ThirtyNine
ESSEX STREET

COMMERCIAL LEASES & SUBROGATED INSURANCE RECOVERY CLAIMS

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INTRODUCTION

1 I am very pleased to have the opportunity to take part in this series of seminars for Greenwoods presented by 39 Essex Street and to address you this morning on the interpretation of commercial leases and subrogated insurance recovery claims.

2 This presentation will focus on the interpretation of standard insurance clauses found in commercial leases and their impact on subrogated property insurance recovery claims, in particular fire and flood claims brought in the name of commercial landlords against their tenants.

3 This short paper accompanies a set of slides and both are available in hard copy and electronically. I have consciously avoided regular reference to legal authority as, first, the purpose of this talk is to alert you to issues commonly arising in subrogated property insurance claims and, second, the outcome in each case necessarily depends on a careful reading and interpretation of the insurance policy and commercial lease in question.

SOME BASICS

Subrogation

4 Subrogated insurance recovery claims are a product of the principles of indemnity insurance.

5 A right of subrogation is given to insurers in two ways:

(1) by operation of law – to prevent:

- the insured from recovering more than a full indemnity and
- the defendant from shifting the burden of paying the insured loss onto the insurer;

(2) by contractual right under the policy – a subrogation clause entitling the insurer to acquire the insured's subsisting rights of action after payment under the policy.

6 The general law does not give an insurer the right to bring subrogated proceedings in the name of the insured until after the insured has been fully indemnified in accordance with the terms of the policy.

7 A subrogation clause may, and typically does, give the insurer subrogation rights "before or after" payment under the policy.

8 It is therefore important to check when in any particular case the insurer client's right of recovery arises before issuing a subrogated insurance claim.

9 An insurer acquires its insured's subsisting rights of action via subrogation only where:

(1) the insurer has agreed to indemnify the insured for a loss;
(2) the insured has been fully indemnified in accordance with the policy terms[1] and
(3) the exercise of the insured's right against the defendant would diminish the loss for which he has been indemnified.

10 A subrogated claim is made in the name of the insured and is subject to the defences the defendant has against that party. In claims involving commercial leases this rule includes the contractual right, if any, of the defendant to refer the dispute to arbitration.

Commercial leases

11 A commercial lease may be defined as the grant by the landlord to the tenant of exclusive possession of land for a term less than that which the landlord has in the land[2].

12 A contractual licence permits the licensee to occupy and use land but does not grant exclusive possession for the term.

13 Under a commercial lease the obligation to insure may be on the landlord or the tenant. In most cases, the obligation is taken by the landlord whose commercial interest in the premises is greater than the tenant's. In addition, where there are a number of leases in the same freehold title, the landlord is able ensure that all units, and common parts, are properly insured with reputable insurers.

[1] See *Lord Napier & Ettrick v Hunter* [1993] A.C. 713
[2] 27 Hals 1

GENERAL PRINCIPLES OF CONTRACTUAL INTERPRETATION

14 A commercial lease creates an interest in land but retains its contractual characteristics.

15 There is reported judicial guidance on many standard clauses in commercial leases, often dating back many years. One should therefore be cautious before coming to a conclusion on the proper interpretation of a clause without a search for and reference to legal authority, if that is available.

16 However, as a commercial contract, the interpretation of a lease is, where not covered by authority, a process to be guided and informed by the following general principles set out by Lord Hoffman in ICS *v West Bromwich Building Soc. Ltd*[3], who talked of "contractual documents":

> (1) Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.
>
> (2) The background was famously referred to by Lord Wilberforce as the "matrix of fact," but this phrase is, if anything, an understated description of what the background may include. Subject to the requirement that it should have been reasonably available to the parties and to the exception to be mentioned next, it includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man.
>
> (3) The law excludes from the admissible background the previous negotiations of the parties and their declarations of subjective intent. They are admissible only in an action for rectification. The law makes this distinction for reasons of practical policy and, in this respect only, legal interpretation differs from the way we would interpret utterances in ordinary life. The boundaries of this exception are in some respects unclear. But this is not the occasion on which to explore them.
>
> (4) The meaning which a document (or any other utterance) would convey to a reasonable man is not the same thing as the meaning of its words. The meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean. The background may not merely enable the reasonable man to

[3] [1998] 1 WLR 896

choose between the possible meanings of words which are ambiguous but even (as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words or syntax: see *Mannai Investments Co. Ltd. v. Eagle Star Life Assurance Co. Ltd.* [1997] A.C. 749.

(5) The "rule" that words should be given their "natural and ordinary meaning" reflects the common sense proposition that we do not easily accept that people have made linguistic mistakes, particularly in formal documents. On the other hand, if one would nevertheless conclude from the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had. Lord Diplock made this point more vigorously when he said in *Antaios Compania Naviera S.A. v. Salen Rederierna A.B.* [1985] A.C. 191, 201:

> "if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business commonsense, it must be made to yield to business commonsense."

INSURANCE CLAUSES

17 Commercial leases typically contain clauses addressing numerous issues arising from the relationship of landlord and tenant; e.g. payment of rent, quiet enjoyment of the premises, assignment, sub-letting and repairing obligations during and on determination of the term. This paper focuses only on insurance clauses.

18 In most cases, insurance cover will be obtained by the landlord but paid for by the tenant, as part of the rental or, more usually, as an additional insurance rental or charge.

19 The tenant will be under an obligation not to do, or omit from doing, anything that would cause the landlord's insurance policy to be vitiated or render irrecoverable the whole or any part of the insurance moneys. A typical clause for the benefit of the landlord is a "non-invalidation" clause which provides that an act or omission on the part of the tenant of which the landlord is unaware shall not invalidate the insurance cover[4].

[4] E.g.: "*This insurance will not be invalidated by any act or omission in respect of any portion of the premises not occupied by the Insured .... or any alteration ... unknown to or beyond the control of the*

20 A typical arrangement, and the clauses covering the position in a recent subrogated property insurance damage case on which I advised for Greenwoods, reads as follows:

"The Landlord covenants and agrees with the Tenant:
(1)
(a) To insure the building, and all additions to it, under a policy which satisfies the conditions set out below:

(b) The conditions with which an insurance policy must comply are:

(i) Cover is provided against the following risks ("insured risks"), so far as that cover is generally available for that type of building:

fire, lightning, explosion, earthquake, landslip, subsidence, heave, riot, civil commotion, aircraft, aerial devices, storm, flood, impact by vehicles and damage by malicious persons and vandals

and other risks which the Landlord from time to time reasonably considers should be covered.

(ii) The sum insured is at least the full rebuilding cost of the building, and any additions to it which should be insured, plus an appropriate percentage for professional fees and three years' loss of rent

(iii) The policy is issued by a reputable insurance office or at Lloyd's.

(2)
To show the Tenant on demand the insurance policy covering the property and the receipt for the last premium, or evidence from the insurers of the terms of the policy and that it is in force. This obligation need only be performed once in any year, unless part of the property suffers damage which may result in a claim under the Policy. In addition, to give the Tenant a copy of every endorsement varying the terms of the policy.

Insured provided that the Insured immediately they become aware thereof shall give notice to the Insurers and pay an additional premium if required."

(3)

(a) UNLESS the next subclause applies, to claim promptly all sums which are or may be payable under any insurance policy arranged by the Landlord as required by this lease, and to use all sums received promptly in rebuilding or repairing any damage, holding the insurance proceeds until used in trust for the Landlord and Tenant and anyone else interested in the proceeds.

(b) If a start on rebuilding or repair is not possible within three years after damage caused by an insured risk

(i) to divide all insurance proceeds (other than from loss of rent insurance) between the Landlord and Tenant and anyone else interested in the proceeds, in the ratio of the open market values of their interests in the property immediately before the damage occurred. Any dispute as to the amount payable is to be referred to arbitration

(ii) this lease, if still current, automatically ends."

The Tenant shall pay to the Landlord, yearly and proportionately for any part of a year.

(a) the Rent .....

(b) by way of additional rent on demand

(i) the gross amount of all premiums and other expenses incurred by the Landlord in respect of the Insurance ..... (or if such premiums and expenses shall also relate to the insurance of other premises a Due Proportion thereof) ....

(ii) any amount deducted or disallowed by way of excess on the Insurance if a claim is made."

(c) (Subject to the insurance obligations contained [in this lease] to keep the Premises in good and substantial repair and condition."

ISSUES ARISING

21 A number of issues regularly occur from these insurance arrangements which affect subrogated insurance recovery claims.

Subrogation waiver clause

22 A party to a lease may agree to exclude the right to sue the other directly or in its name by subrogation.

23 This is unusual in a landlord and tenant situation but is common in contractors' all risks policies. It remains a point to be routinely checked before starting a

subrogated insurance recovery action. The result is achieved by operation of law if the tenant is named as co-insured with the landlord.

Co-insurance clause

24 An insurer may not bring a subrogated claim against a defendant who is found on construction of the policy to be a co-insured.

25 The basis for this rule is said to be that, where an insured agrees to effect insurance for a defendant, he impliedly also agrees to exempt the defendant from liability for causing an insured loss, with the result that neither he, nor the subrogated insurer acting through him, can sue the defendant for such a loss[5].

26 It is unusual for a landlord and tenant to be co-insured under a liability insurance policy but this is again a point to be checked before starting a subrogated insurance recovery action.

Benefit of insurance clause

27 An insurer may not bring subrogated proceedings against a defendant where the insured has previously agreed, expressly or by implication, with the defendant that the insurance shall "enure to the defendant's benefit".

28 An express clause is unusual in a landlord and tenant situation but may be incorporated as part of the insuring clause. It is a further point to be checked before starting a subrogated insurance recovery action.

29 Of far greater significance is the situation where the insuring arrangement under the lease may be interpreted as leading to that result by implication.

30 This is a real issue in situations involving commercial landlord and tenant claims[6]. It has become known as the *Berni Inns* principle after the leading decision in *Mark Rowlands v Berni Inns Ltd*[7].

[5] *Co-operative Retail Services Ltd v Taylor Young Partnership* [2002] UKHL 17

[6] Other common instances are in construction contracts (*Emden's Construction Law* Chap 3, §722 and e.g. *Scottish & Newcastle plc v GD Construction (St Albans) Ltd* [2003] EWCA Civ. 16) and under mortgage indemnity guarantees.

[7] [1986] 1 QB 211

31 If applicable, the principle prevents a subrogated insurance recovery claim against a commercial tenant where insurers have indemnified the freeholder for loss and damage at the demised premises caused by the negligence or other fault of the tenant, typically by fire or flood. The application of the principle depends on the interpretation of the lease.

The Berni Inn

32 The Berni Inn was a feature of the British High Street in the 1960s and 1970s. The brand has now been abandoned. An online obituary on Wikipedia describes a typical menu as follows:

Starters:	Melon boat with maraschino cherry or prawn cocktail
Main courses:	Steak, gammon steak or plaice – all with chips and peas
Deserts:	Black forest gateau, Irish coffee and After Eight mints

The facts in brief

33 A building in Leeds housing a Berni Inn in its basement was damaged by fire caused by the negligence of the tenant. The landlord's fire insurers sought to recover damages from the tenant by subrogation.

34 The insurance clauses of the lease were similar to those set out in paragraph 20 above, in particular:

(1) the landlord was obliged to insure the whole building against fire;

(2) the tenant contributed to the cost of this insurance;

(3) the tenant was relieved of its repairing obligations in the event of damage to the building by fire;

(4) the landlord was obliged to use the insurance monies to rebuild the demised premises.

The decision

35 The court held that in those circumstances the proper interpretation of the lease was that the fire insurance taken out by the landlord should enure for the tenant's benefit. It followed that the subrogated insurance recovery claim by the landlord's insurers against the tenant failed.

A question of interpreting the lease

36 The *Berni Inns* decision does not mean that all the features listed in paragraph 34 must be present to defeat the subrogated claim. They are however relevant considerations in deciding the question of whether the insurance should enure for the benefit of the tenant.

37 A bare covenant to insure by the landlord, without more, will not found an inference that the landlord has agreed to waive a claim against the tenant[8]. Where the lease does not oblige the landlord to insure at all, there would be no reason to exclude a right of subrogation.

SUMMARY

38 The first step is to take care to obtain copies of and read the relevant insurance policy and commercial lease.

39 The second step is to establish whether there are any express clauses which prevent a subrogated recovery action; e.g. subrogation waiver or co-insurance.

40 The third stage is to consider all the terms of the lease and assess whether the proposed subrogated recovery claim is affected by the proper construction of those terms, express and implied; i.e. will the lease, properly interpreted, lead the court to find that the insurance enured for the benefit of the defendant as well as the insured?

FURTHER READING

41 Two useful resources covering this topic are *Subrogation Law & Practice* by Mitchell and Watterson [OUP] 2007 and *Ross on Commercial Leases* 5th Ed (loose-leaf).

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[8] *Lambert v Keymood Ltd* [1997] 2 EGLR 70