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Peer-To-Peer 10

Casualty Restoration Obligations and Termination Rights: When Disaster Strikes

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Hypothetical Set #1:

In a two-story shopping center, a restroom inside an orthodontist office operating on the upper floor suffers a plumbing issue, resulting in water damage in the virtual reality arcade operated by the tenant immediately below the orthodontist. The casualty provision in the lease reads as follows:

> 12. Destruction or Damage.
>
> 12.1. Partial Destruction or Damage. In the event the Premises or any portion of the Building necessary for Tenant's occupancy are physically damaged by fire, earthquake, act of God, the elements or other casualty (a "Casualty"), and Landlord has not elected to terminate this Lease as provided below, Landlord will repair the Building and/or the Premises subject to Section 12.2. In such event, this Lease will remain in full force and effect except that, if all or any portion of the Premises has been rendered untenantable by the Casualty, and Landlord is obligated to perform any repair or restoration work, and such work is necessary to restore such area(s) to tenantability, then an abatement of Rent will be allowed Tenant for such part of the Premises rendered untenantable until the earlier of the date of substantial completion of Landlord's repair and restoration work or the date that the applicable area(s) is/are restored to tenantability. Notwithstanding the foregoing, if: (i) such repairs cannot, in Landlord's opinion, be made within two hundred seventy (270) days; (ii) such damage or destruction is not insured against by Landlord's fire and extended coverage insurance policy covering the Building or if Landlord's reasonable estimate of the cost of making such repairs exceeds the proceeds of such insurance; (iii) such damage occurs during the final eighteen (18) months of the Term; (iv) such damage exceeds twenty-five percent (25%) of the replacement value of the Building; or (v) any mortgagee requires that the insurance proceeds or any portion thereof be used for any purpose other than reconstruction; or (vi) any ground lessor terminates the ground lease, then Landlord may elect, upon notice to Tenant within one hundred twenty (120) days after the date of such Casualty, to terminate this Lease, in which event this Lease will terminate as of the date of such election by Landlord.
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> 12.2. Repair Obligations. If the Premises are damaged by a Casualty and this Lease is not terminated: (a) Landlord will repair at its cost any injury or damage to the roof, exterior walls, and other structural elements of the Building; and (b) Tenant will perform, in a commercially reasonable time, and pay the cost of, repairs to any of Tenant's personal property and to any alterations and leasehold improvements (including, without limitation, any systems exclusively serving the Premises) in the Premises.

Assume that the landlord is not entitled, or does not exercise its right, to terminate the lease, and that the lease includes the following insurance and waiver of subrogation provisions (perform your analysis first including the ***bold italic*** language, and then excluding the ***bold italic*** language):

- **Tenant's property insurance:** At all times during the Term, Tenant shall be required to carry and maintain in effect special form (or its equivalent) property insurance against fire, theft, vandalism, malicious mischief, sprinkler leakage and such additional perils as now are or hereafter may be included in a standard extended coverage endorsement from time to time in general use in the State, insuring all improvements in and to the Premises made by ***or on behalf of*** Tenant ***(including but not limited to the Initial Tenant Improvements)***, in an amount not less than one hundred percent (100%) of the full replacement value thereof***, and with a commercially reasonable deductible not to exceed $50,000.00***.

- **Landlord's property insurance:** At all times during the Term, Landlord shall be required to carry and maintain in effect special form (or its equivalent) property insurance causing the Premises and the Shopping Center (but excluding Tenant's personal property), to be insured under standard fire and extended coverage insurance and liability insurance, in an amount at least equal to one hundred percent (100%) of the full replacement cost thereof.

- **Waiver of Subrogation:** Landlord and Tenant hereby waive any and all rights of recovery, claim, action or cause of action against each other, their respective agents, officers and employees, for any loss or damage that may occur to the Premises, or to any other property, whether real, personal or mixed, located on or in the Premises, by reason of fire, the elements, or any other cause insured against, or required to be insured against, under the terms of policies of insurance maintained, or required to be maintained, for the Premises or such other property, by Landlord or Tenant (as the case may be) under the terms of this Lease, regardless of cause or origin, including negligence of the parties hereto, and their respective agents and employees. In connection with the foregoing, Landlord and Tenant shall each have included in all policies of property insurance respectively obtained by them with respect to the Shopping Center and/or the Premises a waiver by the insurer of all right of subrogation against the other in connection with any property loss or damage thereby insured against. For the avoidance of doubt, if either party elects to self-insure as to the property insurance required to be carried by it hereunder, then this waiver and release respecting liabilities covered by insurance shall extend to liabilities otherwise required under this Lease to be insured against but with respect to which such party has elected to self-insure in whole or in part, as well as liabilities encompassed by the insurance coverages maintained by such party.

1. Is the arcade tenant entitled to any rent abatement if:

    a. The water intrusion damages or destroys the arcade equipment in the downstairs space, but neither the structural portions of the building nor the actual improvements within the downstairs space are damaged?

    b. The actual leasehold improvements within the arcade tenant's space are damaged (e.g., drywall must be ripped out and replaced in order to prevent mold growth)?

    c. The leasehold improvements within the arcade tenant's space are damaged, but, in addition, a load-bearing column for the floor of the upstairs tenant which runs through the arcade tenant's space also suffer some minor damage, requiring repairs that can be performed only by moving the arcade equipment out of the way to areas where they will not practically be usable, but otherwise the arcade space remains safe?

    d. The leasehold improvements within the arcade tenant's space are damaged, but, in addition, the load-bearing elements of the floor of the upstairs tenant are compromised, requiring repairs that can only be performed by opening the ceiling in the arcade, and creating a risk of ceiling collapse into the arcade space until the repairs are completed?

2. If the arcade tenant is entitled to a rent abatement in any of the foregoing scenarios, consider what types of rent are subject to abatement. Also, when does the abatement start, and how long does it last?

3. If you conclude that the tenant is not entitled to any rental abatement, might there be any insurance coverage to which the tenant could look for relief (make reasonable assumptions about the insurance likely carried by the tenant, which may include coverages beyond the insurance required under the lease as set forth above)? Should rent abatement be contingent upon Tenant first seeking (and failing to receive) relief from insurance for such loss of use?

4. Who is responsible for repairs (or for any particular portion of the repairs) – performing them and/or paying for them – in the foregoing scenarios?

5. What, if anything, could the arcade tenant have reasonably negotiated in the lease language to improve its position?

<u>Hypothetical Set #2</u>:

Consider how the foregoing scenarios would play out if, instead of the language above, the relevant portion of the casualty provision in the lease read as follows:

> Should the Premises or any part thereof be damaged or destroyed by fire or other casualty covered by insurance policies applicable to the Premises, Landlord shall, except as otherwise provided herein, and to the extent it recovers insurance proceeds sufficient to cover the entire cost of rebuilding and/or repair, as applicable, repair and/or rebuild the Premises with reasonable diligence. Landlord's obligation to rebuild or repair is subject to and conditioned upon the written consent of Landlord's mortgagee(s) who have a prior right to such insurance proceeds and shall be limited to the condition originally provided by Landlord at the time of Term commencement. Tenant acknowledges and agrees that Landlord shall not be obligated to repair, rebuild, or replace any property belonging to Tenant or any improvements to the Premises furnished by and/or for Tenant. If there should be a substantial, material interference with the operation of Tenant's business in the Premises as a result of such damage or destruction which requires Tenant to temporarily and/or partially close its business to the public, the Minimum Annual Rent shall abate to the extent of such reasonable closing of Tenant's business. Unless this Lease is terminated by Landlord as hereinafter provided, Tenant shall repair, redecorate and refixture the Premises, and restock the contents thereof in a manner and to at least a condition equal to that existing prior to such damage or destruction, and the proceeds of all insurance carried by Tenant on its property, decorations, improvements, fixtures and contents in the Premises shall be held in trust by Tenant for such purposes. Tenant agrees to commence such work within ten (10) days after the date of such damage or destruction or the date Landlord completes any reconstruction required to be completed by it pursuant to the above referenced obligations, whichever date is later, and Tenant shall diligently pursue such work to its completion. Tenant further agrees that all such work required of it shall be done within a period of sixty (60) days after it is required to commence such work.

Hypothetical Set #3:

Please examine the following language:

> 15. Casualty.
>
> (a) In the event of damage or destruction of the Premises, or any portion thereof, by fire or other casualty (a "Casualty"), if the restoration of the Premises to the condition existing immediately prior to the Casualty will take more than one hundred eighty (180) days from receipt of permits, in Tenant's reasonable determination, then Tenant shall have the right, at its option, to terminate this Lease by giving written notice to Landlord of such termination within sixty (60) days after the date on which the Casualty occurs (the "Date of Casualty").
>
> (b) If (i) at any time during the last six (6) months of the Term, there is any Casualty to the Premises, or (ii) at any time during the Term, there is a Casualty to the Premises resulting from (and not insured against) flood, war or insurrection (but no other cause), and in either of the foregoing events (each of the Casualties described in the preceding clauses (i) and (ii), an "Uninsured Casualty"), the restoration would require in excess of two hundred ten (210) days from receipt of permits, then in either such event, Landlord may terminate this Lease by giving a written termination notice to Tenant within sixty (60) days after the Date of Casualty (which termination shall be effective thirty [30] days after Tenant's receipt of the notice). Notwithstanding the foregoing, if Landlord terminates this Lease in accordance with the preceding clause (i), and Tenant at that time still has an unexercised Extension Term remaining, Tenant may preserve this Lease, and vitiate such termination by Landlord, by providing Landlord with written notice exercising such Extension Term on or before the date which is twenty (20) days after Tenant's receipt of Landlord's written notice purporting to terminate this Lease.

(c) If this Lease is terminated by Tenant pursuant to this Section, then the Term shall expire on the Date of Casualty with the same effect as if the Date of Casualty were the Expiration Date, and all Base Rent and Additional Rent shall be apportioned and paid through and including the Date of Casualty.

(d) If this Lease remains in effect following a Casualty, then Landlord shall proceed diligently, continuously and in good faith to restore the Premises to substantially the condition existing prior to such Casualty. Notwithstanding any provision of this Lease to the contrary, if Landlord has not completed the restoration on or before the date that is two hundred forty (240) days after the Date of Casualty, then Tenant shall have the right, at its option, to terminate this Lease by giving written notice of such termination on or before the date that is three hundred (300) days from the Date of Casualty; provided, however, that Landlord shall have the right to vitiate any such notice by completing the Restoration within thirty (30) days after Tenant's termination notice. During restoration, Rent shall be abated between the Date of Casualty and the completion of restoration to the same extent as the Premises are rendered unfit for occupancy during such period of time.

With respect to the preceding provision only, discuss the following:

A. Do you consider this provision to be fair, or favorable to one side or the other?

B. Does anything about this provision strike you as unusual?

C. What kind of Tenant is likely to require (or, at least, request) a casualty provision such as this?

D. What additional risks are placed on the Landlord under this provision? The Tenant?

E. Do any other parties (beyond the Landlord and the Tenant) need to review and approve this language in order for the Lease to be executed?

F. What modifications should the Landlord demand, and what do you do if the Tenant refuses to agree?

SAMPLE ANSWERS TO HYPOTHETICALS:

DISCLAIMER: As with all legal questions, the only truly correct answer is "it depends." Everything stated here should be taken with a reasonably sizeable grain of salt, the exact weight of which shall be subject to approval (not to be unreasonably withheld, conditioned, or delayed) by Landlord and Tenant, and with the understanding that each jurisdiction's unique laws, together with the remaining lease language, can significantly modify any legal analysis. These hypotheticals and sample answers are being provided for discussion purposes only and do not constitute legal advice.

Hypothetical Set #1:

1.a. Since the casualty only damaged Tenant's personal property (not the building itself), Landlord doesn't have any restoration obligations. Since Landlord isn't obligated to perform any repairs or restoration, Tenant does not have a right to an abatement.

1.b. Since the casualty event only damaged Tenant's personal property and interior improvements (not any structural elements of the building), Landlord doesn't have any restoration obligations. Since Landlord isn't obligated to perform any repairs or restoration, Tenant does not have a right to an abatement.

1.c. In this instance, the casualty damaged a load-bearing column, which is located within the arcade and provides structural support for the 2nd floor. Landlord is obligated to repair this column.

- For as long as the structural column is in need of repair, the Tenant can argue that the entire arcade is untenantable because of the risk of collapse. In this event, Tenant is entitled to a full abatement of Rent until restoration is complete and the arcade is tenantable.

- However, in this instance (1) the damage is minor, perhaps not substantial enough to require a closure of the entire arcade/building (is this a risk you'd advise your landlord-client to take?), and (2) the work may be performed after-hours so all or a portion of the arcade can continue to operate. While the temporary relocation of the arcade equipment within the Premises may make it difficult to operate, the Tenant has every right to store that equipment off-site (at Tenant's expense) so as to continue to operate in as much of the Premises as is reasonably possible. Additionally, even if the space is untenantable (in whole or in part), the untenantability is caused by the repairs (not the Casualty itself).

Ultimately, the issue hinges on whether the Premises is "rendered untenantable by the Casualty." Bear in mind that "untenantability" is usually a higher standard than something like "unusable for Tenant's business." Often, untenantability means that the space simply is not (reasonably) habitable at all. So, even if the particular tenant at issue may not be able to operate its specific business, that does not necessarily mean that the space is untenantable. We strongly encourage you to review the applicable State's case law to see if that jurisdiction provides guidance as to this matter. Regardless of what the law may say, however, many landlords will offer a total or partial abatement during this kind of restoration process as a goodwill gesture to its tenant (although this may depend on whether the landlord can obtain rental interruption insurance proceeds from its insurer, and that may, in turn, be tied to whether or not the tenant under the applicable lease is contractually entitled to an abatement).

1.d. This hypothetical provides a far more straightforward analysis: the load-bearing/structural elements of the Premises/building are sufficiently compromised to risk collapse until the ceiling repairs are complete. Tenant is entitled to an abatement through Landlord's performance of repairs.

2 The casualty provision uses the defined term "Rent," which (assuming common market terms were used in drafting the Lease) means all rent and amounts due under the Lease (e.g., Base/Minimum Rent, TICAM contributions, Percentage Rent, and – whether intentionally on the part of the drafter or not – late fees, interest, direct charge-backs for any special services requested by Tenant, and any

other amounts coming due under the Lease). Consider limiting rent abatement rights to recurring monthly amounts (i.e., base rent and TICAM pass-throughs) to avoid this misstep.

The abatement ends on the date of substantial completion of the repair/restoration work by Landlord. This does not cover any restoration work that the Tenant must perform after receiving the space back in tenantable condition. It also does not address actual completion (including of punch list items). The provision is also unclear as to when the abatement commences. Be sure to draft your language to clearly identify that the abatement commences on the date of the Casualty.

3 The tenant may be able to seek recovery from its business interruption insurance if the Premises was physically rendered untenantable from the casualty. Though historically, many landlords have required tenants to seek recovery from business interruption insurance before receiving abatement, the restrictions and limitations of business interruption insurance were elucidated during the COVID-19 pandemic, and this requirement has been lightened (or lifted entirely) in some contexts.

4 This will come down to what each party's property insurance requirements are, what the waiver of subrogation provides, and whether the casualty provision is drafted to accurately work in conjunction with the insurance coverages and waiver of subrogation. Assuming market coverages (Landlord insures the building structure, Tenant insures the premises and all improvements thereto, as well as all personal property therein, and the lease contains a mutual waiver of subrogation), the Landlord is responsible for repairing the structural elements of the Building at Landlord's expense, and the Tenant is responsible for repairing everything else (including improvements and personalty) at Tenant's expense. Note how this differs from the answer to the same question for Hypothetical #2. However, given the insurance requirements specified above, this may be a more difficult question. Landlord's property insurance requirement is not limited to only the structure, so there may be a double coverage situation. The presence or absence of the bold and italicized language in the provision governing the Tenant's property insurance will matter. Which party constructed the initial buildout could also be relevant.

5 The Tenant may have improved its position by providing for a reasonable period of time, following completion of Landlord's work, for the Tenant to perform its restoration before Rent recommences and/or by expanding its termination rights should restoration costs exceed its insurance coverage amounts. The Tenant could also request a "back-end" termination right if the Landlord's restoration work is not actually completed within some period of time. If the Tenant is required to insure the leasehold improvements, and if the Landlord is required to be named as the loss payee on that coverage, it would also be important for the Tenant to require that the Landlord pay over those proceeds to the Tenant if the Lease is not terminated and the Tenant is actually performing the restoration work for the leasehold improvements.

Hypothetical Set #2:

1.a. Tenant is entitled to a rent abatement if there is a substantial and material interference in its operation in the Premises as a result of the damage which requires Tenant to temporarily and/or partially close its business. Without any damage to the building or improvements, one might argue that the Tenant is not entitled to an abatement. However, the specific language here doesn't actually tie the abatement right to any particular damaged elements; rather, Tenant is entitled to an abatement if there is "a substantial, material interference with the operation of Tenant's business in the Premises as a result of such damage or destruction which requires Tenant to temporarily and/or partially close its business to the public." Given that language, Tenant may be entitled to an abatement regardless of which areas and elements suffered damage (even if such damage was limited to Tenant's equipment and other personal property, and not the physical structure of the building or improvements/alterations thereto).

1.b. Tenant will have to rip out and replace drywall to prevent mold, meaning that mold has not yet become a problem. Note that the abatement is limited to a "reasonable closing," so assuming this work can be performed after normal operating hours, arguably, it will not materially and substantially interfere with Tenant's business operations or require a temporary and/or partial closure. If any temporary or

partial closure is, in fact, reasonably necessary to perform the repairs, then Tenant may seek an abatement in proportion to the area affected for the reasonable period of closure (not to exceed 60 days, per the limitations in the final sentence of the provision).

1.c. Given that there is a combination of repairs that need to be made here (first, the structural repairs by the Landlord, which will require the equipment to be relocated, and second, the Tenant's restoration work respecting the non-structural elements in the Premises), and the Lease allows for an abatement to the extent a closure is reasonably required in connection restoration work (not to exceed 60 days for Tenant's restoration work), one might take the position that Tenant can seek an abatement in proportion to the affected area (which may be the entire Premises for a portion, if not all, of the restoration period), both with respect to the period of Landlord's restoration work and the period of Tenant's restoration work (up to, but not exceeding, 60 days). However, see above with respect to the particular wording of the abatement language. The Tenant has an argument that it should get an abatement for the period of its reasonable closing, without regard to the particular areas or elements damaged.

1.d. As with Question #1.c., arguably, Tenant can seek an abatement in proportion to the affected area (which may be the entire Premises for a portion, if not all, of the restoration period), both with respect to the period of Landlord's restoration work and the period of Tenant's restoration work (up to, but not exceeding, 60 days). However, see also Question #1.c. above with respect to the particular wording of the abatement language.

2 This Lease limits recovery to an abatement of Minimum Annual Rent, but expands recovery to encompass the full period of "reasonable" closure by Tenant (i.e., from the date of the casualty through the reopening of the Premises, limited only by the requirement that Tenant complete its restoration work within 60 days of commencement).

3 N/A; see above.

4 Landlord is responsible for restoring the Premises to the condition existing at Term commencement. Since the lease also says Landlord is not responsible for restoring any alterations or improvements made by or for Tenant, we can assume that the Term commenced upon delivery of the Premises (not completion of Tenant's initial improvements). Thus, Landlord would return the Premises to something akin to warm vanilla shell condition (unless the space was delivered as a cold dark shell), and Tenant would be responsible for performing the remaining work, at Tenant's expense (should insurance proceeds be insufficient, Tenant will have to come out of pocket to satisfy its lease obligations).

With respect to cost, however, Landlord's obligation is capped "to the extent it recovers insurance proceeds sufficient to cover" its restoration obligation. Assuming it has full replacement coverage, this should be a non-issue. Otherwise, there will be a "gap" in obligations with respect to the cost - and performance - of the work.

5 The Tenant should require the Landlord to insure for full replacement cost. Additionally, if the Landlord is unwilling to remove the cap on Landlord's restoration obligations (see Question #4 above), then the Tenant should be entitled to terminate the Lease if Landlord is unable or unwilling to restore the Premises to the condition at delivery. Alternatively, the Tenant could seek to modify the language so that the Landlord is either required to fulfill its restoration obligations (regardless of insurance proceeds) or terminate the Lease.

Hypothetical Set #3:

A. This provision appears significantly slanted in favor of the Tenant.

B. Note the "Uninsured Casualty" provision and its stringent limitations, which obligates Landlord to rebuild under nearly every circumstance, regardless of which party is carrying the applicable insurance coverage, the availability of funds, or the rights of a superior mortgagee.

C. This “real life” example comes from an anchor tenant’s lease form for in-line space in an outdoor lifestyle center.

D. The Landlord may have to come out of pocket to cover the restoration obligations, particularly if any of its insurance proceeds are paid over to its lender or if the Tenant is the party carrying the insurance that covers the damage (note that, if the Tenant is carrying this insurance, it essentially gets a windfall). The Tenant may have to extend the Term.

E. The lender must approve this language, and the Landlord should have its risk management team and/or insurance broker review it as well.

F. Throw the whole thing out. Believe it or not, this was the “line in the sand,” it was the “hill to die on,” it was the “no is a complete sentence” of this particular negotiation. After decidedly too much back-and-forth on this language, the landlord finally volleyed back an alternative provision that conformed to the market and said “take it or leave it.” The Tenant took it, and they all lived happily ever after.