

How to Negotiate Adequate Casualty Provisions

By Alan M. Cohen, Esq.

Casualty provisions in commercial leases typically receive less attention than other provisions during lease negotiations. However, recent hurricanes and earthquakes demonstrate why casualty provisions shouldn't be overlooked by tenants. Recently, a Louisiana jury concluded that the owner of a building damaged by Hurricane Katrina breached its lease by its failure to repair the building following the hurricane. In *Marketfare St. Claude, L.L.C. v. Melba Margaret Schwegmann Brown*, the jury awarded the tenant, which operated a grocery store in the leased building, nearly \$2.3 million in lost profits after it determined the store reasonably could have opened in April 2007 had the owner complied with its obligation to restore the building in a timely manner following the hurricane.

The lease obligated the owner to "begin restoration as soon as reasonably practicable," and to "thereafter prosecute the restoration diligently to completion." The owner was ordered to repair the building (at an estimated cost of \$3 million), and to pay the tenant \$38,219.50 in future lost profits each month until the store reopens. Further, approximately \$2.6 million of insurance proceeds paid to the tenant for damages to the building were awarded to the tenant, despite the owner's argument that it should be awarded the insurance proceeds to repair the damages to the building.

The verdict in *Marketfare St. Claude* undoubtedly will be appealed, but the case highlights certain issues to consider when negotiating casualty provisions in commercial leases. Tenants should attempt to include the following five provisions in the casualty sections of their leases.

Get Broad Right to Terminate

Unmodified owner lease forms typically grant owners the right to terminate after a casualty, but they don't grant tenants the same right. Even those leases that do grant tenants the right to terminate generally allow tenants to terminate only in the event of a total loss to the building and/or a total loss to the premises. Most leases must be modified to enable the tenant to terminate in the event of a total or a partial loss to the premises and/or the building. In most instances partial damages to the building or the premises won't war-

(continued on p. 2)

Casualty Provisions

(continued from p. 1)

rant termination by the tenant, but there are instances where even partial damages will justify a tenant's termination of a lease. Partial damages that take several months to repair could significantly impair a tenant's ability to conduct business from the premises.

For instance, a Class A office tenant might elect to terminate its lease following a flood, rather than wait several months, or even years, for restoration of the lobby and first-floor retail space of the building, which may be contingent on the resolution of multiple insurance claims. Most owners will be reluctant to grant a tenant an absolute termination right and will make the tenant's termination right contingent on the owner's failure to repair the damages in a timely manner. Allowing an owner a reasonable period of time to make repairs is generally acceptable, provided the owner's failure to repair damages to the premises and/or the building, including partial losses to the premises or building, within a specified time period allows the tenant to terminate the lease. For an example of lease language you can use, see our Model Lease Clause: Minimize Risk and Interruption from Casualty [par. 2].

Limit Owner's Right to Terminate

As mentioned above, most leases grant the owner the right to terminate in the event of a casualty. A tenant whose business is dependent on location, and/or one that has made significant financial investments in improvements to the premises, should attempt to limit the owner's right to terminate as follows:

- If an owner intends to exercise its right to terminate, it should do so no later than 30 days after the date of the loss to enable the tenant to plan for the future.
- An owner should be allowed to terminate only if an independent design professional determines the restoration of the building and/or the premises will take an extended period of time.
- An owner should not be allowed to terminate simply because its insurance doesn't cover the full cost of the repairs.
- If the owner insured the tenant improvements, the owner's exercise of its termination option should be contingent on the owner's assignment to the tenant of any insurance claims and/or proceeds related to damages to the tenant improvements [Clause, par. 2].

Insist on Timely Restoration of Building and Premises

While most leases obligate the owner to restore the building and the premises in the event of a casualty, they usually don't describe the owner's restoration obligation in sufficient detail. Leases should be modified to make clear that the owner's restoration obligation includes all mechanical, electrical, and plumbing systems serving the building and the premises; the heating, ventilation, and air conditioning systems serving the building and the premises; the roof, foundation, and interior and exterior windows and walls of the building and premises; and the tenant improvements located in the premises,

(continued on p. 3)

Casualty Provisions

(continued from p. 2)

unless the tenant prefers to be the party to restore the tenant improvements. In the event any restoration obligations are shifted to the tenant, the tenant should be entitled to recover any insurance proceeds related to the items the tenant will be obligated to repair.

Owners should be obligated to both commence and complete a timely restoration following a casualty. Generally, it is not unreasonable to require an owner to commence repairs within 30 days of the loss, and to complete repairs within 180 days of commencing them [Clause, par. 1].

The owner should not be excused of its obligation to commence and complete timely repairs by events beyond its control, such as force majeure events or insufficient insurance proceeds. Any attempt by an owner to make its obligation to repair contingent on the recovery of insurance proceeds sufficient to pay for the repairs should be resisted. Insurance claims involving major losses frequently take years to fully resolve and the owner should not be allowed to delay pending resolution of its insurance claims.

As a practical matter, without insurance proceeds, many owners cannot afford to fully restore a property following a major loss, which is one of the reasons it is important for tenants to reserve the right to terminate, as discussed above. While it may seem harsh to hold an owner to a firm construction schedule following a casualty, most tenants cannot afford a delay greater than six months, regardless of the cause of the delay.

Specify Terms of Rent Abatement

Owners typically agree that if all or a part of the premises is damaged, the tenant should receive a rent abatement in proportion to the area of the premises damaged until the leased premises are restored. Tenants are advised to insert language in the lease that makes clear that any abatements of rent pertain not only to base rent, but also to any additional rent due under the lease, such as amounts to reimburse the owner for the building's operating expenses, taxes, and insurance [Clause, par. 3].

Most owners' lease forms don't allow for rent abatement except in the event the premises themselves are damaged, but there certainly exist situations where the leased premises themselves might be spared of damage, but nevertheless affected by a casualty.

Depending on the nature of the premises and the building in which the premises are contained, rent abatement might be appropriate even in the absence of damage to the premises in the event of damages to the building. A tenant leasing the upper floor of a commercial building might experience difficulty operating from the premises in the event the first floor of the building is damaged by a major casualty like a flood. The tenant's rent abatement should commence on the date of the loss, and not end until the premises and the building are fully restored.

(continued on p. 4)

Casualty Provisions

(continued from p. 3)

Don't Make Termination Right Contingent on Damage to Premises

Most casualty provisions are triggered only in the event of actual property damages arising from a casualty. A dispute arising from the February 2011 earthquake in New Zealand demonstrates why tenants should consider including provisions in their leases to allow termination in the absence of actual physical damage to the premises. The New Zealand office building in question was not severely damaged as a result of the earthquake; however, after the earthquake the local government deemed the building unsafe due to damages to neighboring structures, and occupancy was prohibited for an extended period of time.

Five months after the earthquake the owner advised the tenant that it anticipated it would be at least another 12 months before the tenant would be able to once again occupy the building. Nevertheless, the owner argued that the tenant did not have the right to terminate the lease, because the leased premises were not sufficiently damaged. The lease in question provided:

If the premises or any portion of the building in which the premises may form part shall be destroyed or so damaged

- a. as to render the premises untenable then the term shall at once terminate; or
- b. in the reasonable opinion of Landlord as to require demolition or reconstruction, then the Landlord may within 3 months of the date of damage give the Tenant 20 working days notice to terminate and a fair proportion of the rent and outgoings shall cease to be payable as from the date of damage.

Because the actual damages to the building did not render the premises “untenable,” the owner argued that the tenant lacked the right to terminate, despite the fact the tenant would not be allowed to operate from the leased premises for over 12 months. Had the tenant in this case included language in the lease granting it the right to terminate in the event of its inability to access and/or operate from the leased premises for an extended period of time, it would have fared better in its dispute with the owner [Clause, par. 4].

In negotiating casualty provisions, tenants should attempt to minimize financial risk and business interruption, while maintaining flexibility. Insurance should indemnify tenants for property losses and business interruption. To truly minimize the impact of a casualty on a tenant's business, however, casualty provisions should include language to enable the tenant to resume business as quickly as possible following the loss at the tenant's option, either in the reconstructed leased premises or in new premises.

Alan M. Cohen, Esq. practiced in the areas of real estate and commercial litigation for more than a decade, representing landlords and tenants in leasing transactions, dispute resolution, and litigation before working as Counsel in-house in the Austin, Texas, office of URS Corporation, an international, fully integrated engineering, construction, and technical services firm (www.URS.com).

**MODEL LEASE
CLAUSE**

Minimize Risk and Interruption from Casualty

Don't make the mistake of overlooking casualty provisions when negotiating the lease for your shopping center or office building space. The following language, drafted by Texas attorney Alan M. Cohen, will help you minimize financial risk and business interruption, while maintaining flexibility. It's key for your casualty provisions to include language to enable you to resume business as quickly as possible after the loss at your option—either in the reconstructed leased premises or in new premises. Ask your attorney before using this language in your leases.

CASUALTY

- 1. Repair Obligation.** In the event the Premises, or the Building of which the Premises are a part, or any portion thereof, is damaged or destroyed by any casualty, then Landlord shall rebuild and restore the Premises or Building, as the case may be, to substantially its condition immediately prior to the damage or destruction, including, without limitation: (1) all mechanical, electrical, and plumbing systems serving the Building and the Premises; (2) the heating, ventilation, and air conditioning systems serving the Building and the Premises; (3) the roof, foundation, and interior and exterior windows and walls of the Building and the Premises; and (4) all Tenant Improvements constructed in the Premises prior to the date of damage or destruction either by Landlord, or by Tenant with Landlord's consent and/or approval. Notwithstanding the foregoing, Landlord shall have no obligation to repair any damage to, or to replace any of Tenant's personal property, furnishings, fixtures, equipment, or other such property or effects of Tenant, all of which shall be Tenant's responsibility to repair or replace, at Tenant's sole cost and expense, unless said damages are caused by Landlord's negligence or intentional wrongdoing. Landlord shall commence the repairs required of it under this Section within thirty (30) days of the date of damage or destruction, and the repairs shall be completed within one hundred eighty (180) days of commencement of repairs. In the event Landlord is delayed in the commencement or completion of repairs by Force Majeure (as defined in this Lease), Landlord's delay for commencement or completion of repairs shall be extended in accordance with the Force Majeure provision of this Lease.
- 2. Termination of Lease.** Notwithstanding anything to the contrary in Section 1 above, in the event the Premises, or the Building of which the Premises are a part, or any portion thereof, is damaged or destroyed when less than twelve (12) months remain of the Lease Term (provided Tenant has irrevocably waived any option to extend the Lease Term), then Landlord may, at its option, either (1) rebuild or restore the Premises or Building and repair the damaged portions thereof at Landlord's own expense as required under Section 1 above; or (2) terminate this Lease effective as of the date the damage or destruction occurred. If Landlord does not provide Tenant written notice of Landlord's exercise of its option to terminate the Lease in accordance with this Section within thirty (30) days after the damage or destruction, Landlord shall have waived its option to terminate the Lease. If material damage or destruction occurs to the Premises and/or the Building such that they cannot be fully and completely repaired and/or reconstructed for any reason within two hundred ten (210) days of the casualty, or such that they are not fully and completely repaired and/or reconstructed for any reason within two hundred ten (210) days of the casualty, and Landlord has not exercised its option to terminate the Lease in accordance with this Section, Tenant may terminate this Lease upon thirty (30) days prior written notice to Landlord, unless Tenant's actions or omissions are the cause of the damage, in which event Tenant shall have no right to terminate and Tenant shall indemnify Landlord for its losses therefrom to the extent required under this Lease. If Landlord or Tenant elects to terminate this Lease as provided in this paragraph, no obligation shall accrue under this Lease after the effective date of such termination.
- 3. Abatement of Rent.** Tenant shall be entitled to abatement of Rent (including, without limitation, Base Rent and Additional Rent) by reason of damage to and/or destruction of the Premises or the Building, or any portion thereof, to the extent that the Premises and/or the Building cannot reasonably and comfortably be used by Tenant for the conduct of its business, in which event the Rent shall abate proportionately commencing on the date the damage to and/or destruction of the Premises and/or Building occurred until the Building and/or the Premises are fully restored. Notwithstanding the provisions of this paragraph, if any such damage is due to the fault or neglect of Tenant, or any of its employees, agents, suppliers, shippers, customers, or invitees, then there shall be no abatement of Rent by reason of such damage, unless and until Landlord is reimbursed for such abatement pursuant to any rental insurance policy that Landlord may, in its sole discretion, elect to carry.
- 4. Access and Use.** If, due to no fault of Tenant, all or a substantial portion of the Building and/or Premises are rendered reasonably unusable or inaccessible for the operation of Tenant's business for sixty (60) consecutive days as a result of an event other than damage or destruction to the Building and/or Premises, Tenant shall have the right, in addition to any other rights or remedies it may have under this Lease, upon thirty (30) days' prior notice to Landlord, to terminate this Lease. In such event, this Lease shall terminate on the thirtieth (30th) day after receipt by Landlord of such notice, unless said access and use of the Premises and Building have been fully restored within said thirty (30) day period for the customary conduct of Tenant's business as permitted under this Lease.