

PROTECTIVE SAFEGUARDS ENDORSEMENT

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We have been writing about insurance issues for many years, and Chuck has been teaching real estate insurance law to attorneys for over 20 years throughout the country. Nothing ever surprises his audiences more than a discussion about the Protective Safeguards Endorsement (PSE) provision contained in most commercial property insurance policies. The PSE is only a page or two long, stuck in the back of your policy, and is added primarily to save you, the property owner, on the cost of your insurance premiums by, of course, reducing the risk to the insurance company. (Remember, you wanted the cheapest premium!). It's not a bad endorsement, per se, but your failure to comply with it, or to prevent your tenants from violating it, could completely wipe out your fire insurance coverage.

The term "Protective Safeguards Endorsement" sounds like something very favorable to the property owner. Wow, it's "protective" and it's a "safeguard." It must be great! Nothing could be further from the truth. A PSE basically reads that: "You have to do A, B and C, and you can't do X, Y and Z, and, if you don't or you do, we will not pay for any fire loss under the policy." Simple then, just do A, B and C, and don't do X, Y and Z, and then there's no problem! Unfortunately, even if the insurance broker pointed out these items to the owner when he/she purchased the policy, maybe the property owner never told the property manager, never put a corresponding provision in the tenant's lease, and, even if it is in the tenant's lease, never monitored the tenant's compliance.

This is not two attorneys "Crying Wolf" to get your attention. There are literally dozens of court cases completely denying fire insurance coverage because the property owner failed to comply with the PSE. Here are the most common examples of PSEs requiring that, in order for fire insurance to be paid, the following systems be installed, maintained and operating in order for your fire insurance coverage to remain in effect:

An automatic sprinkler system

A fire alarm system

A security service

A cooking exhaust and extinguishing system

Any other unique provision inserted in relation to the specific property and its use (such as periodic cleaning of a duct system)

Here are few examples of insurance coverage being completely denied in a fire:

The Restaurant Tenant. Your retail lease requires your tenant, Lotsa Fries, to maintain the cooking and exhaust system in its restaurant in your shopping center. Lotsa Fries never enters into a maintenance contract on the exhaust system (he's a "do-it-yourselfer"), and you don't check up on it. Your property insurance policy has a PSE requiring a maintenance contract for the exhaust system. A grease fire starts, burns down part of your shopping center. No fire coverage!! You have a breach of contract action against Lotsa Fries, who now owns only some incinerated restaurant equipment! Good luck! Oh, that's right, you are named as an additional insured on Lotsa Fries' liability insurance policy. Maybe you can go after the tenant's liability insurance policy! Yes, but sorry, Lotsa Fries' "fire legal liability" insurance coverage is limited to \$50,000 and your fire loss was \$500,000!

The NYSE Tenant. Medium Box, a major NYSE tenant, leases your 20,000 square-foot space in Owner Town Shopping Center for 20 years. That space has been empty for three years, and you are the happiest landlord in town. Give that tenant anything it wants, and my attorney had better not screw it up worrying about the "boilerplate." Medium Box wants the right under its lease to modify its tenant improvements at any time without the landlord's approval or even notification. That's fine, it's Medium Box and it is a really big company! Medium Box just needs to return the space back to its original condition at the end of the lease. Landlord, of course, continues to insure Owner Town, including the Medium Box space, for fire. In Lease Year 4, the store next to Medium Box catches fire and there is a major loss, including Medium Box. The fire investigators find that Medium Box, during one of its authorized modifications, added and moved some walls, which prevented the fire sprinkler system from extinguishing the fire as the system was designed. Your PSE requires you to maintain a properly operating sprinkler system.

The tenant didn't breach the lease (you allowed it to make any modifications it wanted), but you have no fire insurance. Maybe it wasn't such a good idea to let Medium Box do whatever it wanted in your building after all.

The Industrial Building. Tugg Shacks owns a building in which it builds small outdoor buildings for homeowners and for House Depot to sell to its customers. Tugg Shacks creates a lot of sawdust. The PSE requires Tugg Shacks to maintain a clean ventilation system so the sawdust doesn't collect and catch fire. The owner of Tugg Shacks (who apparently also owns Lotsa Fries) is a "do-it-yourselfer" who will maintain the ventilation on his own, but is a really busy guy. A fire starts in the dirty ventilation system, and Tugg Shacks burns to the ground. Sorry, Tugg Shacks, you have no fire insurance.

The Fire Sprinkler Shut-Off. During a remodel, the manager of Owner Town (this poor center has a lot of losses!) had to shut off the fire sprinkler system for two days while some pipes were moved to service a new store. A fire occurs. The Manager didn't notify the insurance company in advance to obtain the required steps necessary to keep the fire insurance in force during the shutdown. The PSE required the sprinkler system be operational. Even though the system was only shut down for two days for the remodel (same applies to maintenance), there is no fire insurance coverage. The insurance company's assessment of the risk of a fire (and thus the policy premium) was calculated on the assumption that the fire sprinkler system was installed, maintained and operational.

The foregoing examples are real and frightening. While every policy, endorsement and situation is different, property owners, managers and tenants must take precautions to protect themselves against an uninsured fire loss as a result of failing to comply with the requirements of a Protective Safeguards Endorsement.

If you have continued reading this Advisory to this point, you probably don't know if you have a PSE on your property policy. So, here's what you should do:

* First, determine if you have a PSE attached to your property insurance policy. (Just send this Advisory to your insurance broker if you want, asking him/her if you have a PSE attached to your property insurance policy.)

* If you don't, sleep well tonight! For the other 90% of you, review the PSE attached to your policy and determine what provisions are contained in it. (We have a link to a form of PSE below so that you can see what it looks like.)

* Ask your insurance broker the cost to have it removed. If the cost is too high, or you decide not to remove it, continue with the following steps:

A. Let your property managers and maintenance personnel know about the PSE obligations in writing. If you are a property manager, call your owners right now and ask if there are any PSEs attached to their property insurance policies. Also, calendar reviews of the PSE provisions annually when the property insurance policy renews.

B. Make sure you don't make the same mistake as the owner of Owner Town. Don't enter into leases which permit the tenant to make alterations without your approval (not even a \$1,000 wall). And, of course, if they do, require a building permit for anything.

C. Do not turn off any PSE systems (even for maintenance, remodeling or repair) for any period of time without notifying your insurance company and abiding by its requirements (which will most likely be having a fire guard stationed at the property during that period of the shut-down).

D. If you have allowed a tenant to insure your building for fire (definitely not recommended by our law firm), get a copy of that policy's PSE from the tenant's insurance broker (whether PSEs are in existence will not show in the loss payee certificate furnished by the tenant's insurance company).

E. If you are a tenant, especially one with a unique use, and the landlord is insuring the building, you may, during your lease negotiations, want to inquire whether a landlord has a Protective Safeguards Endorsement on its property insurance policies. You may also want to request that the landlord notify you of any changes to the PSE in subsequent renewals of the property insurance policy. Remember, you as the tenant, are paying for that property insurance policy through your common area payments. You may request either that no PSEs be placed in the insurance policy, or that you at least be notified of their existence, so that you have some assurance that the building will be reconstructed in the event of a fire.

Hopefully, the foregoing suggestions will be helpful to you. We acknowledge that other lease

provisions, such as indemnity provisions, may provide relief between the landlord and the financially viable tenant in some of the above examples. However, would you prefer to clarify the problem when you are negotiating the lease initially and during the occupancy, or would you like a really great lawsuit after a fire?

For your convenient reference, attached is an an example Protective Safeguards Endorsement.

If you have questions regarding the Protective Safeguards Endorsement, or how to address this issue in your commercial leases, please contact our Real Estate Transactional Department.