EDITION 3, 2022

REALTALK

A SPECIALIST RISK PUBLICATION FOR THE REAL ESTATE SECTOR

FEATURE ARTICLES

REAL ESTATE INSURANCE MARKET UPDATE

Which adjustments are we expecting in the industry?

EUROPEAN LOGISTICS

Why is the sector now extremely hot as an investment?

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ABOUT GALLAGHER

Founded by Arthur J. Gallagher in Chicago in 1927, Gallagher has grown to become one of the largest insurance brokerage, risk management, and human capital consultant companies in the world. With significant reach internationally, the group employs over 32,000 people and its global network provides services in 150 countries.

Gallagher's London divisions offer specialist insurance and risk management services. We provide bespoke policy wordings, programme design and risk placement solutions, and consulting support across a range of specialisms. We manage complex, large, global risks on a direct and wholesale basis and serve as primary access point to Lloyd's of London, London company markets, and international insurance markets.

WE HELP BUSINESSES GO BEYOND THEIR GOALS. IT'S THE GALLAGHER WAY.

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INSIDE THIS EDITION...

EXECUTIVE FOREWORD

Welcome to the Third Edition of Our Specialist Real Estate Risk Publication, 'Real Talk'.

Firstly, I would like to wish everyone a very Happy New Year; here's to a 2022 full of positivity and progress. Since writing last in the second quarter of 2021, the UK has emerged from its third national lockdown, with England ultimately removing all national restrictions on "Freedom Day" last July. The remainder of Europe has, however, been slightly more cautious in its approach to opening up, therefore travel is still not quite as simple as it once was; with virtual meetings still dominating the diaries of most.

We attended EXPO Real in Munich last October and it is clear that the Real Estate sector is full of life and exuberance. The overriding sentiment that we came away with is that there is a significant volume of capital to invest in quality assets, with the challenge being finding those assets at a fair price – demand currently outstrips supply in logistics, for instance. Confidence also appears to be returning in the hotel/hospitality sector as international travel slowly starts to increase.

In this edition, we pick up on a few of these key themes, including the piping hot logistics sector, as well as focussing on what our customers need to be aware of as the price of materials and labour continues to rise. We also discuss the ever-growing threat that is cyber risk, as the industry becomes more and more reliant on integrated technology.

At Gallagher, we continue to grow and invest in our Real Estate team, with a number of quality new colleagues joining us in recent months. This remains underpinned by the exceptional core of the existing team, dedicated to client service and care. Gallagher as a whole looks set to announce another exceptional year in 2021, proving our quality and resilience in spite of the many challenges faced over the past almost two years.

Once again, on behalf of the team here at Gallagher, I thank you for engaging with us, your ongoing support, and taking the time to read our publication. Feedback is always welcome, as the more we can tailor our content to our audience the better. Wishing you a very happy, healthy and successful 2022.

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01. REAL ESTATE INSURANCE MARKET UPDATE — JANUARY 2022

The Real Estate insurance market continues to adjust its position following two years of continual rating increases. Whilst we are still seeing pricing increases across most sectors, these are plateauing following previous adjustments. It would be an exaggeration to say that we are at the flat renewal stage, but we expect to start seeing flat rates being offered over the next 12-18 months to some clients, depending on the performance of their individual portfolios.

Property Reinsurance Market Renewals 2022

Many of the direct property insurance market pricing and coverage behaviours are as a response to reinsurance market terms and renewals. As such, we can look to the outcomes of renewals in this market for a steer as to where the direct property market is likely to go in 2022.

As explained in far more detail in our Gallagher Re report issued at the start of January, the United Kingdom property reinsurance market remained largely loss-free in 2021. This resulted in only modest pricing increases in the low single figures for most programmes, with plenty of capacity available.

A number of reinsurance programmes with COVID-19 losses on them remain, meaning these often heavily dictated the renewal discussions.

Across the continent, however, a number of territories such as Germany, Switzerland, Austria and Belgium experienced significant natural catastrophe losses in 2021, driving prices up noticeably on these programmes.

As a result, we expect 2022 to be a year where, depending on corrections over the last 24 months, prices start to plateau, with insurers just beginning to regain confidence in the UK property market once more.

Long Term Agreements (LTAs)

Whilst LTAs have been largely absent in the last two years as insurers look to correct their books; some insurers are now beginning to offer long term agreements once more. These tend, however, to come with staggered rating increases rather than decreases, across a 2 or 3 year period—at least providing clients with an element of certainty for future budgetary purposes.

Natural catastrophes

There is currently a real focus on natural catastrophe exposures across the UK and Europe. The recent flooding in Europe has led to insurers reviewing their limits, excesses and pricing in this area.

Residential challenges

The other area for continued scrutiny is residential risks, especially where almost any form of cladding is present. Fewer and fewer insurers are willing to write business in this space, either due to an adverse loss history or due to a relative lack of appetite to grow in any areas other than their absolute target areas, of which residential is almost never one. Where cladding is present then a robust and urgent plan to address any issues is an absolute must.

Capacity

Capacity remains an ongoing issue in the market with insurers continuing to be cautious about what level of support they will offer. Whilst the total amount of capacity in the market is not a concern, insurers willingness to deploy large volumes of capacity on a single risk has diminished, meaning we are seeing more and more risks, where two or more insurers are required to complete the placement.

What can clients do?

Quality and comprehensive information remains the key ingredient to obtaining favourable terms from insurers. Construction details, fire protection and robust risk management planning allows insurers to review risks in the best possible light, thus leading to an increase in accessibility to more competitive offerings. Failure to provide updated information is leading to insurers saying 'no' to many more risks than they would have in a softer market environment.

Lead times are also longer than we have seen in many years. Negotiation with insurers—since they need time to scrutinise information provided—means that renewals need to be started as early as possible. Fast turnaround with a relative lack of information and positive decisions are a thing of the past. It is therefore essential to understand insurers' appetite and present risks to the correct market in the most comprehensive way in order to achieve a positive outcome in terms of pricing and cover.

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02. EUROPEAN LOGISTICS — 2021'S HOTTEST PROPERTY AND THE ASSOCIATED RISK CHALLENGES

Already a significant growth sector in the European property market in the last decade, COVID-19 only served to accelerate further the boom of e-commerce, and with it the European logistics market. The sector is now extremely hot as an investment product; proving its resilience through the global pandemic, and undersupply is only serving to increase valuations further. Europe still only has in the region of 2.5 square metres of logistics space per household, compared to 7.5 square metres per household in the U.S.—meaning there appears to be plenty of room for growth.

Why is logistics so attractive?

The simplest way to look at why logistics is so attractive from an investment perspective is to look at the five key drivers behind valuations.

1. **Rents**: Market rents grew healthily in 2019, before remaining stable during the pandemic, and in some areas are still growing where land is scarce. Most forecasts and predictions suggest rents climbed in 2021 and will continue to do so in 2022 and beyond.

2. **Yields**: In the last six or seven years, market yields in the logistics sector have compressed from 7% or 8% to circa 3% in the UK, Germany, France and the Netherlands—with the remainder of Europe sitting somewhere in the 4%-5% range.[1] The general consensus is that these will continue to reduce to align themselves with prime European office yields—however, for context, U.S. logistics yields are comfortably below prime office yields, meaning there is scope for significant compression still.

3. **Incentives**: Incentives, or payments or concessions offered by a landlord to entice tenants, have generally decreased in recent years, with many transferring into upgrades to the assets, or sustainable features being added to the building.

4. **Downtime**: Downtimes, or periods where a property is vacant, have continued to decrease due to the significant demand across both the sector and geographies.

5. **Non-Recoverable Costs**: Non-recoverable costs, or costs that cannot be recharged to tenants, have remained broadly stable for owners/landlords.

Finally, and equally of importance, the cost of land continues to rise, as do construction costs, meaning the cost of building new stock and new assets continues to increase—only serving to make good quality existing assets that much more valuable.

All in all then, logistics assets as an investment product look to be both relatively stable and therefore lower risk, but also the market as a whole appears to be on an upward trajectory, meaning it is unsurprising that capital providers from all over the world are looking to gain a piece of the European logistics pie.

What does all this mean for insuring these assets?

Logistics assets present a number of challenges—some that are fairly synonymous across the property sector, and some that are unique to logistics.

[1] Lados, Balazs. New suburban distribution hubs and European industrial variations. REFI Global, 12 May 2021. Webinar.

Constuction and Valuation: Of interest to insurers of all property assets, knowing what the building is made of, with a particular microscope on cladding/panelling, is crucial to getting insurers onboard. Often, if it is unclear as to the makeup of composite panelling, insurers will require intrusive testing to be undertaken prior to committing to provide cover.

With rapid rises in construction costs, ensuring regular Reinstatement Cost Assessment (RCAs) are undertaken to maintain adequate sums insured, and/or ensuring there are sufficient inflation provisions within your policy wording has arguably never been more important to prevent any risk of underinsurance.

Tenants and Storage Heights: Tenancy, tenant fit-outs and storage are all crucial factors in underwriting logistics business. The significant variance of both tenants themselves and the contents they are storing at these assets can have a significant bearing on the cost of insurance. Storage heights are also of significance, as if such assets are sprinklered, insurers want to have confidence that the sprinkler/fire suppression systems are able to properly function, and are not hindered by excessive storage blocking them.

Whilst not currently a major problem due to the overwhelming demand, keeping insurers informed of tenant changes and/or periods of vacancy at a property is a material fact and therefore crucial to ensuring continuity of cover.

Location and Site Security: Location is always critical in property insurance for a number of reasons—including but not limited to the potential flood risk, proximity to other assets/buildings, volumes of local traffic and/or footfall, and local crime rates. Site security therefore plays a significant role in the underwriting process, not least because often logistics sites can be prone to arson attacks and/or travelling communities looking to set themselves up on-site. By the nature of logistics assets, they can often be quite difficult to fully secure due to the size of the perimeters, so having either good, operational and monitored CCTV, and/or a permanent physical guard presence can go a long way to alleviating insurers concerns in this regard.

Logistics is clearly here to stay. As important as it is for successful investors in this sector to utilise local knowledge in the various European geographies, it is also vital to have a broker who has an in-depth understanding of the sector and a strong network of local experts and relationships in those corresponding territories. This allows insurance to be kept off the critical path and ensures clients can focus their energy where it is needed in what is a dynamic, fast moving and ultra-competitive sector.

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03. WITH RISING BUILDING COSTS, ARE YOU ADEQUATELY INSURED?

It has been well-documented in the press in recent months that the cost of raw materials has surged following pandemic-induced disruption to the supply chain and rising demand—with steel prices and other metals reaching record highs. This raises questions for property owners as to whether they are adequately insured, and what steps can be taken to avoid underinsurance, which can result in claims payments being reduced.

Ensure your Building Reinstatement Cost is correct at renewal

The most important step to be taken to ensure you are adequately insured is by checking your Building Reinstatement Cost(s) at inception and/or renewal of your policy. We recommend a Royal Institute of Chartered Surveyors qualified professional is engaged to provide Reinstatement Cost Assessment(s). These valuations can be undertaken via site visits or alternatively 'desktop' valuations can be produced relinquishing the need for site visits.

It is not uncommon for property owners to rely on previous owners' insured values or historic reinstatement assessments; when factoring the rising rebuild costs, this can lead to significant underinsurance and is a very risky approach to take.

Ensure your policy has a 'Day One' inflationary provision included

Once you have an adequately set on your reinstatement value for 'Day One' of the insurance period, also known as a 'Buildings Declared Value', consideration should be provided to the effects of inflation during the policy period.

Most comprehensive buildings insurance policies include a 'Day One' inflationary provision. This provision provides protection against the effects of inflation during the period of insurance for a given percentage uplift figure. The percentage uplift will vary by terms agreed with insurers but typically can range anywhere between 10% and 50%.

Therefore, if your policy includes a 30% 'Day One' provision, you will have the benefit of an additional 30% allowance on top of your reinstatement cost declared, thus providing protection in the event of rising rebuild costs during the policy period and also mitigating the need to adjust your policy mid-term.

Your policy schedule will commonly detail two values—one referred to as the 'Buildings Declared Value' and the other as the 'Buildings Sum Insured'. The difference between the two is your 'Day One' protection.

It is important to note that your 'Buildings Declared Value' must be accurate as of the start of the policy period, as the 'Day One' provision protects against inflation only; insurers still have the right to reduce a claim in the event of being underinsured as of 'Day One'.

Ensure your policy has an 'Underinsurance Waiver'

A comprehensive policy will also typically include a clause whereby underinsurance shall not apply providing evidence of a reinstatement valuation having been carried out by and/or under the supervision of a Royal Institute of Chartered Surveyors professional valuer at least once every three years and the Buildings Declared Value having been adjusted accordingly with an uplift applying in the intervening years to reflect prevailing inflation.

This clause can provide comfort that as long as its provisions are met, your insurer(s) cannot reduce their claims payment should you be underinsured and you will benefit up to the full value insured for.

Conclusion

This article has outlined some key areas of focus to help ensure you are in an optimal position to be adequately insured and avoid the major pitfalls around underinsurance. We would, however, always recommend engaging a qualified insurance professional, and should this article have raised any questions, we would be delighted to have a further conversation.

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04. CYBER RISK AND PROPERTY DAMAGE — WHAT'S THE CONNECTION?

As we touched upon in our April 2021 edition of Real Talk, technology is being incorporated more and more into buildings, with the phrase 'smart buildings' becoming common parlance in the sector. Much of this technology is connected to a local area network if not the internet, meaning it is as vulnerable to hackers as any other piece of modern IT equipment. This article from Tom Draper, Technology & Cyber Practice Leader, explores where the line sits between property insurance and cyber cover, and what can be done to fill any potential gaps.

The background

Following two major NotPetya and WannaCry ransomware incidents in 2016, where global property insurers suffered nearly USD3 billion of losses from these cyber-events,[2] global regulators and reinsurers insisted that all insurers should be taking steps to reduce the unintended exposures caused by non-affirmative or 'silent' cyber coverage in their policies.

Lloyd's of London issued a directive to make sure all policies provide cyber insurance cover on an affirmative or non-affirmative basis, with no ambiguity for all first party property damage policies incepting on or after 1 January 2020, and included all types of property and terrorism insurance policies. This was echoed with other global insurers, such as AIG and AXA XL, following suit.

Scenario — Cyber property claim example

Whilst the reporting of such incidents is sporadic due to lack of specific regulation, one such example from a German steel mill[3] provides an excellent case study. In this scenario, a hacker successfully infiltrated the systems of a German steel mill. Once the attackers had navigated their way from the corporate to the plant network, they altered critical process components resulting in a loss of control and eventual massive physical damage to the individual control system components. This kind of property loss would now be excluded following the changes in 2020.

How Gallagher's Cyber team can help

Our Cyber team has been working with cyber markets to place cyber property damage specific policies for clients across a range of industries and sectors. These products enable a client to secure 'buyback' cover for now affirmatively excluded cyber events (Cyber Carveback Products). These carveback products can then be aligned with your traditional corporate cyber policy and your property damage policy to help ensure there are no gaps in coverage.

These products are able to cover:

- Cyber Property Damage
- Breach Response Costs
- Privacy Regulatory Fines and Penalties
- Security and Privacy Liability
- Cyber Extortion Costs and Ransoms
- Non-Physical Cyber Business Interruption, including IT Ecosystem Interruption.

Our Cyber team can assist you and/or your tenants with the quantification of their cyber risk. Using in-house analytics, we are able to empower organisations to select an effective risk transfer option, and to help ensure that there are no gaps between your cyber and property covers.

TO FIND OUT MORE ›

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[2] https://www.lmalloyds.com/LMA/News/LMA_bulletins/LMA_Bulletin_2013/LMA19-031-PD.aspx/

[3] https://www.industrialcybersecuritypulse.com/throwback-attack-a-cyberattack-causes-physical-damage-at-a-german-steel-mill/#:~:text=According%20to%20the%20report%2C%20hackers,implants%20malware%20into%20the%20system.

05. RIGHTS OF LIGHT

A right of light is an easement that gives a landowner the right to receive reasonable light through defined apertures in buildings on their land. Natural light is generally perceived as a desirable quality, particularly in residential premises, and can often enhance the value of a property.

How do you identify a right of light?

In order to ascertain whether or not a particular property enjoys a right to light, the age of the existing building should be considered (we cover this in greater detail below). You should also find out whether the injured property has replaced a previous property. A review of the legal title should be conducted to all the relevant properties. To do this, it would be beneficial to instruct a surveyor to identify any affected properties as well as a solicitor to review all necessary legal titles.

How do you acquire a right to light?

There are many ways a freehold owner and tenant can acquire a legal right to light over neighbourly land. Some examples below:

- Rights can be granted expressly in a transfer or lease.
- By prescription: Following 20 years or more enjoyment, pursuant to the Prescription Act 1832 or the common law doctrine of lost modern grant.
- Right of light can transfer automatically from a demolished building if the position of the windows in the new building is essentially the same as the windows in the demolished building.

What to consider when developing?

There are certain factors that can be looked at when developing and potentially breaching a third party right to light.

- Is the breach necessary? Can a viable development still be implemented without a breach? This removes the risk entirely.
- What should the developer's strategy be? There are many ways that a strategy can be implemented:
  - Wait and See
  - Agreed Conduct
  - Reactive Agreed Conduct
- Developer conduct: In Beaumont Business Centres Ltd V Florala Properties Ltd 2018, we saw that the developer's conduct was questioned and therefore the judgement took this into account. Try to liaise with neighbouring properties and negotiate with injured parties. If they are not willing to negotiate, the fact that the developer engaged at an early stage, may be beneficial in the event of an injunction claim.

Why is a right of light insurance policy important in the context of development?

First and foremost, a right of light can be protected by legal action. Therefore, the likes of an injunction to restrain development that infringes a right to light can be made, as well as an order requiring a completed development to be cut back. As you can imagine this can create considerable delays to development projects, as well as added costs.

Developers (and funders) must try to ascertain at an early stage whether their scheme may infringe such rights and if so, factor in the potential requirement for a right of light insurance policy.

An insurance policy can cover both pre and post planning developments. Specialist brokers will also be able to structure options for stage 1 and stage 2 premium attaching key milestones within the project into the policy if it is placed on cover pre-planning, so that this breaks up the cost.

What is covered by the policy?

The majority of policies can cover the following:

- Court costs and out of court settlements
- Loss in the market value of the property
- Defence costs, legal fees and other expenses
- Abortive costs of works and alteration, demolition and reinstatement of a property
- Professional fees associated with the above

Additional coverage options

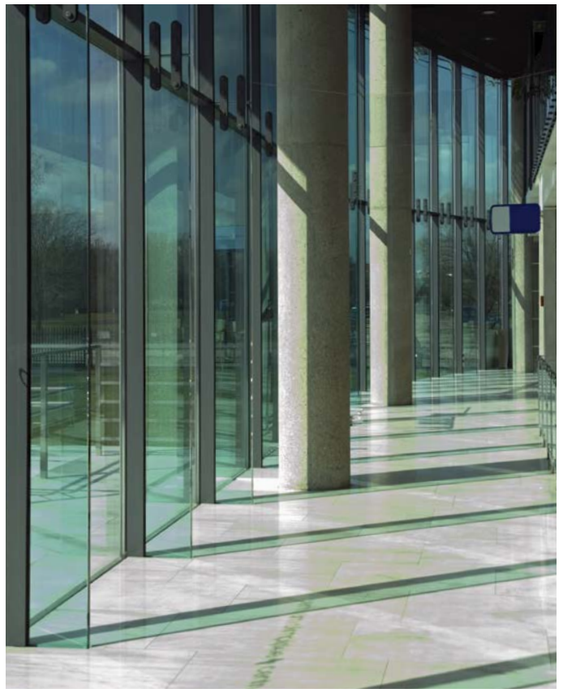
Delay costs
The costs associated with the suspension of works pending a court order or resolution of a claim.

Business interruption
Loss of rental income and service charges in the event of an injunction.

Re-location costs
Costs of relocating tenants in the event of an injunction or court order pending resolution.

Interest on loans or fees associated with early termination
Where financing is in place, fees and interest can mount up particularly if there are delays.

Service provider costs
Utilities and other services can be covered by the insurer if there is a delay in a development due to the defect. Some insurers provide Delay Costs as standard in their policies.



What next?

Liaise early with your legal team, right of light surveyor, and insurance broker. The earlier your broker is involved, the easier the placement of a policy that fully protects the developer. Think about the strategy to adopt—taking into consideration the developer conduct, the needs of the insurer, and the advice of the legal team/surveyor is key before a policy is incepted. What happens if there is a claim? Notify the broker/insurer immediately and do not send any correspondence without the insurer's written approval. This is critical and could affect your ability to claim under the policy.

What information do we need?

- Gross development value
- Rights of light report including Equivalent First Zone figures (EFZ)
- Details of any neighbourly matters e.g. party walls/crane oversail
- Details of whether any light obstruction notices have been served
- Planning officers' report if cover is required post planning

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06. TENANT WORKS TO EXISTING STRUCTURES

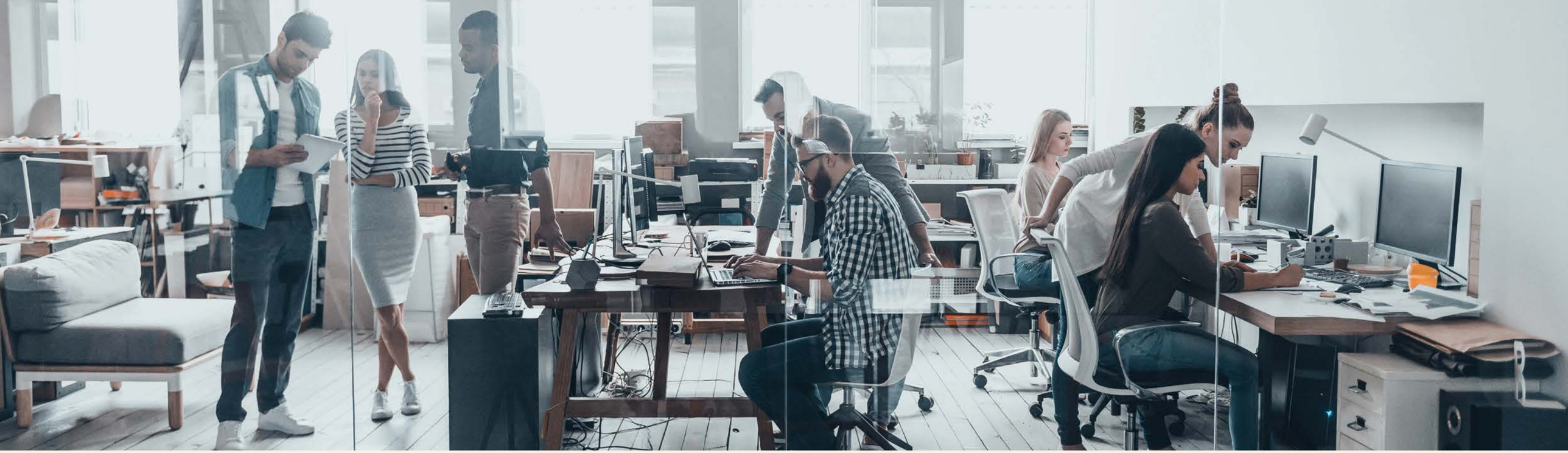
Tenants, particularly in office space, have always been keen on personalising their space to bring it in line with their corporate brand, values and working preferences. There is a rapid change in working styles, and as a result of the pandemic, there has been a huge up-tick in remodelling of workspace to meet the demands of agile and/or hybrid working. In this article, Sam Hiller, a Partner in our Construction team, examines the intricacies of projects when tenants are employing contractors to carry out works, and how insurance policies ought to be suitably adjusted.

In the construction insurance market, we often come across a client who is a tenant within an operational existing structure who is employing a contractor to carry out a non-structural fit out. Commonly, the Joint Contracts Tribunal (JCT)—form of a contract—is utilised and Insurance Option C is assumed to apply, but this insurance option comes with two key requirements:

- C.1 – The employer must maintain a policy in joint names of the contractor, covering the existing structures for any loss or damage due to any Specified Perils.
- C.2 – The employer must maintain a policy in joint names of the contractor for all risks insurance covering the contract works.

Where the employer is the tenant, they are not the landlord, and therefore they cannot achieve the requirements of C.1, at which point their legal advisor will need to amend the contract to avoid a breach of contract conditions. JCT 2016 contracts allow replacement provisions where C.1 cannot be achieved, and the JCT's view is that the preparation of such replacement provisions must be assigned to insurance professionals.

At this stage, it is key that the tenant's contractor agrees a position with the landlord regarding how they are to be treated during the works in respect of the risk of damage being caused to the existing structure.



There are three main options in this situation:

1. The ideal solution for the tenant would be that the landlord agrees to name both the tenant and their contractor as composite insureds on the existing structures property policy, which would mean that they cannot subrogate against them in the event of a loss. Failing this, a written confirmation of a full waiver of subrogation would suffice.

2. It is often difficult to obtain the above solution, given that naming the tenant on a policy could affect the landlord's claims experience—so a secondary option would be to agree a cap on liability for the tenant during the works. The property insurers can agree to provide the tenant and their contractor with a waiver of subrogation above a specified limit, which is commonly a nominal value e.g., GBP5 million or GBP10 million. From the tenant's contractors point of view in this case, the lower the better.

3. Should this be something the landlord and their insurers are not willing to agree to, the final option is that the tenant's contractor is not given any beneficial cover on the property insurance and are held fully liable in respect of damage to the existing structure arising out of the works. The solution in this case would be for the tenant to procure project specific Third Party Liability insurance to protect themselves.

Typically, the tenant is automatically named on the existing structures policy due to the fact that they contribute to the premium. As a minimum, the tenant can usually expect a full waiver of subrogation from the landlord's property insurers. It is important that the tenants' legal advisors are consulted on this point. Ultimately, this is a negotiation between the landlord and tenant's contractor, assisted by their insurance and legal advisors as appropriate. However, it is appreciated that as the tenant is employing the works, they may have to facilitate the negotiation.

Furthermore, the size of the contract works in comparison to the reinstatement value of the existing structures needs to be taken into consideration. Should options 2 or 3 above be the case, it is imperative to keep the appropriate legal advisor appraised and ensure that the contractor is carrying sufficient Third Party Liability insurance up to at least the reinstatement value of the existing structure, or at least to the relevant liability cap, per option 2 above. This is because it is likely that the existing structure is to be deemed third party property to the contractor, and possibly to the tenant too and this must be clearly disclosed and evidenced to the Third Party Liability insurers.

This will help ensure you have enough cover should there, however unlikely, be a total loss arising out of the works. When a tenant is carrying out fit-out works to an existing building, there are three key construction insurances to consider:

1. Firstly, Construction All Risks (CAR), that provides indemnity for damage to the contract works, permanent or temporary.

2. Loss of Revenue/Delay in Start-Up cover is available to insure financial losses both landlord and tenant would suffer following insured damage to the contract works (note that this insured damage must be covered under the Construction All Risks insurance to trigger any cover under the Loss of Revenue insurance). For the tenant, the financial loss could be the cost of sourcing alternative accommodation in the event the works are damaged and therefore delayed.

3. Finally, Third Party Liability insurance protects tenants against their legal liability for damage or injury to third parties or third party property, but the extent to which this is required will be defined by the outcome of any negotiations with the landlord in respect of cover provided under their property programme.

Although the legal advisor will ultimately sign off the final contract wording, it is essential not to underestimate the importance of consulting your insurance broker to understand if there is any relevant text that should be included in the contract to make the final proposal for insurances clear. The insurances must accurately reflect the contract requirements, to prevent the tenant being exposed to a breach of contract and, consequently, any losses associated with the breach.

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