

The Advisor

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Disasters and Property Leases - Don't get hit twice

by Peter Collins

Hurricane Sandy wreaked havoc in New York and New Jersey recently, and attracted worldwide attention. The collapse of a portion of the rooftop parking lot at the Algo Centre Mall in Elliot Lake, Ontario earlier this year caught the attention of Canadians, due to the human tragedy involved.

From a commercial property perspective, the consequences of those disasters are only now coming into focus. These rare but significant events will call into play several obscure clauses in leases – clauses which often do not receive much attention in the lease negotiation process precisely because they are considered unlikely to occur, abstract, and not worthy of attention.

It's bad enough that a disaster can occur; don't let poorly negotiated lease provisions make you suffer twice from the same disaster.

The Landlord's Perspective

The most relevant lease provisions would typically include:

- **Damage and Destruction** – these clauses typically require rebuilding in the event of less significant damage (usually defined by reference to percentage of area affected, or length of time to carry out the repair), with a right to terminate in the case of a major damage event. Is the termination right available only to the landlord, or also to the tenant? What is the scope of the rebuilding obligation: base building only, or also the tenant's leasehold improvements? Must the landlord rebuild to exactly the same plan, or can it make minor, or major, changes to the building design?
- **Rent Abatement** – in what circumstances does rent abate? Is there a delay in commencement of rent abatement? When does rent resume: when landlord's repairs are completed or when tenant re-opens?
- **Structural and other Repair** – does the landlord have an obligation to repair structural damage? Is the repair obligation capped by the available insurance proceeds?
- **Liability** – where the disaster is a result of a design, construction or maintenance failure, is the landlord liable to the tenants at all, or only if negligent? Is liability limited to property damage, or does it extend to liability for injury and death? Is liability capped at direct damage, or does it extend to consequential loss, loss of profits, etc.?
- **Insurance** – does the landlord have property insurance covering the damage in question? Does the landlord have rental loss insurance? If no rental insurance, does the lease require tenants to carry business interruption insurance, with loss payable to the landlord?
- **Force Majeure** – is there a *force majeure* clause? Does it mesh, or clash, with the Damage and Destruction clause?

In addition to the lease, the landlord should also check its mortgage or credit facilities with its lender. Can the lender scoop the insurance proceeds? If so, how does that mesh with the landlord's duty to repair in the leases? If the landlord does not have rental insurance, is there cash flow from the development to service the mortgage debt?

A landlord's goal in structuring the disaster provisions in a lease should be to maximize flexibility (especially in regard to the obligation to rebuild, and the manner of rebuilding), minimize or exclude liability, and ensure appropriate insurance coverage (not only for the cost of the loss, but for the loss of the rental stream).

The Tenant's Perspective

As is often the case with leases, the issues of concern to the tenant will be similar, but opposite in interest, to those of the landlord.

- **Damage and Destruction** – a prudent tenant will want the election to terminate if its own premises are substantially damaged or destroyed. Even if its own premises are not damaged, it is prudent to have the right to terminate, because there is little benefit to being tied to a lease to a mall or shopping centre which isn't open for business or is under prolonged reconstruction. For tenants with multiple locations, the loss of one location is not fatal to the tenant's business, but, if it is a single location business, the tenant needs the ability to quickly terminate and relocate.
- **Rent Abatement** – all rent should abate in the event of major damage or destruction that prevents the business from operating. Beware clauses that delay the start of rent abatement, and be alert to the timing of the end of abatement.
- **Repair and Rebuilding** – if the tenant is a major or anchor tenant of a development, with a unique location and place in the market, it might be critical for the tenant that the landlord must rebuild. What are the tenant's own rebuilding obligations? Is the rebuilding period adjustable according to the scope of the damage?
- **Liability** – it is difficult, but desirable, for tenants to obtain liability and indemnity rights against larger landlords where the disaster is a result of a design, construction or maintenance failure. Because it is often difficult to obtain indemnity rights against landlords, insurance is critically important for tenants. Smaller landlords might be less sophisticated in this area, or more open to negotiation in order to finalize a lease.
- **Insurance** – prudent tenants should carry replacement cost coverage for leasehold improvements, trade fixtures, equipment, furnishings and inventory in the premises. It is important for smaller tenants (and, especially, single location tenants) to carry business interruption insurance, and to ensure that such insurance is payable to the tenant (except for the portion equal to rent, if the lease cannot be terminated).
- **Force Majeure** – is there a *force majeure* clause? Does it allow the tenant to terminate the lease? Is the obligation to pay rent an exception?

A tenant's main goal in negotiating the disaster provisions in a lease should be to have a broad right to terminate in response to a disaster, even if the disaster has not affected the tenant's own premises. If that right is not secured, then a prudent tenant should seek provisions that ensure a prompt and comprehensive rebuilding by the landlord, full rent abatement, and an appropriate time period for the tenant to rebuild. In all cases, smaller tenants should pay particular attention to insurance coverage (property damage and business interruption).

As Hurricane Sandy and the Elliot Lake mall disaster show, disasters happen, so the disaster clauses in a lease can have a significant effect on the success or failure of a business. Whether you are a landlord or a tenant, you should always carefully consider how the disaster provisions in your lease would play out. As the old saying goes, "fail to plan; plan to fail."

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