeding the remainder of the lease term and which were subject to removal by the tenant, taking into account the possibility that the lease might be renewed as well as that it might not. *Almota Farmers Elevator and Warehouse Co. v. United States*, 409 U.S. 470, 93 S.Ct. 791, 35 L.Ed.2d 1 (1973).

2. **Interplay with Other Lease Clauses**

a. **Permitted Use Clauses**

The condemning authority must pay the market value of the property being condemned valued at its "highest and best use." *E.g., State v. Windham*, 837 S.W.2d 73, 77 (Tex. 1992). Absent a provision in the lease addressing allocation of the award on condemnation, even though a tenant's use is limited to a use that is not determined by the court to be the highest and best use of the property, a tenant might successfully argue that the landlord should not get the all of the balance of the award after deducting the value of the tenant's leasehold as its use is limited by the lease's permitted use clause. There is some authority for the proposition that the tenant should share in the balance of the award as without tenant's participation during the lease term, landlord can not realize the property's true value. *Irv-Ceil Realty Corp. V. State*, 43 A.D.2d 775, 350 N.Y.S2d 784 (1973). Whether such leverage is a compensable interest is not yet determined in Texas.

b. **Renewal Clauses**

In valuing a tenant's interest in condemnation, where the lease is silent as to allocation of the condemnation award, the law presumes that a tenant would exercise its renewal option absent a condemnation and in a case where a tenant has a leasehold advantage, it is measured over the term of the lease as if renewed and under the terms applicable to the existing and renewal term. *Fort Worth Concrete Co. v. State of Texas*, 416 S.W.2d 518 (Tex. Civ. App.—Fort Worth 1967, writ ref'd n.r.e.); and *Luby v. City of Dallas*, 396 S.W.2d 192, 199 (Tex. Civ. App.—Dallas 1965, writ ref'd n.r.e.).

3. **Effect on Tenant's Obligation to Pay Rent**

a. **Rent Abated on Total Condemnation**

Tenant is relieved of its obligation to pay rent when its entire leased premises are condemned. *Elliott v. Joseph*, 351 S.W.2d 879, 881 (Tex. 1961).

b. **Rent Not Proportionally Abated if a Portion of Leased Premises Taken**

If the lease is silent as to partial abatement of rent on a partial condemnation of the leased premises, rent is not abated or partially abated, and tenant's remedy is to look to an apportionment of the damages assessed against the condemning authority based on the reduced value of his lease. *Elliott v. Joseph*, 351 S.W.2d 879, 881-882 (Tex. 1961). The following example of this allocation is given in Adler and Shelton, *Condemnation Issues in Leasing: Who Gets What and How to Get What Your Client Wants*, ADVANCED REAL ESTATE DRAFTING COURSE 1, 3 (2003):

A partial condemnation may reduce a leasehold advantage to a leasehold disadvantage. The tenant holds a leasehold disadvantage when it has a continuing contract rental obligation that exceeds the market rent for the use and occupancy of the "after" condemnation premises. For example, if the market value of the use and occupancy of the premises before the condemnation was \$100 per year and the tenant was only required to pay \$90 per year under the lease, the tenant held a \$10 leasehold advantage. If the condemning entity takes that advantage, it must compensate the tenant for the present value of that \$10 for each of the years remaining in the lease, including the tenant's option to renew if there is one. But, if the condemning entity only takes part of the leased premises such that the tenant is still able to use the premises, but the market rent for the use and occupancy of the lease has been reduced to \$70 per year, the condemning entity must compensate the tenant for the loss of its leasehold advantage plus the disadvantage that results from the condemnation. In total, under this scenario, the tenant is entitled to the present value of \$30 per year (\$10 for the loss of its leasehold advantage + \$20 for the resulting leasehold disadvantage) for the duration of the lease.

B. Contractual Apportionment of Award

The parties are free to contractually apportion a future condemnation award contractually taking into account such future factors as they can contemplate.

1. Value of Tenant's Use is Less than Highest and Best Use at Time of Taking.

As opposed to being silent in the lease as to how the parties will allocate the award, the lease can address allocation of a portion of the award to either landlord or tenant in a case where tenant's use at the time of condemnation is not the compensable highest and best use of the property at the time of taking. For example tenant may be using the property for warehouse uses, but at the time of taking the highest and best use of the property, as a hotel, yields an award greater than the actual use taken. Adler and Shelton, *Condemnation Issues in Leasing: Who Gets What*

and How to Get What Your Client Wants, ADVANCED REAL ESTATE DRAFTING COURSE 1, 4 (2003):

In that situation (where tenant's use is not the highest and best use), is the tenant's leasehold advantage calculated as leasehold advantage of a comparable warehouse property, or is the leasehold advantage valued with regard to the market ground rent for hotel tracts? The parties could agree on the answer in the lease, and avoid litigating the question, by providing that the tenant's leasehold interest is to be calculated using a market rental based either on the use the tenant is making of the premises or the highest and best use of the property as of the date of condemnation.

2. Value of Tenant's Improvements Not Fully Amortized at Time of Taking.

The parties can address in the lease the risk that at the time of condemnation the tenant will not have fully amortized the value of its tenant's leasehold improvement and apply a formula to how to compensate tenant for the ensuing loss on taking of the premises.

C. Contractual Allocation of Award to Landlord

Landlords incorporate into leases several types of clauses to assure that they receive the entire award or to minimize tenant's claim. These clauses include a provision that the lease terminates on condemnation, a disclaimer by the tenant of any right to an award for its taken interest other than the contractually agreed method of compensating it for its loss, and an assignment by tenant of all rights and awards to the landlord other than as expressly set forth in the allocation provision in the lease. Due to the perceived harshness of an automatic termination clause, courts will strictly construe such a clause to save the tenant's interest. *Norman's, Inc. V. Wise*, 747 S.W.2d 475, 477 (Tex. App.—Beaumont 1988, writ den'd).

1. **“Termination-on-Condemnation”
Clauses.**

a. **Automatic, Optional and Mixed**

(1) **Automatic termination clauses**

A “termination-on-condemnation” clause provides that the tenant’s interest terminates on condemnation of the leased premises (called an “**automatic termination clause**”). The result of such a clause is to terminate the tenant’s interest in the property and extinguish any right of the tenant to share in the condemnation award.

See for example the following clause upheld in *United States v. Petty Motor Co.*, 327 U.S. 372, 66 S.Ct. 596, 599, 90 L.Ed. 729 (1946):

If the whole or any part of the demised premises shall be taken by Federal, State, county, city or other authority for public use, or under any statute, or by right of eminent domain, then when possession shall be taken thereunder, the term hereby granted and all rights of the Lessee hereunder shall immediately cease and terminate, and the Lessee shall not be entitled to any part of any award that may be made for such taking, nor to any damages therefor except that the rent shall be adjusted as of the date of such termination of the Lease.

Termination of lease without termination of all rights leaves tenant right to some compensation.

The following clause in *Evans Prescription Pharmacy, Inc. v. County of Ector*, 535 S.W.2d 704, 706 (Tex. Civ. App.–El Paso 1976, writ ref’d) was construed as not terminating tenant’s interest to the extent of tenant’s right to compensation for its improvements taken by condemnation and its removal expenses:

Should the leased property be taken by right of eminent domain the lease shall be terminated.

No termination on partial condemnation if clause fails to specify termination of lease on partial condemnation.

Sometimes strict construction against termination of tenant’s interest can work to the tenant’s disadvantage. In *Norman’s, Inc. v. Wise*, 747

S.W.2d 475, 476 (Tex. App.–Beaumont 1988, writ den’d), the tenant’s leasehold estate was held not to have been terminated by condemnation of a portion of the landlord’s property (condemnation of a portion of the parking area) where the automatic termination clause was determined by the court to apply only in a case of the condemnation of the entire premises and not to a condemnation of “any part thereof.” The *Wise* automatic termination clause reads as follows:

It is specially understood and agreed by and between Lessor and lessee that in the event the demised premises are condemned for public use by any governmental agency, or other entity with the power of condemnation, this lease shall cease and terminate and be of no further force and effect, and Lessee shall have no claim or demand of any kind or character in and to any award made to Lessor by reason of such condemnation.

No termination if fail to state lease terminates as of condemnation.

A lease was held not to terminate automatically on condemnation where it terminated the “further liabilities” of the parties. 26 AM. JUR. 2d *Eminent Domain* § 264 (1996) citing *Maxey v. Redevelopment Authority of Racine*, 288 N.W.2d 794 (Wis. Ct. App. 1980).

(2) **Optional termination clause.**

Optional termination on taking of entire premises.

Some clauses are drafted to provide an option in tenant or landlord to terminate the lease on condemnation of the leased premises or on condemnation of a part of the leased premises. The following clause was construed by the court to automatically terminate the lease as the court held the optional termination on condemnation of the entire leased premises was superfluous, no option applied :

If the whole or any substantial part of the demised premises should be taken for any public or quasi-public use under any governmental law, ordinance or regulation, or by right of eminent domain, or should be sold to the condemning authority under threat of condemnation, this Lease shall, at the option of the landlord, terminate and the rent shall be abated during the unexpired

portion of this lease effective when the physical taking of said premises shall occur.

J. R. Sillern, Inc. v. leVison, 591 S.W.2d 598, 599-600 (Tex. Civ. App.—Eastland 1979, writ ref'd n.r.e.).

The tenant in *Texaco Refining and Marketing, Inc. v. Crown Plaza Group*, 845 S.W.2d 340, 342 (Tex. App.—Houston [1st Dist.] 1992, no writ) elected under the following optional termination clause not to exercise its option to terminate the lease due to a condemnation of a portion of the leased premises that effectively destroyed the use of the balance for its intended use as it wanted to preserve its right to be share in the award for the portion its leasehold interest taken in condemnation:

If, during the term of this lease, a part only of said premises be taken for public use under right of eminent domain, and if the remainder, in the opinion of the lessee, is not suitable for its purpose, lessee, at its option, may cancel and terminate its lease, but if it shall not elect so to do, the monthly rental thereafter to be paid shall be reduced by an amount which bears the same ratio to that herein provided for as the area taken bears to the total area prior to such taking.

The court found that the condemnation took the tenant's interest thereby terminating the lease but tenant's interest was compensable and the award for partial condemnation was to be allocated between landlord and tenant. The court rejected landlord's complaint that the tenant acted in bad faith by continuing to renew the lease even though it was too small to be used as a gas station because, the court said, the tenant had no duty to the landlord to act in good faith in an ordinary commercial contract where there was no special relationship between the parties.

Optional termination on partial taking.

A court upheld tenant's termination of the lease on condemnation of a portion of the common areas of ancillary to the leased premises under the following clause in *Weingarten Realty Investors v. Albertsons, Inc.*, 66 F.Supp. 2d 825, 840 (S. D. Tex. 1999), *aff'd* 234 F.3d 28:

Whether or not any portion of the Leased premises may be taken by ...[an authority having the power of eminent domain], either Landlord or Tenant may nevertheless elect to terminate this Lease or to continue this

Lease in effect in the event any portion of any building in the portion of the Shopping Center outline in green, or more than twenty five percent (25%) of the Common Area of the Shopping Center be taken by such authority.

(3) Mixed termination clause.

A "mixed termination clause" provides for automatic termination in the event the entire leased premises is condemned and optional termination on a partial condemnation.

In *Houghton v. Wholesale Electronic Supply*, 435 S.W.2d 216, 218 (Tex. App.—Waco 1968, writ ref'd n.r.e.) the court upheld tenant's election not to terminate the lease due to a condemnation of a portion of the leased premises that destroyed tenant's use of the leased premises for the purpose for which it was originally leased, but was still useful to tenant for other purposes (condemning authority condemned tenant's building and 55% of the land but tenant wished to use the remaining 45% of the land not condemned to provide a driveway and access to adjoining land owned by tenant):

Condemnation clause:

If the entire premises be taken in Eminent Domain proceedings, then the lease shall terminate. If any taking of less than all the leased premises ... is such as substantially to impair the usefulness of the property for lessee's purposes, then at the lessee's option the lease may be terminated; but if the taking of a portion which does not substantially impair for lessee's purposes, that is, any portion of the area, as for example, any condemnation for a sidewalk or alley way, or if any condemnation of the right to use for some definite or indefinite period shall occur, it is agreed .. that the rights, duties and obligations of the parties hereto under the terms of this instrument shall be modified fairly with such abatement of rent as shall fairly and equitable adjust the rights, duties and obligations of the parties hereto under the changed circumstances...

Use clause:

Lessee is specifically permitted and authorized to use the leased premises for the storage, handling, shipping, display and sale of goods and merchandise (including

without limitation electrical and electronic items) and related activities and for any other lawful business purpose or purposes. Provided, however, anything sated to the contrary notwithstanding, it is expressly understood and agreed that the leased premises shall not be used for any purpose which tends to substantially reduce the value of the leased property.

A different result would have occurred had the condemnation clause provided the lease terminated if tenant's use of the remainder of the premises after condemnation be the same use as the tenant was making of it at the time of the condemnation or to be one of a specified list of uses.

b. Coupling with a clause for rent abatement or partial rent adjustment or partial rent abatement

A corollary provision to the "termination-on-condemnation" clause is to couple it with a "rent abatement clause" or a "partial rent adjustment clause" or "partial rent abatement clause". If the lease provides for termination of the lease on condemnation in order to negate tenant sharing in the condemnation award, the lease should be drafted so as also to address the effect on tenant's obligation to pay rent. Why would a tenant give up its right to share in the condemnation award if it is not released from its obligation to pay rent? If the lease is silent as to rent abatement, the tenant may seek to participate in the condemnation award and argue that its right to share was not terminated as its obligation to pay rent was not expressly abated.

Total taking and total rent abatement.

An example of a coupled clause is

The term hereby granted and all rights of the Lessee hereunder shall immediately cease and terminate, and the Lessee shall not be entitled to any part of any award that may be made for such taking, nor to any damages therefor except that the rent shall be adjusted as of the date of such termination of the Lease.

United States v. Petty Motor Co., 327 U.S. 372, 66 S.Ct. 596, 599, 90 L.Ed. 729 (1946) fn 4; see also *J. R. Sillern, Inc. V. leVison*, 591 S.W.2d 598, 599-600 (Tex. Civ. App.—Eastland 1979, writ ref'd n.r.e.).

Partial taking and partial rent adjustment.

See *County of McLennan v. Shinault*, 302 S.W.2d 728, 730-732 (Tex. Civ. App.—Waco 1957, no writ) addressing the following clause in a case where the lease provided that in the event of partial condemnation, if the remaining portion was still capable of being used for the tenant's purpose, the lease would remain effect

with a reduction in the rental price proportionate to the decreased utility to the land remaining.

See *Texaco Refining and Marketing, Inc. V. Crown Plaza Group*, 845 S.W.2d 340, 342 (Tex. App.—Houston [1st Dist.] 1992, no writ) where the lease provided that in the event of partial condemnation, the tenant held the option to terminate, but the tenant did not exercise its option,

but if it shall not elect so to do, the monthly rental thereafter to be paid shall be reduced by an amount which bears the same ratio to that herein provided for as the area taken bears to the total area prior to such taking.

Also see *Houghton v. Wholesale Electronic Supply*, 435 S.W.2d 216, 218 (Tex. App.—Waco 1968, writ ref'd n.r.e.) where the lease provided for partial rent adjustment as follows:

it is agreed .. that the rights, duties and obligations of the parties hereto under the terms of this instrument shall be modified fairly with such abatement of rent as shall fairly and equitable adjust the rights, duties and obligations of the parties hereto under the changed circumstances...

The court held that where the condemnation left only 45% of the leased premises remaining, the rent was reduced 45% from its original \$450 per month to \$202.68 per month and no appraisal was required.

c. Coupled with a Disclaimer of Claim or Assignment of Claim Clause.

Some termination on condemnation clauses are drafted to additionally include an assignment by tenant to landlord of tenant's rights, if any, to an award as a means of back stopping the termination clause. This is a wise tactic given court's disposition to strictly construe the language of a termination clause as not terminating a tenant's interest. Additionally, an assignment clause may broaden

interpretation of a termination clause to also pickup and assign to landlord tenant's right to compensation for its improvements.

See the following lease language:

United States v. Petty Motor Co., 327 U.S. 372, 66 S.Ct. 596, 599, 90 L.Ed. 729 (1946) fn 4:

the Lessee shall not be entitled to any part of any award that may be made for such taking, nor to any damages therefor...

County of McLennan v. Shinault, 302 S.W.2d 728, 730-732 (Tex. Civ. App.—Waco 1957, no writ)

Lessee shall have no right or interest in the proceeds received by the lessor in such condemnation, for such property taken...

d. "Ownership of Improvements at End of Lease Term" Clauses

A termination of lease clause and an assignment of tenant's interest clause which is silent as to the tenant's right to compensation out of the condemnation award for its tenant improvements has been interpreted as only depriving the tenant of compensation for the value of the leasehold and not as depriving the tenant of compensation for its improvements. 26 AM. JUR. 2d *Eminent Domain* § 265 (1996). The court in *Evans Prescription Pharmacy, Inc. V. County of Ector*, 535 S.W.2d 704, 705 (Tex. Civ. App.—El Paso 1976, writ ref'd) held that the tenant could recover for its fixtures and improvements even though it was not entitled to recover for its leasehold interest (as noted in the discussion above, the lease contained a bare bones termination on condemnation clause merely stating that the lease terminated on condemnation and did not address compensation for tenant's improvements.).

2. Types of Allocation Clauses.

The following are approaches to address compensation for tenant improvements as opposed to remaining silent on the issue.

a. Allocation of Set Amount to Tenant or Establishing a Method of Valuation of Tenant's Interest in Tenant's Improvements

b. Assign Rights to Improvement Value to Landlord

Ervay, Inc. V. Wood, 373 S.W.2d 380, 382 (Tex. Civ. App.—Dallas 1963, writ ref'd n. r. e):

It is expressly understood and agreed that any and all damage and payment awarded or collected for such taking of the property for any public purpose shall belong to and be the property of the Lessor, whether such damage be awarded as compensation for diminution in value to the leasehold or to the fee of the premises herein leased and Less shall assert no right or claim to any damage as the result of any such taking.

c. Permit Removal of Improvements at End of Lease Term due to Condemnation

The termination clause in *Ervay, Inc. V. Wood*, 373 S.W.2d 380, 382 (Tex. Civ. App.—Dallas 1963, writ ref'd n. r. e) went on to state that tenant was entitled to remove its improvements from the leased premises in the event of condemnation. Also see *Fort Worth Concrete Co.*, 416 S.W.2d 518, 520, 522-523 (Tex. Civ. App.—Fort Worth 1967, writ ref'd n.r.e.).

d. State Landlord Owns Leasehold Improvements at End of Lease Term

If the lease provides that landlord owns tenant's leasehold improvements at the end of the lease and contains a termination on condemnation clause, then tenant has no compensable interest for its improvements on condemnation, even if it owns the improvements during the lease term.

e. Better to Recognize Tenant's Right to Improvement Value as Opposed to Being Silent

County of McLennan v. Shinault, 302 S.W.2d 728, 730-732 (Tex. Civ. App.—Waco 1957, no writ), the court held that tenant was bound to the measure of damages awarded in the condemnation proceeding, because the lease clause addressed such matter:

no right or interest in the proceeds received by the lessor in such condemnation, for such property taken ... However, in the event any of the demised premises shall be taken as hereinabove mentioned and proceeds received for the removal of improvements thereon, or damages to such improvements, then and in that event such amount or amounts received as damages or for the removal of property shall belong to the lessee and paid directly to him.

3. Protecting Tenant's Lender.

Tenant's lender may require that landlord assign to tenant's lender all or a portion of the condemnation award attributable to tenant's interest under the lease as if the tenant's interest had not been terminated by the landlord required termination of lease clause which also is coupled with an assignment to landlord of tenant's right to compensation for tenant's improvements.

THE BASIC PRINCIPLES AS APPLIED TO A HYPOTHETICAL

I. HYPOTHETICAL

The forms attached to this Article beginning on page 25 have been completed to address the following hypothetical. The Office Lease (**Form A2**) is the standard form TEXAS REAL ESTATE FORMS MANUAL Office Lease Form 11-3 with **Form 11-34** Insurance Addendum and **Form 11-35** Tenant Improvements Rider to Lease or Work Letter attached.

DeBaker & Coolidge, L.L.P. (“**Tenant**”) desires to lease a medical office suite (the “**Leased Premises**”) in a multi-tenant medical office building known as “Fannin Center” (the “**Office Building**”) from Crescent Real Estate, L.P. (“**Landlord**” or the “**Building Owner**”). The Office Building has been completed and is occupied by other tenants. The Leased Premises is an entire floor in the Office Building. The Leased Premises are approximately 20,000 square feet (Rentable Area). DeBaker & Coolidge, L.L.P. will be a prized tenant to the project. It has been offered a below-market rent as its presence will guarantee that the Building will be filled quickly. If DeBaker & Coolidge, L.L.P. were to seek comparable space in another property, it likely would have to pay rent greatly in excess of the rent at Fannin Center. It has negotiated a significant leasehold advantage at Fannin Center.

The Leased Premises have never been occupied by another tenant, and have not been finished-out, but are basically bare concrete shell space enclosed by exterior walls of the Office Building.

The Office Lease provides for the Tenant to build out the improvements to the Leased Premises, including certain improvements that would be considered Common Areas improvements, if located on other floors of the Office Building (for example, the bathrooms, HVAC handlers, and certain partitioning).

The Landlord is funding a tenant allowance of \$30 per square foot (\$600,000) to cover “building standard” improvements to the floor. The balance of the cost of the Tenant Improvements (\$400,000 in upgrades a.k.a. betterments) will be paid for by Tenant.

Tenant has hired Joe AIA (“**Tenant’s Architect**”) to design and supervise the Tenant Improvements. Tenant has also hired ABC Construction, Inc. (“**Tenant’s Contractor**”) to construct the Tenant Improvements. Landlord has required Tenant to coordinate the construction of the Tenant Improvements with Constructors, Inc., the building contractor (“**Building Contractor**”) and its architects and engineers, including the Building Design Architect (“**Landlord’s Architect**”) and the HVAC engineer for the Office Building (“**Office Building HVAC Contractor**”). Tenant’s construction activities will have to be coordinated with various other contractors of the Landlord providing on-going operational services at the Office Building, including the management service (“**Project Manager**”), the security guard service (“**Security Contractor**”) and the parking garage contractor (“**Parking Garage Operator**”).

Landlord has tendered to Tenant to review Landlord’s standard Office Lease (**Form A2**) and assures Tenant that it should have no problem complying with the requirements of the Office Lease and that since this is a standard deal, very little lawyer time should be involved. After all it is the State Bar’s Office Lease form.

The Office Lease provides that Tenant, Drs. DeBaker and Coolidge (the “**Tenant’s Principals**”), and the Tenant’s Contractor are to indemnify Landlord and certain “**Landlord-Related Persons**” (the Project Manager, the Office Building Architect, the Building Contractor, the Office Building HVAC Contractor, the Security Contractor, the Parking Garage Contractor, and Landlord’s Lender) from injuries occurring during construction and thereafter during the tenancy. The Office Lease contains provisions addressing property insurance covering the Tenant Improvements during construction and after their completion during the Lease Term. The Office Lease also requires Tenant to obtain Payment and Performance Bonds covering the construction of the Tenant Improvements.

(Form A2 - Office Lease ¶ A 15):

“**Tenant agrees to** – INDEMNIFY, DEFEND, AND HOLD LANDLORD HARMLESS FROM ANY INJURY (AND ANY RESULTING OR RELATED CLAIM, ACTION, LOSS, LIABILITY, OR REASONABLE EXPENSE, INCLUDING ATTORNEY’S FEES AND OTHER FEES AND COURT AND OTHER COSTS) OCCURRING IN ANY PORTION OF THE PREMISES. **THE INDEMNITY CONTAINED IN THIS PARAGRAPH (A) IS INDEPENDENT OF TENANT’S INSURANCE, (B) WILL NOT BE LIMITED BY COMPARATIVE NEGLIGENCE STATUTES OR DAMAGES PAID UNDER THE WORKERS’ COMPENSATION Act OR SIMILAR EMPLOYEE BENEFIT ACTS, (C) WILL SURVIVE THE END OF THE TERM, AND (D) WILL APPLY EVEN IF AN INJURY IS CAUSED IN WHOLE OR IN PART BY THE ORDINARY NEGLIGENCE OR STRICT LIABILITY OF LANDLORD BUT WILL NOT APPLY TO THE EXTENT AN INJURY IS CAUSED BY THE GROSS NEGLIGENCE OR WILLFUL MISCONDUCT OF LANDLORD.**”

(Form A2 - Office Lease - Insurance Addendum ¶ A 1, A 2 and B):**A. Tenant agrees to –**

1. Maintain the property and/or liability insurance policies required below and such other insurance coverages an/or higher policy limits as may be required by Lienholder during the Term and any period before or after the Term when Tenant is present on the Premises: *Liability Insurance Policies* Commercial general liability (occurrence basis) Per occurrence: \$5,000,000, Aggregate: \$5,000,000. *Property Insurance Policies* Causes of loss– special form 100 percent of replacement cost of (a) all items included in the definition of Tenant’s Rebuilding Obligations and (b) all of Tenant’s furniture, fixtures, equipment, and other business personal property located in the Premises ...
2. Comply with the following additional insurance requirements:
 - a. The commercial general liability ... must be endorsed to name Landlord and Lienholder as “additional insureds” and must not be endorsed to exclude the sole negligence of Landlord or Lienholder from the definition of “insured contract.”
 - b. Additional insured endorsements must not exclude coverage for the sole or contributory ordinary negligence of Landlord or Lienholder.

- B. Landlord agrees to** maintain the property and/or liability insurance policies required below during the Term: Commercial general liability (occurrence basis or occurrence: \$5,000,000, Aggregate: \$5,000,000. Causes of loss–special form property 100 percent of replacement cost of the Building exclusive of foundation, footings, infrastructure, sitework, and the rebuilding requirement of all lessees.

Tenant asks you to review the indemnity and insurance provisions of the Office Lease and to assure it that it is “standard and not a problem.”

Tenant’s Architect has prepared and delivered to you a Construction Contract for the Tenant Improvements. You take comfort from the detailed indemnity and insurance provisions contained in the AIA form. You notice, however, that –

The AIA form identifies your tenant client as the “Owner.”

The form provides that the Owner is to purchase and carry the “*Owner’s usual liability insurance.*” (AIA A201 ¶11.2.1).

The Contractor is to purchase “such insurance as will protect the Contractor from claims which may arise out of or result from the Contractors operations” (AIA A201 ¶11.1.1) and that the “Owner may require the Contractor to purchase and maintain Project Management

Protective Liability insurance from the Contractor's usual sources as primary coverage for the Owner's, Contractor's and Architect's vicarious liability for construction operations under the Contract." (AIA A201 ¶11.3.1). Further "the Owner (is to) reimburse the Contractor" for such insurance. (AIA A201 ¶11.3.1).

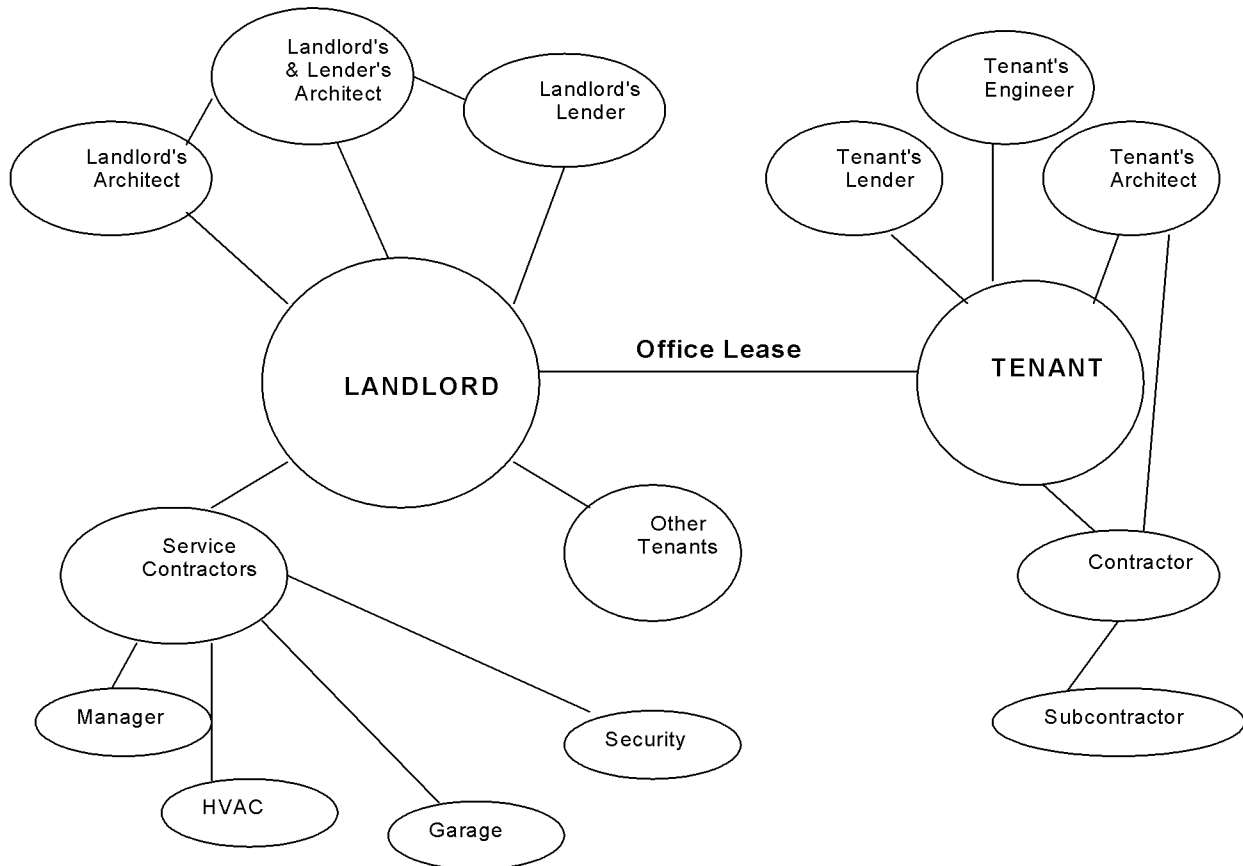
You note that the Contract provides that the "Owner shall not require the Contractor to include the Owner, Architect or other persons or entities as additional insureds...." (AIA A201 ¶11.3.3).

You further note that the Contract provides that "the Owner shall purchase and maintain ... property insurance written on a builder's risk 'all-risk' or equivalent policy form" and that "this insurance shall include interests of the Owner, the Contractor, Subcontractors and Sub-subcontractors in the project." (AIA A201 ¶11.4.1).

You wonder if these provisions are consistent with the Office Lease.

The parties involved in this hypothetical have been requested to have their respective insurance agents issue Certificates of Insurance reflecting the contracted-for coverages. (Office Lease ¶A 2c; Construction Contract AIA A201 ¶11.1.3).

You make a sketch of the various parties involved.



II. FORMS

	Page No
A1. Texas Real Estate Forms Manual Ch. 11 Leases - Manual's Commentary on Risk Allocations.....	24
A2. Forms Manual Form 11-3 Office Lease.....	26
A3. Forms Manual Form 11-35 Tenant Improvements Rider to Lease or Work Letter.....	31
A4. Forms Manual Form 11-34 Insurance Addendum to Lease	32
A5. Supplement to Insurance Addendum to Lease	35, 42
B. Office Lease - Tenant's Certificates of Liability and Property Insurance	46, 49
C. Office Lease - Landlord's Certificates of Liability and Property Insurance	53, 55
D. Tenant's Contractor's Certificates of Liability and Property Insurance	59
E. Endorsement to Tenant's Insurance Policy Making Landlord Additional Insured: CGL Endorsement - CG 20 11 01 96 Additional Insured—Managers or Lessors of Premises.....	67
F. Endorsement to Landlord's Insurance Making Tenant Additional Insured: CGL Endorsement - CG 20 26 07 04 Additional Insured—Designated Person or Organization.....	73
G. Endorsement to Contractor's Insurance Policy Making Tenant and Landlord Additional Insureds: CGL Endorsement - CG 20 10 07 04 Additional Insured – Owners, Lessees or Contractors – Scheduled Person or Organization	77
H. CGL Waiver of Subrogation Endorsement - CG 24 04 10 92 Waiver of Transfer of Rights or Recovery Against Others To Us	79
I. Endorsement to Tenant's Business Auto Policy Making Landlord Additional Insured: TE 99 01B (BAP Texas) Additional Insured	80
J. Endorsement to Tenant's Business Auto Policy Waiving Insurer's Subrogation Rights As to Claims Against Landlord: TE 20 46A (BAP Texas) Changes In Transfer Of Rights Of Recovery Against Others To Us (Waiver Of Subrogation)	82
K. Endorsement to Tenant's Workers Compensation Policy Waiving Insurer's Subrogation Rights As to Claims Against Landlord: WC 42 03 04 A Workers Compensation And Employers Liability Insurance Policy	84

Appendix A1**Texas Real Estate Forms Manual Ch. 11 Leases and
Ch. 18 Risk Allocation: Indemnity, Waiver, and Insurance**

The following is a quoted portion of the commentary in chapters 11 Leases and 18 Risk Allocation of the *Texas Real Estate Forms Manual* concerning the risk allocation provisions contained in the 8 forms of lease contained in the manual: Manual Form 11-1 Lease [Basic], Manual Form 11-2 Retail Lease, Manual Form 11-3 Office Lease, Manual Form 11-5 Residential Lease, Manual Form 11-6 Industrial Lease, Form 11-7 Hunting Lease, Manual Form 11-8 Agricultural Lease and Manual Form 11-9 Grazing Lease, the form of insurance addendum, Manual Form 11-34 Insurance Addendum to Lease, and the tenant improvement construction addendum, Manual Form 11-25 Tenant Improvements Rider to Lease or Work Letter.

Ch. 8 Leases**§ 11.1:4 Cautions: Risk Allocation**

Indemnities and Waivers: The indemnity provision of the multitenant building or project lease forms are designed to protect the respective parties from their own ordinary negligence (but not gross negligence or willful misconduct) on a geographic basis; that is, the tenant indemnifies the landlord for any damage or injury occurring within the premises, whether or not the ordinary negligence of the landlord is a cause of the damage or injury, and the landlord indemnifies the tenant for any damage or injury occurring within the common areas, whether or not the ordinary negligence of the tenant is a cause of the damage or injury. The waiver of subrogation provision contained in the multitenant building or project lease from releases both parties from liability for property damage and loss of revenues up to the limits of the property insurance coverages required to be carried under the lease, notwithstanding the ordinary negligence of the party causing the property damage or loss of revenues. The indemnity and waiver provisions are designed to comply with the two-pronged “fair notice doctrine” under Texas case law: (1) the “express negligence rule” set forth in *Ethyl Corp. v. Daniel Construction Co.*, 725 S.W.2d 705 (Tex. 1987), and (2) the “conspicuousness rule” enunciated in *Dresser Industries, Inc. V. Page petroleum, Inc.*, 853 S.W.2d 505 (Tex. 1993).

Insurance: The indemnity and casualty provisions of the lease are designed to mirror the insurance coverages required of landlord and tenant under the lease. Thus, it is critical that the parties consult with their insurance professionals to determine the exact insurance coverages to be included on the insurance addendum incorporated into the lease form or, if applicable, the separate insurance addendum (Manual Form 11-34) and that the attorneys tailor the indemnity and casualty provisions in response to the actual insurance policies that will be carried by the parties.

Rebuilding Obligations: The restoration obligations of the parties after a casualty are tied to the description of “Tenant’s Rebuilding Obligations” contained in the Basic Terms of the lease. The tenant is expected to restore those leasehold improvements described in “Tenant’s Rebuilding Obligations” in addition to replacing its personal property (including inventory, furniture, trade fixtures, and equipment). Because the tenant should carry property insurance to cover its restoration obligations, a detailed description is imperative. See clauses 11-10-9, 11-10-10, and 11-10-11 in Manual Form 11-10 in this chapter. The landlord’s restoration obligations are defined in terms of the portions of the premises that the tenant is not required to rebuild.

For example, the tenant may be receiving the space in shell condition and be responsible for the initial construction of all leasehold improvements. The parties may decide that the tenant will restore all of the leasehold improvements inside the shall if the premises are destroyed. At the other extreme, the tenant may be receiving the premises with existing leasehold improvements, and the parties may decide that the landlord should restore all leasehold improvements after a casualty. Obviously, the possibilities are infinite and depend on the economic underpinnings of the transaction as well as the relative sophistication of the parties. However, the question must be asked at the outset of the transaction so that both parties are clear about the allocation of the risk for restoration and that adequate property insurance is obtained.

**Ch. 18 Risk Allocation: Indemnity, Waiver,
and Insurance****§ 18.5:3 Additional Insured
Endorsement Forms**

Additional insured forms contain a granting clause stating that the party listed in the endorsement is to be included as an insured under the policy followed by restrictions introduced by the phrase “but only with respect to.” Additional insured endorsements do not cover partners, employees, agents, and other parties related to the party named as additional insured unless language to that effect is added. Many additional endorsements explicitly or by implication exclude coverage for the sole or contributory negligence of the additional insured. Hence, the type of additional insured endorsement to be used must be stipulated by name, form number, and date or, at a minimum described in terms of the desired coverage. The additional insured endorsements discussed below are standard forms promulgated by Insurance Services Office, Inc....

