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FROM THE EDITOR

A retailer leases a storefront and makes considerable improvements to adapt the facility for selling and servicing its products. A fire breaks out and heavily damages the building, including the features the retailer added. Suddenly, those improvements, which were contributing to the success of both the retailer and landlord, are the focus of questions: whose property were they, who is responsible for repairing the damages, and how are those determinations made?

While "improvements and betterments" seem like simple concepts, understanding them in the context of insurance coverage or a lease provision can be anything but. That's the subject insurance expert Robert Prahl addresses in this issue of Adjusting Today.

Mr. Prahl discusses how courts have ruled in relevant cases, and outlines the applicable language found in standard policy forms. Ultimately, he explains the importance of understanding the insurance ramifications of improvements and betterments, and how they can impact the businesses involved.

Sheila E. Salvatore
Editor

Understanding Improvements and Betterments: Be Mindful of Lease and Insurance Provisions

By Robert J. Prahl, CPCU

"Improvements and betterments" typically are defined as *fixtures, alterations, additions* or *installations* made a permanent part of a building by and at the expense of the tenant, which may not legally be removed. These improvements become the property of the landlord or building owner, except that ordinarily under most leases, the tenant is responsible for repairing or replacing the improvements in the event of loss.

The term "improvements" has been defined in a variety of ways. An improvement is anything that adds to the value of property; it changes,

for the better, the original condition of property; or it enhances the quality of something. Examples of improvements and betterments are cabinets, counters, partitions, new flooring or ceilings, appliances, and built-in shelves or bookcases.

Keep in mind that the aforementioned terms, as well as who is responsible for restoring damaged improvements, often are subject to the particular wording of the lease agreement and a court's interpretation of those provisions.

For example, in *Chernberg v Peoples National Bank of Washington,* 564 Pac. 2d 1137 (Wash.), the tenant operated a restaurant in a portion of a building located in Seattle. When the abutting building was razed, a former party wall[1] became exposed and was determined to be structurally unsafe and in need of substantial repairs by the local building department. Although the leased premises did not abut the exposed wall, the tenant requested that the landlord make the necessary repairs, estimated to cost between $30,000 and $50,000. The landlord refused to make the repairs and terminated the lease because of the unsafe condition of the building. The lease required the tenant to make repairs necessary to maintain the leased premises, except for the outside walls and other structural components of the building within the leased premises, but was silent as to which party was obligated to maintain the structural components of the building outside of the leased space. The Washington Supreme Court upheld a lower court ruling concluding that there was an implied duty imposed on the landlord to make repairs mandated by government authority where such repairs arise from defective building conditions or are required for reasons of the public welfare.

However, in *Ell & L. Invest. Co.,* 286 Pac. 2d 338 (Colo.), the court held that the lessee should pay for substantial alterations to avoid the threatened condemnation of the building, based on the lease language. The lease provided "that the lessors shall not be liable for the expense of making any alterations, improvements, or repairs to the demised premises" — and the court upheld that language.

It is difficult to provide any rule of thumb that might avoid disputes as to the meaning of lease provisions because circumstances will vary. However, it helps to make the lease provisions as clear as possible to reflect the intent of the parties.

Tenant's Use Interest

It can be said that from the tenant's standpoint, it is not the improvements and betterments that are insured, but rather the tenant's *use interest* in them

that is covered. For example, when improvements are damaged, the tenant has not sustained a loss to property that belongs to the tenant, but rather has lost use of the property. It is this right of use that creates the tenant's insurable interest in the improvements. (See *Daeris, Inc. v Hartford Fire Ins. Co.,* 105 N.H. 117, 193 A. 2d 886, where the court held that a tenant's use interest in improvements and betterments gives the tenant insurable interest.)

Insurance Coverage for Improvements and Betterments

In many cases, a tenant may rent a shell within a building for its business and spend thousands of dollars or more upgrading the property so that the business can function. These fixtures, alterations, and additions are considered improvements and betterments. For example, a bicycle retail and repair shop might install a sales area partitioned off to display the bicycles, permanent shelves for parts and tools, and machinery for repairing bicycles. These improvements need to be insured. Standard commercial property insurance provides coverage for any combination of the following property: (The standard businessowners policy is set up in similar fashion.)

- Building
- Your Business Personal Property
- Personal Property of Others

Coverage for a tenant's improvements and betterments is included within the "Your Business Personal Property" category, item (6), as shown below:

b. Your Business Personal Property[2] located in or on the building described in the Declarations or in the open (or in a vehicle) within 100 feet of the described premises, consisting of the following unless otherwise specified in the Declarations or on the Your Business Personal Property — Separation of Coverage form:

(1) Furniture and fixtures;
(2) Machinery and equipment;
(3) "Stock;"
(4) All other personal property owned by you and used in your business;
(5) Labor, materials or services furnished or arranged by you on personal property of others;
(6) Your use interest as tenant in improvements and betterments. Improvements and betterments are fixtures, alterations, installations or additions:
  (a) Made a part of the building or structure you occupy but do not own; and
  (b) You acquired or made at your expense but cannot legally remove;
(7) Leased personal property for which you have a contractual responsibility to insure, unless otherwise provided for under Personal Property of Others.

The declarations page of the standard Insurance Services Office (ISO) Commercial Property Coverage form includes a heading for "Coverages Provided." Wording adjacent to this heading states that "Insurance at the Described Premises Applies Only for Coverages for which a Limit of Insurance is Shown." It is under this heading where specific coverages are listed. The following is an example:

Prem. No.	Bldg. No.	Coverage	Insurance Limit	Causes of Loss	Coinsurance	Rates
001	001	Building	5,000,000	Special	80%	(See Sched.)
		Your Bus. Per. Prop.	1,000,000	Broad	80%	
		Per. Prop. Of Others	100,000	Broad	80%	
		Bus. Income & Extra Expense	500,000	Special	80%	

The landlord's interest in improvements and betterments is covered under the landlord's building coverage. It is important that the insurance limit for building coverage include the value of any improvements that the tenant has made to the property. Why? Because failing to add such value to the insurance limit may subject the landlord to a coinsurance penalty.

The declarations page of a tenant's policy will not show a limit for building coverage because the tenant does not own the building. It will indicate whether the insured tenant selected coverage for improvements and betterments by the entry of a limit of insurance under the Business Personal Property category. If there is no entry, coverage for the tenant will not apply.

Generally, the landlord carries insurance on the building, including their interest in improvements and betterments, while the tenant covers their use interest in the improvements — and may wish to include coverage for personal property of others and loss of business income.

Trade Fixtures v. Improvements

Improvements and betterments ordinarily become the property of the landlord, and the tenant, who paid for them, cannot legally remove them. Trade fixtures, however, are handled differently. You will not find a definition of trade fixtures in the insurance policy. Generally, a trade fixture is a fixture that is installed by the tenant, sometimes as a moveable fixture while other times as a built-in which becomes part of the building. The tenant has the right — and sometimes the duty — to remove trade fixtures when the lease expires or the building is vacated. In many cases, whether an item is a trade fixture or improvement or betterment will be clarified in the lease. But not always. In some cases, whether an object is a trade fixture or improvement will be determined by trade customs in a particular jurisdiction. Some leases make a distinction between tenant's improvements and tenant's property, the latter referring to trade fixtures. A tenant's trade fixtures are covered as furniture and fixtures in item (1) under Your Business Personal Property shown earlier.[3]

Trade fixtures retain the character of personal property. Using a store as an example, a new front

installed by the tenant is an improvement; but counters or shelves, no matter how firmly attached to the building, ordinarily are considered trade fixtures.[4]

Repairs or Maintenance

The term "repair" has been defined in a variety of ways. It means to mend, fix, restore, or renovate, and contemplates an existing structure or object that has been subject to damage or decay, and restored or put back in good condition.

Are repairs or maintenance performed by the tenant considered to be improvements and betterments? For example, does painting or wall papering, or replacing a small section of tile or wood flooring, constitute improvements or betterments? To some extent, it depends on one's viewpoint.

One view takes the position that anything a tenant does to enhance the building and that cannot be removed is an improvement to the building. This view would undoubtedly include painting or wall papering as an improvement. Another view holds that the improvement must be significant and, for instance, would likely require replacing an entire floor instead of just a small section, or installing a new heating or air conditioning system.

> ***Improvements and betterments ordinarily become the property of the landlord, and the tenant, who paid for them, cannot legally remove them. Trade fixtures, however, are handled differently.***

This latter view was supported by the decision in *Modern Music Shop v. Concordia Fire Ins. Co. of Milwaukee,* 226 N.Y.S. 630 (1927). The case involved an older coverage form that referred simply to "the insured's interest in improvements and betterments." The court held that these words imply a substantial or fairly substantial alteration or change to the premises, surpassing that of a simple or minor repair.[5]

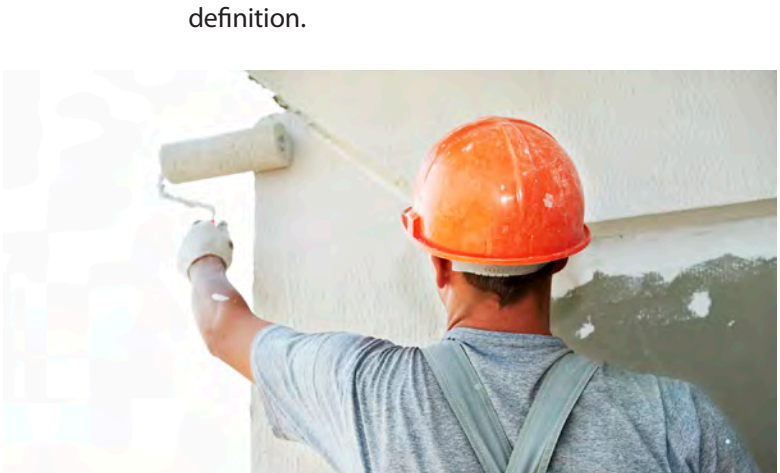
In another case, *U.S. Fire Ins. Co. v. Martin,* 282 S.E, 2d 2 (Va. 1981), the Virginia Supreme Court ruled that air conditioners the insured tenant had repaired but not installed were not improvements or betterments. Since the tenant had not paid for the original installation of the air conditioners, the expenses paid by the tenant involved repairs only and did not constitute improvements or betterments.

In view of these decisions, there is some support for the position that an improvement must substantially change or modify the building. Thus, common maintenance or repairs, e.g., painting, or fixing a leaky faucet or unsightly marks on a wall, likely would not be considered an improvement or betterment. But again, circumstances vary and each case must be decided on its own merits. Another point to consider is that tenants often agree, either in the lease or voluntarily, to perform such tasks as keeping the premises reasonably clean, checking and replacing smoke detector batteries, and performing minor repairs.

Adjusting Losses — Loss Valuation of Damaged Improvements

The Building and Personal Property Coverage Form (CP 0010) provides three methods for handling damage to improvements:

- If the insured tenant pays for repairs and is not reimbursed by the landlord, the tenant's policy pays for the actual cash value of the damaged property. The policy requires that repairs be made *promptly,*[6] but the form does not define *promptly.* Depending on the circumstances, e.g., the availability of parts or workers to do the job, "promptly" can be a relative term and 60 days, 90 days, or even six months or more could be considered promptly in the absence of a policy definition.



- If others (e.g., the landlord) pay for the repairs, the tenant's policy owes nothing. In this situation, the tenant has not suffered a loss. If the insured sustains a loss of income while the property is being repaired, business income coverage — provided the insured carries that coverage — should respond.

- If repairs are not made promptly, the tenant recovers a portion of the original cost of the damaged property.

This last method can be the most challenging. When repairs are not made promptly, or the improvements are destroyed and not replaced, the policy pays what can be described as the unamortized portion of the original cost or investment in the improvement.

When the insured or landlord does not promptly repair or replace the improvements, the basis for recovery is the original cost of the improvements, including the cost to prepare the space before the improvements can be installed. Depreciation is not relevant. Neither does it matter if the improvements would cost more or less to replace than they cost to install. Actual cost of the installation is the insured tenant's investment and that is what has been lost when improvements are not replaced.[7]

The policy states that if the insured does not make repairs promptly, the loss will be valued at a proportion of the original cost as follows:

"Multiply the original cost by the number of days from the loss to the expiration of the lease, and divide that amount by the number of days from the installation of improvements to the expiration of the lease."[8]

When the insured or landlord does not promptly repair or replace the improvements, the basis for recovery is the original cost of the improvements, including the cost to prepare the space before the improvements can be installed.

Say a tenant has invested $20,000 in improvements at the beginning of a five-year lease. Thus, the tenant has bought the use of the improvements for five years. A fire destroys the improvement after one year and the tenant loses four years of use of the improvement. If the improvements are not repaired or replaced, this last valuation provision applies. The insured tenant will recover an amount reflecting the loss of use of the improvement for four years, or $16,000 ($20,000 original cost less $4,000, the latter representing the one year of use of the improvements).

Another, more involved example follows:

Five-year lease:	1/1/11 to 12/31/15
Installation of improvement at original cost of $50,000:	2/1/11
Date of loss:	2/12/12

Valuation (For illustration purposes, leap years are not considered.)

Number of days from loss date of 2/12/12 to lease expiration of 12/31/15 = 1,418 days.

$50,000 multiplied by 1,418 days = $70,900,000.

Number of days from installation of improvement, 2/1/11, to lease expiration of 12/31/15 = 1,794.

$70,900,000 divided by 1,794 days = $39,521.

Here the insurance is paying for the unused portion of the improvements. In this case, the tenant had slightly more than a year's use of the improvements, that is, from the installation date of 2/1/11 to the loss date of 2/12/12.

Occasionally, a question arises concerning lease renewal options. If the lease includes a renewal option, the renewal option period is included in the loss settlement calculation.

For example, assume a tenant has a one-year lease on the building that expires on December 31. The lease includes a one-year renewal option. On August 5, the tenant alters the space by installing a partition to separate rooms at a cost of $2,000. On November 2, a fire causes extensive damage and the insured permanently closes the business. Had the loss not occurred, the insured would have stayed in business and exercised the renewal option.

In the absence of the renewal option, the tenant would recover $805 for the improvement: $2,000 X 60 days (loss of Nov. 2 to lease expiration of Dec. 31) = $120,000 divided by 149 days (date improvement installed of Aug. 5 to Dec. 31) = $805. If the renewal option period of 365 days were exercised, the settlement would be $1,654: $2,000 X 425 (60 + 365) = $850,000 divided by 514 (149 + 365) = $1,654. With the renewal option, there is a sizeable increase in the loss settlement.

Conclusion

Disputes exist with coverage for improvements and betterments as they do with many insurance provisions. Although it is advisable and beneficial to make lease provisions as precise as possible to reflect the intent of the parties, it is difficult, if not impossible, to draft leases that can be so comprehensive as to completely eliminate all possible disputes. It is nevertheless essential that all involved in placing coverage or adjusting losses review the lease provisions as carefully as they review the insurance coverage itself.

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[1] A party wall is a dividing partition between two adjoining buildings that is shared by tenants of each building.
[2] Building and Personal Property Coverage Form, CP 0010 06 07, Insurance Services Office (ISO Properties, Inc. 2007).
[3] Jerome Trupin and Arthur L. Flitner, Commercial Property Risk Management and Insurance, 8th edition (American Institute for Chartered Property Casualty Underwriters/Insurance Institute of America, Malvern, PA 2009) p. 3.8.
[4] Donald S. Malecki, Commercial Property Coverage Guide, 5th edition, (National Underwriter Company, Erlanger, KY 2013) p.26.
[5] Malecki, p. 25.
[6] The sixth edition of Black's Law Dictionary, published in 1990, stated that the meaning of *promptly* "depends largely on the facts in each case, for what is 'prompt' in one situation may not be considered such under other circumstances or conditions." See also *State v. Chesson,* 948 So.2d 566, 568 (Ala. Civ. App. 2006) which held that the term "promptly" has been construed to mean within a reasonable time in light of all the circumstances. (From Adams on Contract Drafting, 2013 Kenneth A. Adams, kadams@adamsdrafting.com.)
[7] Malecki, p. 27.
[8] Building and Personal Property Coverage Form, CP 0010 06 07, Insurance Services Office (ISO Properties, Inc. 2007).

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