INSURANCE ISSUES AFFECTING GREEN DEVELOPMENT

By Jack Fersko

The benefits of green development have been well publicized and include increased worker productivity, reduced operating costs, improved air and water quality, improved corporate image, and federal and state financial benefits, such as tax credits, accelerated depreciation, grants, and proceeds from the sale of renewable energy certificates. See Charles F. Kenny et al., *Construction and Development*, in *Commercial Real Estate Transactions in New Jersey* 8.66–.72 (Jack Fersko, ed., New Jersey Institute for Continuing Legal Education, 2d ed. 2010). Although much has been written on the topic of sustainable development, the full significance of the question, "what will insurance cover?" is only beginning to be understood.

This article provides a general overview of the myriad issues that need to be considered in the context of green development. It also describes some of the insurance products currently available in the market and offers an insurance clause to consider when crafting a lease for a green-certified building. It is important to underscore that there are more questions than answers concerning insurance and green development. It is also important to note that the insurance issues affecting green development are complex and require the assistance of a skilled insurance professional to ensure that all issues are properly addressed. For example, this author was assisted in the analysis of coverages now being offered, and discussed below, by both Ursula Knowles and Fred Frey of Marsh Insurance.

Developing Green

One of the first considerations in green development is understanding the related undertakings between and among the real estate owner/landlord, the architects, the engineers, the building contractors, and the prospective tenants. If the real estate owner/landlord enters into a lease with a prospective tenant to build and lease a green building, how will liability be distributed among the various parties if the project fails to achieve its stated green threshold—for example, LEED Silver, LEED Gold, or LEED Platinum? (LEED means Leadership in Energy and Environmental Design and is a rating system developed by the U.S. Green Building Council.) Who will be responsible if components of the development fail to function as designed—for example, if there is water infiltration because of an improperly designed green roof? How will liability be distributed if grants or tax credits are lost because the building fails to satisfy the necessary LEED certification threshold or if energy costs are greater than expected because the alternative power-generating equipment does not achieve the expected level of efficiency? In a recent Maryland case, a developer/owner filed a counterclaim against its general contractor, contending that the failure to construct the building to meet LEED Silver status resulted in a loss of a \$635,000 tax credit. Counter-Complaint, *Southern Builders, Inc., v. Shaw Dev., LLC*, No. 19-C-07-011405 (Somerset County, Md., Cir. Ct. Feb. 16, 2007). The case was settled before trial. Because the era of green development is in its infancy, and these issues have not yet been developed through case law, there is no clear answer to these questions. For a good general discussion

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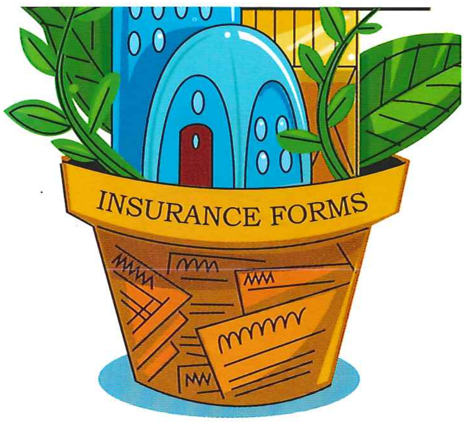
Jack Fersko is a member of the Westfield, New Jersey, law firm of Farer Fersko, a Professional Association. He is group chair of the Section's Leasing Group.

Dave Klug

of the legal theories of liability concerning green building construction, see *Commercial Real Estate Transactions in New Jersey*, supra, at 8.72–8.76. As a result, it is particularly important that a lawyer structuring a green development examine whether any of the risks can be covered through insurance.

Traditional commercial general liability coverage protects against claims relating to bodily injury and property damage. A breach of warranty or similar breach of contract claim, however, is excluded from coverage. See Marilyn



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C. Maloney, Jo-Ann M. Marzullo, Marie A. Moore & Grace H.I. Tate, *Liability and Property Insurance: The Basics and Hot Issues, Including the Insurance Certificate Problem*, 2010 ABA Real Prop., Tr. & Est. L. Sec. Spring Symp. 1–2. Consequently, a contractor that covenants to construct a building that will meet a particular LEED certification will not likely have coverage for a claim arising out of a breach of that covenant.

Professional errors and omissions policies cover a professional for his or her ordinary negligence—measured by a standard of professional skill and care ordinarily provided by a similar professional in the same or similar locality and in the same or similar circumstance. It is unclear, however, whether the risks associated with green development fall outside the scope of ordinary negligence, and therefore outside the scope of coverage of a professional errors and omissions policy. See *Commercial Real Estate Transactions in New Jersey*, supra, at 8.75. In addition, standard errors and omissions policy language excludes a breach of a guarantee or warranty. See Kate Bowers & Leah Cohen, *The Green Building Revolution: Addressing and Managing Legal Risks and Liabilities* 4, 21 (Harvard Law School Environmental Law and Policy Clinic Mar. 10, 2009), available at www.nmhc.org/Content/ServeFile.cfm?FileID=7439 (last visited June 12, 2010); Meredith Dubarry Huston, *Sustainable Building: Anticipate Potential Liability to Manage Risk*, The Legal Intelligencer, June 19, 2008. Also unclear is whether a claim against an architect alleging that, as a LEED accredited professional, the architect is subject to a heightened duty of care not applicable to architects generally, is really a breach of warranty claim—thus falling outside of the scope of a professional errors and omissions policy.

Similarly, what happens if there is a casualty during construction of a green development? Will the additional construction costs entailed in the green nature of the development be a covered loss under a traditional builder's risk policy? Many of the costs associated with green development are likely outside the scope of a traditional builder's risk policy. For example, this policy may not cover construction delays to obtain specialized equipment, added costs attributable to debris recycling rather than landfill disposal, building commissioning expenses, recertification fees, and loss of tax credits.

Some carriers are providing endorsements to their builders' risk policies to address green issues. Fireman's Fund, Zurich, Travelers, and Ace USA are just a few examples of carriers that provide such coverage. Coverage provided by the endorsements can include

- added soft costs associated with green development, such as recycling costs, which may be more expensive than landfill disposal;
- the cost to flush out space with 100% fresh air;
- building commissioning expenses of qualified engineers;
- re-registration fees;
- LEED accredited professional expenses;
- additional expense for using green products; and
- financial losses because of changed standards, loss of earnings from alternative fuel sources (such as the sale of energy back to the grid from solar panel-generated power), and loss of tax credits and other financial incentives.

For a more complete analysis, see Marsh, *The Green Built Environment in the United States: 2008 Year-end Update of the State of the Insurance Market*) 2–8 (2008) [hereinafter *Green Built*], available by request at http://global.marsh.com/news/articles/Green_Building/index.php. It is not clear whether surety bonds will cover any of the risks associated with green development. See id. at 16–17. In addition, and specifically concerning solar panels, an installation floater can provide coverage for loss because of damage to the solar panels during transit, as well as during installation.

Completed Green Buildings

Once a building is completed, a Special Form Property Policy typically will cover the cost to replace the destroyed property with property that is of a "like kind and quality." Many questions and concerns arise, however, in the context of a casualty loss involving a green building. See generally Edward J. Ozog, *Developments in Green Building Insurance*, Prac. Real Est. Law. (Mar. 2010), at 29. What if standards have changed, requiring additional costs to achieve the same LEED certification standard as a previously constructed green building—is there coverage for the added costs? Also, is there coverage for building commissioning expenses, recertification fees, construction delays because of the length of time to obtain green building products, recycling fees, and the loss of income from the loss of alternative energy production during reconstruction?

A number of carriers provide coverage that addresses many of these issues and more, either by way of endorsement to a property casualty policy or through a stand-alone policy. Fireman's Fund, Lexington Insurance Company, Travelers, Ace USA, Affiliated FM, Aon, XL Insurance, Liberty Mutual Property, Zurich, and Chartis Insurance are a few of the carriers that offer this product.

Coverage can address a host of risks; however, it is important to evaluate the coverage carefully to understand its full scope and whether any applicable sub-limits apply to all or particular aspects of the coverage. For example, green buildings usually have sophisticated HVAC, electrical, and plumbing systems. An owner can obtain coverage to pay for a professional commissioning engineer that will oversee a system's reconstruction and commissioning to ensure that the system is properly aligned with all other systems and is properly balanced and thus functioning at its peak level of performance. Some carriers, however, impose a cap or sub-limit on coverage—for example, a limit of $25,000. Other policies provide a lump-sum amount equal to the coverage limits and permit the insured to determine the green components that will be covered by the proceeds during reconstruction. For example, Affiliated FM provides an endorsement that does not contain sub-limits. See *Affiliated FM Rolls Out New Green Coverage Endorsement*, Datamonitor (Sept. 18, 2008), www.datamonitor.com/store/news/?productid=70D1D150-ABE7-43D6-9749-2E3EC2E84C49.

Some carriers offer casualty insurance coverage that will provide proceeds to upgrade an existing green certified building to the next level of green certification and a nongreen building to a basic green-certified level. Coverage can be provided either by way of endorsement to a property casualty policy or through a stand-alone policy. In each instance, there can be coverage for a wide variety of losses that can include the following:

- the additional cost of upgrades because of a change in green building standards;
- losses caused by the loss of LEED certification, including government tax credits, utility credits, and other financial incentives;
- additional debris removal costs associated with recycling in lieu of landfill disposal;
- the cost of hiring a LEED accredited professional to oversee design and construction;
- the added expense of retaining a qualified engineer to ensure that the building's systems are designed, installed, and tested properly to confirm that the systems perform according to the design intent, are properly aligned with one another, and operate at peak performance;
- registration and fees for the re-certification of the building;
- increased business interruption coverage for the extended period required for re-certification or to upgrade to green-certified, as the case may be;
- the cost of reconstructing a vegetative roof;
- the cost of air testing as well as the cost of flushing out the reconstructed space with 100% fresh air;
- the cost of obtaining alternative energy-producing equipment and any extra expenses that may be incurred in connection with the purchase of replacement power during the interim construction period;
- the loss of income from alternative energy-producing equipment that is sending surplus power to the public utility power grid;
- for a building that is not green-certified, the cost of upgrading furniture and equipment to green status, upgrading building materials to those that have lower odor emissions (such as paints and carpeting), upgrading lighting, heating, and cooling to those that are energy efficient, and upgrading plumbing to equipment that is water efficient; and
- additional soft cost expenses such as additional interest expenses, additional legal, accounting, and architectural expenses, and lost rental value for the added period of construction attributable to the green development requirements.

Other Insurance Coverage, Benefits, and Issues

As indicated above, commercial general liability policies cover bodily injury and property damage but do not cover breach of warranty and breach of contract claims. Therefore, a charge that a building does not meet the announced green building status will be excluded from coverage under the typical CGL policy. Recently, however, Chartis Insurance announced its Green Reputation CGL endorsement, which will provide coverage for defense costs and costs of crisis management consulting services. See Susanne Sclafane, *Insurers "Green Up" Gray Coverage Areas—Construction Carriers Tackling Unique Liability Risks of Green-Building Projects*, Prop. & Cas. (Jan. 11, 2010), available at www.property-casualty.com/Issues/2010/January-11-2009/Pages/Insurers-Green-Up-Gray-Coverage-Areas-.aspx (last visited June 12, 2010).

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Some carriers provide discounts to insureds that develop green. For example, AIG Environmental Group is providing a discount of up to 10%

on its premiums for Pollution Legal Liability policies issued for LEED certified facilities. See Greener Buildings Staff, *AIG Environmental Adds Financial Incentives for Building Green* (Dec. 12, 2007), available at www.greenbiz.com/news/2007/12/12/aig-environmental-adds-financial-incentives-building-green. Fireman's Fund is offering a 5% premium discount off its regular premiums for "green-certified" buildings. See *Fireman's Fund Green Insurance Fact Sheet*, available on the Fireman's Fund Insurance Company website.

It is imperative, however, that the owner or its lawyer review the policy carefully. For example, one policy reviewed by this author provided that the green building coverage would not apply if the building had been vacant for more than 60 consecutive days before the loss or damage. Consequently, the continuous operation/going dark issue typically found in retail leases may take on an added level of importance in a green-certified facility.

Lease Insurance Clause

The following insurance clause is one prepared from a landlord's perspective. Although some lease agreements obligate the tenants to pay their proportionate share of the insurance costs by lumping them into the common area maintenance charge provisions of the lease, other lease agreements carve out insurance and require tenants to pay their proportionate share of premiums in a separate clause. In either instance, if the building is green-certified, the landlord should assure that this clause requires the tenant to pay its proportionate share of the premiums for broad coverage that will permit the reconstruction of the damaged or destroyed building to a level of green certification that is equivalent to its original level of green certification. The clause below requires the tenant to pay its pro rata share of a very broad level of coverage; however, it does not obligate the landlord to maintain this coverage. Of course, this clause addresses only casualty coverage and does not address all liability or other insurance for which a tenant must reimburse the landlord under a lease agreement. For an excellent discussion of landlord and tenant insurance issues, see Maloney et al., supra.

(a) Casualty Insurance. The Tenant shall pay the Landlord, as additional rent, either upon demand or, in the Landlord's discretion, as provided in subparagraph (b) below, the Tenant's Proportionate Share of the Landlord's premiums for Property Insurance (Special Form). This coverage may include such coverage and endorsements as the Landlord shall determine in its discretion, including, without limitation, rent insurance, water damage insurance, building ordinance coverage, vandalism and malicious mischief insurance, flood insurance and war and terrorism insurance, as well as any other coverage that may reasonably be required by a mortgagee of the Landlord. The Tenant acknowledges that the Building on the Property, of which the Premises is a part, has been certified as [insert rating] under the U.S. Green Building Council's Leadership in Energy and Environmental Design ("LEED") system. Without limiting any of the foregoing, the coverage obtained by the Landlord may include, without limitation, coverage and endorsements that will cover the cost to reconstruct the Building in a manner that shall enable the Building to be certified as [insert rating] under the LEED system; or if the LEED system no longer exists, a similar rating under a then-existing equivalent rating system. Such coverage may include, without limitation, the following risks and/or losses: (i) the additional cost of upgrades due to a change in applicable green building standards; (ii) losses associated with the loss of a LEED certification, including government tax benefits, utility credits, and other financial incentives; (iii) additional debris removal costs associated with recycling in lieu of landfill disposal; (iv) the cost to hire a LEED accredited professional, or a then similarly qualified professional, to oversee Building design and construction; (v) the added expense to retain a qualified engineer to properly commission the Building in order to ensure that the Building's systems are designed, installed, and tested to ensure their performance according to the design intent, their proper alignment with one another and their operation at peak performance; (vi) registration and re-certification fees to re-certify the Building as [insert rating] under the LEED system, or if the LEED system no longer exists, a similar rating under a then-existing equivalent rating system; (vii) additional business interruption loss during the extended period required for re-certification as [insert rating] under the LEED system, or if the LEED system no longer exists, a similar rating under a then-existing equivalent system; (viii) the cost to reconstruct a vegetative roof; (ix) the cost to obtain and reconstruct any alternative energy-producing system existing at the time of the casualty; (x) the cost of air testing as well as the cost to flush out the reconstructed space/Building with 100% fresh air; (xi) the cost of obtaining alternative energy during the interim construction period; (xii) the loss of income if alternative energy-producing equipment was

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sending surplus power to the public utility power grid; and (xiii) additional soft cost expenses such as additional interest expense, additional legal, accounting, and architectural expenses, and lost rental value for the added period of construction attributable to green development requirements. This insurance may: (A) name only the Landlord and the Landlord's mortgagee, if any, as the insured and provide that any loss shall be payable to the Landlord and the Landlord's mortgagee, if any, as their respective interests may appear; (B) be in an amount equal to the full replacement cost of all buildings, improvements, alterations, additions, and replacements now or hereafter on or at the Property; (C) provide that no act of the Tenant shall impede the right of the Landlord or the Landlord's mortgagee, if any, to receive and collect the insurance proceeds; and (D) provide that the right of the Landlord and the Landlord's mortgagee, if any, shall not be diminished because of any additional insurance carried by the Tenant for the Tenant's own account.

(b) Insurance Escrow. At the option of the Landlord, which the Landlord may exercise at any time, and from time to time, during the Lease Term, the Tenant shall pay the Landlord the Tenant's Proportionate Share of all insurance premiums for the insurance coverages referred to in subparagraph (a) above, on the first day of each month in advance, in a sum equal to 1/12th of the Tenant's Proportionate Share of all insurance premiums then due and payable. Additional rent based upon insurance premiums payable for the first and last years of the Lease Term, shall be adjusted and prorated, so that the Landlord shall be responsible for the Landlord's prorated share for the period prior to and subsequent to the Lease Term, and the Tenant shall pay the Landlord its prorated share for the Lease Term.

This clause is an example of a pro-landlord casualty insurance provision, and it underscores the need for careful review by the tenant's lawyer. First, the tenant's lawyer may want to make a minimum level of coverage mandatory, subject to a cost analysis, because the tenant will have to pay a share of the premiums. In addition, both the landlord and the tenant need to align

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carefully the risk of loss clause with the insurance provisions of the lease. Although the tenant may have an interest in requiring the landlord to rebuild to a particular green-certified level, before committing to do so, the landlord needs to ensure that the actual insurance for which the tenant will reimburse the landlord is sufficient to permit the landlord to achieve compliance without coming out of pocket. As a result, while the lease can structure the landlord's insurance requirements in a permissive fashion, the rebuilding requirements of the lease will dictate the coverage that the landlord actually should procure—and for which the tenant should reimburse the landlord if the lease requires this reimbursement.

In addition, depending on which party has responsibility for restoring the interior space of the building, the landlord and the tenant may be in a role reversal relative to the required insurance and rebuilding standards.

Conclusion

Although the current economic crisis has significantly reduced development generally, as the real estate industry moves out of this crisis, there will be an increasing need for real estate developers to distinguish their product. As a result, green-certified buildings may well become more commonplace in the industry. As the sustainable development model becomes more popular, even limited efforts, such as solar panels and other forms of alternative fuel production, will require a more careful analysis of the risks and related insurance needs. Just as the insurance industry responded to the increased risks associated with brownfield redevelopment, it is likely that insurers will provide an increasing number of products that meet the demands of sustainable development. Real estate lawyers will have to understand the risks inherent in green development and be able to evaluate the insurance products that are available to address those risks. ■