An Emerging Risk Issue From

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Real Estate Leases –Bursting with Risk

You have just moved into a magnificent commercial office building in the city's new office park. To accommodate your organization's needs, you have installed substantial improvements to your space – your build out costs are right around $1 million. Of course, you have already signed the ten-year 50 plus page lease, which contains numerous clauses with multiple sub-clauses.

Four years after you have moved in, a fire of unknown origin occurs. Unfortunately, the resulting damage is extensive, affecting most of the building, including a portion of your space. As the building is badly damaged, you cannot use your space. Now what happens?

The Real Estate Lease Agreement

You decide to review your lease to determine the action required of the landlord. Flipping to the Insurance Section of the lease, you find that the landlord has agreed to purchase property insurance on a replacement cost basis for the building, including coverage for damage by fire. So far, so good – you want to get back into your space right away. However, days turn into weeks and nothing is happening – no repairs are being made.

Who is to Rebuild? You take a closer look at the lease, and, despite its voluminous clauses, you can't find any wording that obligates the landlord to rebuild. In fact, in the section of the lease called Casualty, which is several pages from the Insurance Section, you find that the landlord may, at *their* sole option, elect not to rebuild the building. Instead, the landlord may apply their insurance proceeds to their mortgage and cancel your lease. It appears you are in limbo - the landlord will not commit to a course of action. The only good news is that you do not have to pay rent until you can again occupy your space.

Improvements To make matters worse, you now hear that the landlord is locked in a dispute with their property insurer – it is the landlord's insurer's position that the landlord has greatly underinsured the building as the values of the tenants' improvements (including your improvements), were not included in the policy limit. The coinsurance penalty to the landlord is several million dollars, leaving nowhere near enough for the landlord to rebuild the building.

Your Improvements You take a look at your own property insurance and note that covered property includes improvements you have made at your expense to a building you occupy but do not own, provided you cannot legally remove the improvements. The improvements you have made seem to fit into this category, as you built computer rooms, conference rooms and bathrooms, extending the plumbing, electrical, heating, ventilation and air conditioning within the building.

Your Insurance You make a claim on your insurance policy for the full replacement value of the improvements, which you now estimate is about $1.2 million.

Your insurer asks you who owns the improvements. Again you go back to the lease – no answers there. The lease is silent on who owns the improvements.

Are you required by the lease to replace your improvements your insurer wants to know? Again, the lease is silent – neither you nor the landlord has specifically agreed to replace your improvements.

Insurable Interest Things continue to get worse – your insurer denies your claim *entirely* for your improvements. As far as they are concerned, you do not have an insurable interest in your improvements – they consider the improvements to be owned by the landlord when they were installed and, since you don't own or have the obligation to replace, you don't have an insurable interest in those improvements. Further, even if you do have an insurable interest in your improvements, you are covered only for the portion of your improvements actually damaged by the fire.

The Litigation Because the landlord is unable to obtain an acceptable settlement with their insurance company, they provide all the tenants with notice that all leases are cancelled. The landlord sues the insurer, contending that the insurer's position is not reasonable – how could the landlord have included the value of tenants' improvements into the value of their building when they did not know the value of the tenants' improvements?

The landlord's insurer points out that the landlord could have excluded coverage from their policy for tenants' improvements - and thus would have avoided the substantial coinsurance problem. The trial court enters judgment in favor of the insurer – the coinsurance penalty stands.

Tenant's Insurer As you did report and insure all your property on a replacement cost basis – including your improvements - is your insurer right? You get nothing?

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The insurer is wrong about your insurable interest. You do have an insurable interest in your improvements – it is a *use* interest. That is, you installed the improvements with the understanding that you would have *use* of the improvements until the lease ends.

The insurer is correct on one count – you will *not* have coverage for *undamaged* improvements – even if you have lost the use of the *undamaged* improvements because of the lease cancellation resulting from the fire. A special type of insurance, called ***leasehold interest insurance,*** is available for this and similar risk facing tenants.

Will you recover the full replacement cost on the *damaged* portion of the improvements? Not in this case (your lease has been cancelled) – *unless you promptly replace* your improvements, most property insurance policies pay only the *original cost* less your reduced use interest in those improvements.

As you are in the fourth year of a ten year lease, 40% of your use interest has expired or been amortized. The insurer will be obligated to pay only what is left (60%) of your use interest in the *original cost* of the *damaged* improvements. Remember, your original cost for all improvements was $1 million. Let's say half those improvements were damaged ($500,000). Your recovery would be 60% of the *original cost* of the *damaged* improvements or $300,000 – a long way from the $1.2 million replacement cost you claimed.

An Exculpatory Clause In the investigation of the loss, your insurer determines the fire was caused by the landlord's failure to maintain the electrical system. You (and your insurer via subrogation) make claim against the landlord for the financial loss you have suffered. The landlord's liability insurer denies responsibility for your loss – they point to a clause in the lease that you have previously overlooked which stated:

> "Lessor, its agents and employees shall not be liable for any loss, damage or other casualty of any kind however caused to the property of anyone, including Lessee…"

Does the above effectively relieve the landlord of liability? It might – you signed the lease and agreed to its terms.

Lessons Learned – A Look Back

Might the lease have been written differently to avoid some of these problems?

Responsibility to Rebuild If you are leasing space that's use is crucial to the operation of your organization; wouldn't you want a written promise in the lease that the landlord will, with reasonable speed, rebuild the building in the event of a "casualty" loss?

While some landlords might wish to retain the right to cancel your lease if a certain percentage of the building is damaged, all of this should be clearly understood and incorporated into the lease.

Your choice to install improvements or even enter the lease will be influenced by the landlord's right to cancel the lease. You should also be concerned with whether the landlord's insurance is adequate to keep their promise to rebuild.

Your Improvements – Ownership It is generally understood that tenant improvements become the property of the landlord upon installation. If this is the intent, express it in the lease. If you want to retain ownership of your improvements as you intend to sell them to the landlord or remove them at the expiration of the lease, then you had better obtain the landlord's agreement on this matter in the lease.

Your Improvements – Responsibility to Replace In the absence of an agreement (or statute) to the contrary, it is generally understood the landlord is *not* responsible to replace tenants' improvements. If you believe the landlord will replace your improvements, include that agreement in the lease – including the landlord's responsibility to *adequately* insure your improvements as part of their building insurance (but be prepared to report the value of your improvements to the landlord). Requiring the landlord to provide you with evidence that your improvements have been adequately insured is recommended.

It may, however, be better for you to agree in the lease to be responsible to replace your improvements. Relying on others and their insurance can be problematic (as is illustrated by the landlord's coinsurance problem in our example). Of course, you will need to include the value (probably the replacement value) of your improvements in your property insurance.

Conclusion

Whether you are a landlord or tenant, real estate lease agreements are full of risk, well beyond what is found in the Insurance Section. Unidentified risks cannot be managed, yet risks in real estate leases are routinely missed or ignored. Instead of being surprised, obtain the advice of a qualified risk and insurance professional *in conjunction with* qualified legal counsel.

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