Lowndes

Insights

Self-Insurance Means No Insurance

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It is not unusual for Tenants, especially larger ones, to negotiate for so-called "self-insurance" in their Leases. This concept can be applied to any form of insurance that a Landlord may require from a Tenant, except for insurance that is mandated by law (such as workmen's compensation insurance). It is important for Landlords to consider, however, that self-insurance is not insurance at all. It is merely a term used for the allocation of risk to the Tenant without requiring insurance.

In a perfect world, a Tenant that is self-insuring is doing what an insurance company would do… that is, maintaining a reserve fund to which it periodically contributes reasonable amounts based on actuarial and other empirical data, from which it will be able to pay future, unexpected liabilities. However, that is not actually required for a Tenant to self-insure. Instead, unless the Lease expressly requires such a fund (a rare occurrence), the Tenant can just go about its business and hope for the best.

Self-insurance by a Tenant should be allowed by a Landlord only when the Tenant is considered a "credit tenant," which means that it is a good risk. Your own personal credit score is based on your income, payment history and other data evidencing the extent to which you have the resources, and are likely, to pay your personal obligations. A Tenant's credit is likewise determined by its financial strength and the likelihood that it can pay its business obligations, including contingent liabilities. Any large national company that issues publicly traded debt receives a credit rating, which is similar to an individual's credit score. The credit rating of such a company is determined by rating agencies such as Standard and Poor's (S&P) and Moody's Investor Service (Moody's).

If you are a Landlord presented with a proposal by a Tenant to self-insure, keep in mind that no company is really "too big to fail." Think of the financial difficulties that have affected large retailers like Radio Shack, KMart and Toys "R" Us. If you are going to permit self-insurance, do it only so long as the Tenant actually has the resources. How do you determine that? Perhaps self-insurance should be allowed only during any period in which the Tenant has a particular S&P or Moody's rating, if that is applicable. A

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Tenant may still be a good risk if it is not rated by one of these agencies. Publicly-traded companies without long-term debt may not have a credit rating because of that fact. Similarly, many companies are privately owned and do not issue publicly traded debt or bonds, so they are not rated but may still be good risks. If the Tenant is not rated, consider using another standard tied to some form of net worth, such as one of the following:

- The Tenant's net worth according to customary accounting practices.
- The Tenant's tangible net worth, which excludes good will and intangible assets. This is a better indicator of financial stability, since it eliminates assets having speculative value to anyone other than a buyer of the company.
- The Tenant's "EBITDA," which is an acronym for Earnings Before Interest, Taxes, Depreciation and Amortization. This is basically net income with interest, taxes, depreciation and amortization added back into it. This is a potentially better indicator of financial stability, since it eliminates the effects of financing and accounting decisions.

Any of these net worth standards will require the Landlord to approve the Tenant's financial statements periodically, so the Lease should require the Tenant to provide one that reflects the appropriate standard before the Lease is signed, and at reasonable intervals thereafter, at least once per year during the Lease term, and perhaps upon request if the Landlord has reasonable grounds to do so.

What should an S&P or Moody's rating be? Perhaps it should be maintained at whatever rating was in effect when the Lease was signed. Absent a rating, what is the minimum net worth a Landlord should require under any such standard? This should be determined after reviewing a financial statement provided by the Tenant before the Lease is signed. Perhaps the Tenant should be required to maintain that same minimum during the Lease term.

During any period in which a rating or net worth standard is not met, the Lease should require the Tenant to obtain insurance meeting the Landlord's customary requirements, in lieu of self-insurance. It is important throughout the Lease term for a Landlord to monitor the Tenant's credit rating, so that insurance is required promptly when a Tenant experiences a financial circumstance that makes self-insurance problematic. Absent a credit rating, the Landlord should consider monitoring internet news stories about the Tenant in order to keep abreast of its reported financial condition.