

Winning Compromises: Pass Through Your Insurance Deductibles—But Set Limits

Issue to Negotiate

Every insurance policy you buy for your building or center—such as boiler and machinery insurance or liability insurance—is likely to have a deductible. So, when damage covered by the policy occurs and you file a claim, you won't get reimbursed for the amount of the deductible. In this situation, should you be able to pass through the amount of the deductible to your tenants as an operating expense or CAM cost?

Owner's View

Ideally, you'll want to pass through as much of your insurance costs as possible to your tenants. Since your insurance premiums are passed through, there's no reason for the deductible not to be passed through, too.

Tenant's View

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

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

Compromise: Pass Through Reasonable Amount Only

There's a way you can ease the tenant's fear of being unexpectedly hit with a big expense, while still getting the right to pass through the deductible to your tenants, says Susan Fowler McNally, a partner in the Santa Monica, Calif., law firm of Gilchrist & Rutter. In the lease, exclude from operating expenses or CAM costs any part of the insurance deductible in connection with a capital improvement that's above a "reasonable" amount for that type of insurance.

Example: You buy boiler and machinery insurance for the building with a deductible of \$750. But several insurance brokers say that a reasonable deductible for this size and type of insurance is only \$500. If the insurance is triggered because you must install a new boiler (a capital improvement) and you must pay the deductible, you can pass through only \$500. You must absorb the remaining \$250 (\$750 – \$500).

Set Up Compromise in Lease

To set up this compromise, add the following language to the lease clause in which you list exclusions to operating expenses (or CAM costs):

Model Lease Language

Insurance deductible amounts incurred by Landlord in connection with the repair or replacement of a capital improvement in excess of reasonable and customary deductible amounts.

A tenant will generally agree in concept to this compromise, says McNally. But it may question the "reasonable" standard as too ambiguous to be a good gauge. The tenant may prefer to set a specific dollar amount in the lease for each type of insurance. For example, says McNally, the lease will say that you can't pass through any boiler and machinery insurance deductible over \$500 in any calendar year.

This is a fair point. But make sure you research the amounts before setting them. Ask several insurance brokers what deductible is reasonable for each type of insurance. And remember, if you're signing a long-term lease, the amounts of reasonable deductibles are likely to change over time, McNally says. If they increase, you'll be stuck with an unreasonably low deductible, she warns, or you may no longer be able to buy insurance because it's not available with such a low deductible. So make sure the lease lets you pass through at least the lowest insurance deductible amount you can get from a reputable insurance carrier licensed to do business in the state where the building is located.

PRACTICAL POINTER: Also, if the deductible is very high, but it's the only insurance available—such as earthquake insurance, which typically has a very high deductible—you may want to agree to amortize the deduction over the useful life of the repaired or replaced capital improvement, McNally suggests. ▲

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