

DON'T BE A CASUALTY OF YOUR TENANT'S CASUALTY!
Replacement of Custom Tenant Improvements after Loss
– Does Your Office Lease Protect You?

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Every office building owner and leasing manager knows the basic tenets of leasehold-related insurance: the landlord insures the “building”, the tenant insures its personal property, and both sides agree to have their respective insurers waive any right of subrogation against the other in the event of a casualty loss. If the tenant’s computers are damaged due to a burst pipe, the tenant has to go to its own insurer for coverage of the loss, and tenant’s insurer cannot then look to the landlord or the landlord’s insurance company for reimbursement. Similarly, if a fire destroys the premises, even if caused by the failure of tenant or its employees to turn off a coffee maker, the landlord knows that, except under certain circumstances, it must rebuild the premises using insurance proceeds obtained from its own insurer.

Until a casualty actually occurs though, it’s very likely that neither party has given much thought to whose insurance covers, and who has the responsibility to restore, expensive non-building standard items such as the tenant’s customized doors, flooring, wall finishes and paneling, lighting fixtures, and hardware. These items fall within a gray area between personal property (tenant) and real property (landlord) and, therefore, landlords often assume that insuring and restoring such items after casualty is the responsibility of the tenant, while tenants often assume that they are the responsibility of the landlord.

The typical office lease casualty restoration section simply provides that landlord will restore the premises to their condition prior to the occurrence of the casualty and, therefore, makes no distinction between the “extra” leasehold improvements and the demising walls, partitions and other building standard leasehold improvements that the Landlord expects to be responsible for. This is not necessarily an inequitable result, as in many cases the landlord may have paid for and installed these finishes at the inception of the lease, through payment of an improvement allowance or otherwise, giving rise to a reasonable expectation on the part of the tenant that landlord would be responsible for restoring after casualty. Moreover, the additional insurance premiums allocable to such improvements are not particularly onerous, and the premiums are paid for by the tenants anyway.

Yet, where the leasehold improvements at issue are (i) highly customized, (ii) especially expensive, or (iii) constructed by tenant alone at its sole cost during the lease term (for example, installation of a full kitchen with expensive cabinetry and countertops), there may be good reasons for the landlord to consider trying to alter this default provision and transferring the risk of loss with respect to such items to the tenant.

- Increased Building Insurance Premiums Post Casualty. Although the additional premiums for coverage of tenant improvements (even expensive ones) over standard building coverage are relatively minimal, covering claims for expensive tenant improvements can materially increase the size of the insurance claim to be filed by the landlord after a casualty, thus resulting in substantial increases in future insurance premiums for the

building as a whole. While the cost of insurance is generally paid by the tenants, tenants with leverage may seek to offset such increased insurance cost, in other ways, including negotiating lower rental payments, resulting in reduced rental income for the landlord.

- Delay in Restoration / Delivery. Additionally, obtaining certain customized improvements following a casualty may take significant lead time, possibly resulting in significant delay in the re-delivery of the premises to the tenants, and therefore the re-commencement of rental payments. Although landlord's rental income insurance may cover that entire rebuilding period, future insurance premiums will rise as the direct result thereof, and tenants will be unhappy because of the delay - or the increase - or both.

For these reasons, the landlord may wish to make the tenant responsible for insuring leasehold improvements which are above building standard, and restoring them upon the occurrence of a casualty.

The Lease Casualty Provision

The first step in making the tenant responsible for insuring and restoring the above standard tenant improvements is to modify the casualty clause of the lease to provide that, notwithstanding (i) any other provisions of the lease to the contrary, and (ii) any legal interpretation that all improvements become part of the realty upon being attached to the premises, following a casualty the landlord shall be responsible only for restoring the premises to building standard levels of improvement, and the tenant shall be responsible for insuring and replacing the above building standard tenant improvements or betterments that made the premises "customized" for its use. If possible, the lease should refer to a tenant improvement schedule for purposes of identifying the customized finishes to be insured and restored by the tenant after a casualty, as this will better ensure that the tenant's own insurance providers will not dispute the items to be covered.

The Tenant Insurance Provisions.

To the surprise of many tenants, the same insurance policy that covers personal property, namely the "ISO Building and Personal Property Coverage Form", CP 00 10 04 02, already does provide a degree of coverage for tenant improvements. This is because the tenant, like the landlord, possesses an insurable interest in the tenant improvements despite "landlord ownership" clauses in the lease. The tenant's insurable interest is based on the lease or "use" value it has for the same over the term of the lease. Thus, the property coverage sections included in the tenant's insurance requirements of the lease should specify that the insurance is to cover, in addition to any personal property at the premises, "the above-building standard leasehold improvements and betterments incorporated into the premises, whether or not initially installed and/or paid for by Tenant." The provision must require that tenant elect "full replacement coverage", rather than "actual cash value", in the declarations portion of its insurance policy in order to ensure that it will receive sufficient insurance proceeds for restoration of the improvements. The provision must further require that the tenant's aggregate coverage amount be sufficient to cover both the tenant's personal property at the premises and the leasehold improvements, since unlike the landlord's building policy, there are no separate coverage limits or allocations between personal property and leasehold improvements, and thus there is risk that the insurance proceeds will be disproportionately applied by the tenant to cover its personal property, leaving insufficient

proceeds for restoration of the leasehold improvements. Finally, the provision should provide that so long as the lease is not terminated pursuant to the terms of the casualty clause, the proceeds of tenant's insurance policy with respect to the tenant improvements shall be used to restore or replace the same. Landlord can exercise some control over the use of the proceeds by requiring that the tenant name landlord as an "additional named insured" or "loss payee" on the tenant's insurance policy. Of course, the landlord or its counsel must be vigilant in obtaining and reviewing the tenant's property policy to confirm that the coverage amounts are sufficient and that the tenant has elected full replacement coverage thereunder.

Landlord Should Maintain Duplicate Coverage on All Tenant Improvements Despite Transfer of Risk.

The landlord should nevertheless continue to insure all leasehold improvements through its own building insurance policy. Despite the landlord's best efforts, upon the occurrence of a casualty landlord may discover that the tenant has failed to maintain the levels of insurance needed to replace its improvements, or that the tenant's insurer takes the position that landlord's insurance should cover these improvements as part of the building. If necessary, landlord's own insurer can then step in and cover the cost of restoring the improvements so that the tenant can commence operations and payment of rent. In such a case, the landlord and/or its insurer will then have a subrogation right against the tenant and its insurer.

Conclusion.

Although it is generally acceptable to office building landlords to retain the obligation to insure and, after casualty, restore, leasehold improvements, in those instances in which the leasehold improvements are particularly expensive or especially customized, or completed by the tenant after the commencement of the lease term (i.e. after the delivery of the premises by landlord), there may be good reason to consider shifting to the risk of restoring the same after a casualty to tenant. In attempting to do so, landlords should enlist knowledgeable counsel at the lease drafting stage to ensure that, among other things, the casualty and tenant insurance provisions of the lease are drafted to achieve the desired goals, and to review the tenant's own insurance coverages to confirm that it has obtained sufficient insurance to comply with these obligations.

If you have any questions regarding tenant improvements, please contact any member of the real estate group at (410) 727-6600 or by e-mail at:

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